FINAL COURSE STUDY MATERIAL

PAPER 1

FINANCIAL REPORTING

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Study Material has been prepared by the faculty of the Board of Studies. The objective of the Study Material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the Study Material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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SYLLABUS

PAPER 1 : FINANCIAL REPORTING

(One paper – Three hours – 100 marks)

Level of Knowledge: Advanced knowledge

Objectives:

(a) To gain ability to analyze financial statements including consolidated financial statements of group companies and financial reports of various types of entities,

(b) To gain ability to apply valuation principles,

(c) To familiarise with recent developments in the area of financial reporting,

(d) To gain ability to solve financial reporting and valuation cases.

Contents:

1. Accounting Standards and Guidance Notes on various accounting aspects issued by the ICAI and their applications.

2. Introduction of Indian Accounting Standards (Ind AS); Comparative study of ASs vis-a-vis Ind ASs; Carve outs/ins in Ind ASs vis-à-vis International Financial Reporting Standards (IFRSs).

3. Corporate Financial Reporting - Issues and problems with special reference to published financial statements.

4. Accounting for Corporate Restructuring (including inter-company holdings).

5. Consolidated Financial Statements of Group Companies

   Concept of a Group, purposes of consolidated financial statements, minority interest, Goodwill , Consolidation procedures – Minority interests, Goodwill, Treatment of pre-acquisition and post-acquisition profit .

   Consolidation with two or more subsidiaries, consolidation with foreign subsidiaries.

   Consolidated profit and loss account, balance sheet and cash flow statement.

   Treatment of investment in associates in consolidated financial statements.

   Treatment of investments in joint ventures in consolidated financial statements.

6. Accounting and reporting of financial instruments

   Meaning, recognition, derecognition and offset, compound financial instruments

Measurement of financial instruments

Hedge accounting

Disclosures

7. Share based payments

   Meaning, Equity settled transactions, Transaction with employees and non- employees

   Determination of fair value of equity instruments

   Vesting conditions

   Modification, cancellation and settlement

   Disclosures

8. Financial Reporting by Mutual funds, Non-banking finance companies, Merchant bankers, Stock and commodity market intermediaries.

9. Valuation

   (a) Concept of Valuation

   (b) Valuation of Tangible Fixed Assets

   (c) Valuation of Intangibles including brand valuation and valuation of goodwill

   (d) Valuation of liabilities

   (e) Valuation of Shares

   (f) Valuation of Business

10. Developments in Financial Reporting

   (a) Value Added Statement

   (b) Economic Value Added, Market Value Added, Shareholders' Value Added

   (c) Human Resource Reporting

Note– If either old Accounting Standards (ASs), Guidance Notes (GNs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, GNs, Announcements and Limited Revisions to AS are issued by the Institute of Chartered Accountants of India in place of existing ASs, GNs, Announcements and Limited Revisions to AS, the syllabus will accordingly exclude / include such new developments in the place of the existing ones with effect from the date to be notified by the Institute.

A WORD ABOUT STUDY MATERIAL

The paper of Financial Reporting in the Final Course concentrates on aspects of preparing and analyzing financial statements. Students are expected to acquire advanced knowledge in this paper. The importance of the subject of financial reporting is growing over the years due to various factors like liberalization, flow of cross-border capital, emergence of global corporations and movement towards better corporate governance practices. Standardization of accounting policies and financial reporting norms are significant aspects that make the subject more interesting in the recent years. It may be noted that significant changes are taking place in the area of Accounting Standards and Guidance Notes. Many new Accounting Standards and Guidance Notes have been formulated by the Institute of Chartered Accountants of India keeping in mind the growing importance of financial reporting in the corporate scenario. Existing Accounting Standards and Guidance Notes are also revised from time to time. Keeping all this in view, it has been decided to publish a separate book containing the Framework for Preparation and Presentation of Financial Statements, Accounting Standards and relevant Guidance Notes. For text of Framework for Preparation and Presentation of Financial Statements, Accounting Standards and Guidance Notes the students are advised to refer the publication on Accounting Pronouncements.

The students are required to develop understanding of the Accounting Standards and the relevant Guidance notes and gain ability to apply the provisions contained therein to practical situations. The last decade has witnessed a sea change in the global economic scenario. The emergence of transnational corporations in search of money, not only for fuelling growth, but to sustain ongoing activities has necessitated raising of capital from all parts of the world. When an enterprise decides to raise capital from the foreign markets, the rules and regulations of that country will apply and the enterprise should be able to understand the differences between the rules governing financial reporting in the foreign country as compared to that of its own country. Thus translations and re-instatements of financial statements are of great significance. Therefore, chapter based on Indian Accounting Standards, has also been included in the Final Course curriculum.

The Financial Reporting study material has been divided into three modules dealing with conceptual theoretical framework of the topics specified in the syllabus in detail while practice manual contains number of illustrations for practice. Care has been taken to present the chapters in the same sequence as prescribed in the syllabus to facilitate easy understanding by the students. Small illustrations have been incorporated in each chapter/unit to explain the concepts/principles covered in the chapter/unit.

The students are expected to cover the entire syllabus and practice on their own while going through the Practice Manual. The main aim of the Practice Manual is to provide guidance as to the manner of writing answers in the examination. The Practice Manual will serve as a useful and handy reference guide while preparing for Final Examination. Further, it will enhance the understanding about the pattern of questions set and the manner of answering such questions. It will enable solving the problems in the best possible manner and guide the students to improve their performance in the examinations. It will also help them to work upon their grey areas and plan a strategy to tackle theoretical as well as practical problems.

Students are also advised to update themselves with the latest changes in the area of financial reporting. For this they may refer to academic updates in the monthly journal 'The Chartered Accountant' and the Students' Journal 'The Chartered Accountant Student' (published by the Board of Studies), financial newspapers, SEBI and Corporate Law Journal, published financial statements of companies etc. Latest relevant amendments in SEBI Regulations, notified sections of the Companies Act, 2013 and RBI notifications for NBFCs have been incorporated in this revised edition.

An effort has been made to arrange the questions in more logical manner i.e. sub-topic wise or on the basis of accounting standards to will help the students in preparing for the Final Course Examination.

Any additions made in the chapters, whether theoretical or practical illustrations, have been highlighted with grey shading or in bold-italics in the study material for easy identification and quick reference.

In case you need any clarification/guidance, you may send your queries at seema@icai.in; shilpa@icai.in; asha.verma@icai.in.

Happy Reading and Best Wishes!

SIGNIFICANT ADDITIONS/AMENDMENTS IN THIS EDITION

Chapter/Unit No.	Name of the Chapter	Changes
Chapter 1	Accounting Standards and Guidance Notes	
Unit 3	Valuation of Inventories	Para 3.6 amended
Unit 5	Contingencies and Events occurring after the Balance Sheet Date	Para 5.3 amended
	Unit on Depreciation Accounting	Deleted
Unit 9	Property, Plant and Equipment	Newly added by deleting the old unit on 'Accounting for Fixed Assets'
Unit 12	Accounting for Investment	Para 12.7 amended
Unit 13	Accounting for Amalgamation	Para 13.2 amended
		Para 13.7 amended
		Illustration 3 modified
Unit 20	Consolidated Financial Statements	Para 20.2 amended
Unit 28	Provisions, Contingent Liabilities and Contingent Assets	Para 28.11 amended
		Para 28.19 inserted
Unit 29	Guidance Notes	In Para 29.3, list modified
		In Para 29.4, Explanation of "GN(A) 9 (Issued 1994) Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares" deleted
		In Para 29.4, summary of three

		new Guidance Notes have been added
		Certain new illustrations also added
Annexure	**Schedule III to the Companies Act, 2013**	Amended and Division II on Ind AS added

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DETAILED CONTENTS: MODULE – 1

CONTENTS

1

Accounting Standards and Guidance Notes

UNIT 1: INTRODUCTION TO ACCOUNTING STANDARDS

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

1.1 Objectives of Accounting Standards

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

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

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

(ii) measurement of these transactions and events,

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

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

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

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

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

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

1.2 Benefits and Limitations

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

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

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

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

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

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

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

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

1.3 Standard-Setting Process

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

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

1.4 How Many Accounting Standards?

The council of the Institute of Chartered Accountants of India has, so far, issued ***thirty-two Accounting Standards. However, AS 6 on 'Depreciation Accounting' has been withdrawn on revision of AS 10 'Property, Plant and Equipment*' and*** AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are ***30*** Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Status of Accounting Standards

It has already been mentioned that the standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard. The Companies Act had earlier notified 28 accounting standards and mandated the corporate entities to comply with the provisions stated therein. ***However, in 2016 the MCA has***

* Earlier AS 10 was on 'Accounting for Fixed Assets'.

withdrawn AS 6. Hence, effectively there are now only 27 notified accounting standards as per the Companies (Accounting Standards) Rules, 2006 (as amended in 2016).

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

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

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

(c) Does it apply to the financial item concerned?

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

1.6 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, the ICAI had earlier issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards'. As per the announcement, entities were classified into three levels. Level II entities and Level III entities as per the said Announcement were considered to be Small and Medium Entities (SMEs).

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

According to the 'Criteria for Classification of Entities and Applicability of Accounting Standards' as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2006 and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs.

Consequent to certain differences in the criteria for classification of the levels of entities as issued by the ICAI and as notified by the Central Government for companies, the Accounting Standard Board of the ICAI decided to revise its ''Criteria for Classification of Entities and Applicability of Accounting Standards' and make the same applicable only to non-corporate entities. Though the classification criteria and applicability of accounting standards has been

*The Companies Act, 1956 is being replaced by the Companies Act 2013 in a phased manner. Now, as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA). Section 132 of the Companies Act, 2013 deals with constitution of NFRA. It may be noted that this section is not notified till 30th November, 2016.

However, the Ministry of Corporate Affairs has, vide clarification dated 13th September, 2013, announced that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority.

largely aligned with the criteria prescribed for corporate entities, it was decided to continue with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

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

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

Level I Entities

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

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

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

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

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

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

Level II Entities (SMEs)

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

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

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

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

Level III Entities (SMEs)

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

*This change is made as per the announcement 'Revision in the criteria for classifying Level II non-corporate entities'. This revision is applicable with effect from the accounting year commencing on or after April 01, 2012.

Additional requirements

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

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

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

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

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

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

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

Illustration 1

M/s Omega & Co. (a partnership firm), had a turnover of ₹ 1.25 crores (excluding other income) and borrowings of ₹ 0.95 crores in the previous year. It wants to avail the exemptions available in application of Accounting Standards to non-corporate entities for the year ended 31.3.2016. Advise the management *of M/s Omega & Co in respect of the exemptions of provisions of ASs, as per the directive issued by the ICAI.*

Solution

The question deals with the issue of Applicability of Accounting Standards to a non-corporate entity. For availment of the exemptions, first of all, it has to be seen that M/s Omega & Co. falls in which level of the non-corporate entities. Its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to the ICAI, non-corporate entities can be classified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

An entity whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year, will fall under the category of Level I entities. Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

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

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

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

As the turnover of M/s Omega & Co. is more than ₹ 1 crore, it falls under 1st criteria of Level II non-corporate entities as defined above. Even if its borrowings of ₹ 0.95 crores is less than ₹ 1 crores, it will be classified as Level II Entity. In this case, AS 3, AS 17, AS 21, AS 23, AS 27 will not be applicable to M/s Omega & Co. Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 25, AS 28 and AS 29 are also available to M/s Omega & Co.

1.6.2 Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2006

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

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

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

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

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

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

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

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

Non-SMCs

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

Instructions

A. General Instructions

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

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

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

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

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

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

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

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

B Other Instructions

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

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

1.6.3 Applicability of Accounting Standards to Companies

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

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

***** Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.***

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards. Provisions with respect to Depreciation has been incorporated in revised AS 10.

1.6.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

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

AS 3 Cash Flow Statements

AS 17 Segment Reporting

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

(i) AS 21, Consolidated Financial Statements

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

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

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

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

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

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

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

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined

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

by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

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

(iii) AS 20, Earnings Per Share

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

(iv) AS 28, Impairment of Assets

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

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

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

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

1.6.4 Applicability of Accounting Standards to Non-corporate Entities

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

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition

AS 10	***Property, Plant and Equipment*****
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

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

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

AS 3	Cash Flow Statements
AS 17	Segment Reporting

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

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

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

(i)	AS 21, Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

***** Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.***

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) AS 19, Leases

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

(iii) AS 20, Earnings Per Share

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

(iv) AS 28, Impairment of Assets

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

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

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

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results e.g.,

quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

1.7 List of Accounting Standards

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

AS No.	*AS Title*	*Date*
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement (Revised)	01/04/2001
4	Contingencies and Events Occurring after the Balance Sheet Date	01/04/1998
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)	01/04/1996
6	Depreciation Accounting	***Withdrawn w.e.f 1.4.2016 after issuance of revised AS 10 on PPE***
7	Construction Contracts (Revised)	01/04/2002
8	Research & Development	Now included in AS 26
9	Revenue Recognition	01/04/1993
10	***Property, Plant and Equipment (revised 2016)***	***01/04/2016***
11	The Effects of Changes in Foreign Exchange Rates (Revised)	01/04/2004
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments	01/04/1995
14	Accounting for Amalgamations	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001
19	Leases	01/04/2001
20	Earnings Per Share	01/04/2001
21	Consolidated Financial Statements	01/04/2001

22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investments in Associates in Consolidated Financial Statements	01/04/2002
24	Discontinuing Operations	01/04/2004
25	Interim Financial Reporting	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004
30*	Financial Instruments: Recognition and Measurement	01/04/2009 (Encourage to follow**)
31*	Financial Instruments: Presentation	01/04/2009 (Encourage to follow**)
32*	Financial Instruments: Disclosures	01/04/2009 (Encourage to follow**)

AS 1 to AS 29 (excluding ***AS 6 and*** AS 8) have been discussed in detail in the succeeding units of this chapter. AS 30, 31 and 32 are not applicable from the examination point of view hence not discussed in detail.

1.8 Development in the area of Accounting Standards in India

1.8.1 Need for Convergence towards Global Standards

In the present era of globalisation and liberalisation, the world has become an economic village. The globalisation of the business world and the attendant structures and the regulations, which support it, as well as the development of e-commerce make it imperative to have a single globally accepted financial reporting system. A number of multi-national companies are establishing their businesses in various countries with emerging economies and *vice versa*. The entities in emerging economies are increasingly accessing the global markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside their country. Capital markets are, thus, becoming integrated consistent with this world-wide trend. More and more Indian companies are being listed on overseas stock exchanges. The use of different

*AS 30, 31 and 32 are not applicable from the examination point of view. However, the same have been mentioned above for knowledge purpose only.

**The status of AS 30, 31 and 32 is "Encourage to Follow" for non-corporate entities. For corporate entities these standards are not notified, hence not applicable. For them Ind AS will be made applicable in a phase manner.

accounting frameworks in different countries, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore, increasing complexity of business transactions and globalisation of capital markets call for a single set of high quality accounting standards.

High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of national accounting standards with IFRSs.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international

1.8.2 Benefits of Convergence with IFRSs

There are many beneficiaries of convergence with IFRSs such as the economy, investors, industry etc.

The Economy: When the markets expand globally the need for convergence increases since the convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: A strong case for convergence can be made from the viewpoint of the investors who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors' confidence is strong when accounting standards used are globally accepted. Convergence with IFRSs contributes to investors' understanding and confidence in high quality financial statements.

The Industry: A major force in the movement towards convergence has been the interest of the industry. The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

1.9 Convergence Strategy

In the scenario of globalisation, India cannot insulate itself from the developments taking place worldwide. In India, so far as the ICAI and the Government authorities such as the National Advisory Committee on Accounting Standards established under the Companies Act, 1956, and various regulators such as Securities and Exchange Board of India and Reserve Bank of India are concerned, the aim has always been to comply with the IFRSs to the extent possible with the objective to formulate sound financial reporting standards. The ICAI, being a member of the International Federation of Accountants (IFAC), considered the IFRSs and tried to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

UNIT 2 : AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

2.1 Introduction

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

During 1977, when ASB was established, the business environment in India was such that enterprises were reluctant to prepare accounting notes, few enterprises used to disclose the important accounting policies but the degree and method of disclosure varies considerably. Some enterprises used to disclose them as part of main financial statement, few others as a supplementary.

Therefore the main aim of this statement is not only to promote disclosure of accounting policies but also to determine that all accounting policies are disclosed at one place as main part of the financial statement.

AS 1 deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. The purpose of the Standard is to promote better understanding of financial statements by establishing through an Accounting Standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

2.2 Applicability

This AS was issued in 1979 and is now mandatory and applicable for all enterprises.

2.3 Fundamental Accounting Assumptions

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

(a) Going Concern

(b) Consistency and

(c) Accrual.

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

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

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

Example: A Ltd. has proposed to acquire B Ltd. in January, 2017. The acquisition of B Ltd. took place during May 2017, since then B Ltd. is no more a going concern. This fact should be disclosed in the financial statements of B Ltd. for the year ended March 31, 2017.

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

Example: Credit sales of goods on March 01, 2017; money receivable after three months are recognised as sales during the financial year 2016-17 itself and amount due is debited to the customer's account. Similarly, credit purchase of goods is also recorded as purchases during the year when purchase takes place and amount payable is credited to the suppliers account in the year of purchase though the payment is made in the next financial year.

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

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

2.4 Disclosure of Deviations from Fundamental Accounting Assumptions

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

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy.

2.5 Accounting Policies

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

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

Items to be disclosed	*Method of disclosure or valuation*
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Depreciation	Straight Line Method, Reducing Balance Method, Depletion Method etc.

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

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

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

2.6 Considerations in the Selection of Accounting Policies

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

***Prudence*:** As defined in the statement, prudence means recognising all losses immediately but ignoring anticipated profits. Business environment is highly dynamic, therefore, enterprises has to keep anticipate the future and take managerial decisions accordingly. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Example: If valuation of inventory is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing inventory at cost price means ignoring anticipated losses. Similarly if inventory is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on inventory in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profits (if any) but any anticipated losses would be taken care of.

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

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

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

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

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

2.7 Disclosure of Accounting Policies

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

(ii) The **disclosure of the significant accounting policies** as such should **form part of the financial statements** and the significant accounting policies should normally be **disclosed at one place**.

2.8 Disclosure of Changes in Accounting Policies

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

2.9 Illustrations

Illustration 1

ABC Ltd. was making provision for non-moving inventories based on no issues for the last 12 months up to 31.3.2016.

The company wants to provide during the year ending 31.3.2017 based on technical evaluation:

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

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

Solution

The decision of making provision for non-moving inventories 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 inventories 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 inventory, the change in the amount of required provision of non-moving inventory from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2016-17:

"The company has provided for non-moving inventories 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 lower by ₹ 1 lakh."

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2015. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2017. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

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

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

(iii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.

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

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2016-2017.

Solution

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

Notes on Accounts:

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

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

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

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

Illustration 3

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

Solution

Para 17of AS-1 'Disclosure of Accounting Policies' recognises 'prudence' as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Also as per para 10 of the AS 1, 'accrual' is one of the fundamental accounting assumptions. Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for non-payment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest. In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled. Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

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

UNIT 3 : AS 2 : VALUATION OF INVENTORIES

3.1 Introduction

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

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

(a) Work in progress arising under construction contracts, including directly related service contracts.

(b) Work in progress arising in the ordinary course of business of service providers.

(c) Shares, debentures and other financial instruments held as inventory-in-trade and

(d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

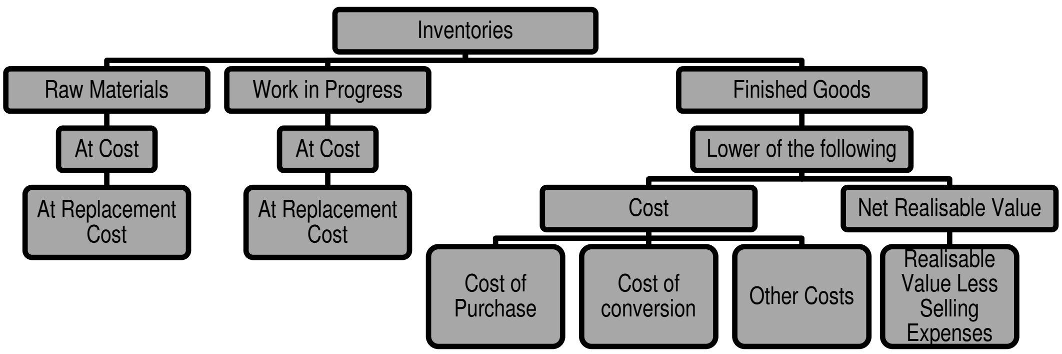
3.2 Scope

AS 2 defines inventories as assets-

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

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

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



3.3 Measurement of Inventories

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

3.3.1 Cost of Inventories

Cost of goods is the summation of:

(a) Cost of Purchase.

(b) Cost of Conversion.

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

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

Cost has three elements as discussed below:

Cost of Purchase Cost of purchase includes the purchase price plus all other necessary expenses directly attributable to purchase of inventory like, taxes and duties (other than those subsequently recoverable by the enterprise from the taxing authorities), carriage inward, loading/unloading excluding expenses recoverable from the supplier.

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

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

Direct Material + Direct Labour = Prime Cost

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

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

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

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

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

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

Fixed overheads per unit are taken on the basis of normal capacity when actual production is equal to normal capacity or the difference is minor. In case when actual production increases normal capacity considerably, actual fixed overheads are included, however, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. When actual production is substantially less than normal capacity, fixed overhead per unit is included on the basis of normal capacity i.e. the amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred.

To understand the reason for such a provision we take an example

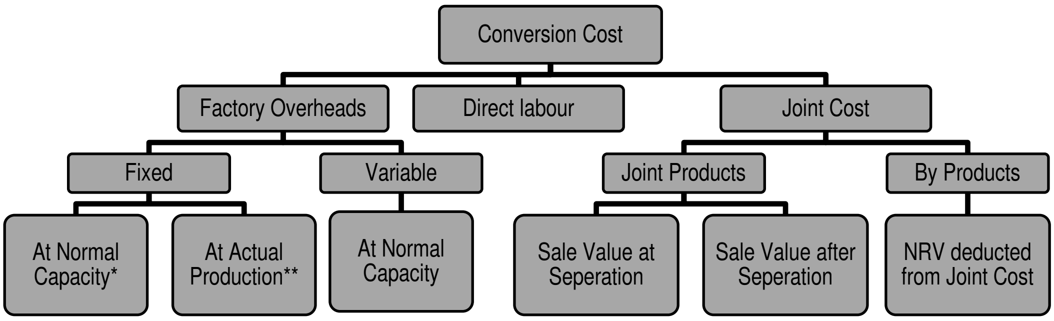
ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is ₹ 18 lacs. Fixed overhead on the basis of normal capacity is ₹ 18 (18 lacs/1 lac).

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

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

Case 3: Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at ₹ 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 18 per unit, total fixed overhead comes to ₹ 21.6 lacs whereas, actual fixed overhead expense is only ₹ 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) ₹ 18 lacs.

Sometimes, a single production process may result in more than one product. In case, this additional product is the intended item and has a good market value, they are known as joint products. The cost of conversion incurred on all the production and not identifiable separately is allocated among the products on some rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. If this additional product doesn't have good market value then they are



considered as by-products. In this case, the net realisable value of the by-product is deducted from the total cost of conversion to calculate the cost of conversion for main product.

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

** When actual production is higher than normal capacity.

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

Exclusion from the Cost of Inventories

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

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

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

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

(d) Selling and distribution costs.

Borrowing Costs

Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

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

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

Illustration 1

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

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

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

Solution

Calculation of cost for closing inventory

Particulars	*₹*
Cost of Purchase (1,00,000 x 100)	1,00,00,000
Direct Labour	10,00,000
Variable Overhead	1,00,000
Fixed Overhead $\frac{(1,00,000 - 40,625)}{95,000}$	59,375
Cost of Production for normal output i.e. 95,000 MT	1,11,59,375
Cost of closing inventory per unit (1,11,59,375/95,000)	₹ 117.47 (approx)
Net Realisable Value per unit	₹ 105

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

Note: Abnormal wastage of 10,000 MT i.e.10,000 MT x ₹ 117.47 = ₹ 11,74,670 will be separately accounted for in the books.

Illustration 2

In a manufacturing process of Vijoy Limited, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process are here under:

Item	*Unit*	*Amount (₹)*	*Output (unit)*	*Closing inventory*
Raw material	*15,000*	*1,60,000*	*MP1-6,250*	*800*
Wages	*-*	*82,000*	*MP2- 5,000*	*200*

Fixed overhead	-	*58,000*	*BP-1,600*	-
Variable overhead	-	*40,000*	-	-

Average market price of MP1 and MP2 is ₹ 80 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 25 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 4,000 and packing charges of ₹ 6,000, ₹ 6,000 was realised from sale of scrap.

Calculate the value of closing inventory of MP1 and MP2.

Solution

As per para 10 of AS 2 'Valuation of Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value and this value is deducted from the cost of the main product.

1. Calculation of net realizable value of by-product, BP

		₹
Selling price of by-product BP	(1,600 units x ₹ 25 per unit)	40,000
Less: Separate processing charges of by-product BP		(4,000)
Packing charges		(6,000)
Net realizable value of by-product BP		30,000

2. Calculation of cost of conversion for allocation between joint products MP1 and MP2

	₹	₹
Raw material		1,60,000
Wages		82,000
Fixed overhead		58,000
Variable overhead		40,000
		3,40,000
Less: NRV of by-product BP (See calculation 1)	(30,000)	
Sale value of scrap	(6,000)	(36,000)
Joint cost to be allocated between MP1 and MP2		3,04,000

3. Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP1	MP2
Output in units (a)	6,250 units	5,000 units
Sales price per unit (b)	₹ 80	₹ 50
Sales value (a x b)	₹ 5,00,000	₹2,50,000
Ratio of allocation	2	1
Joint cost of ₹ 3,04,000 allocated in the ratio of 2:1 (c)	₹ 2,02,667	₹ 1,01,333
Cost per unit [c/a]	₹ 32.43	₹ 20.27

4. Determination of value of closing inventory of MP1 and MP2

	MP1	*MP2*
Closing inventory in units	800 units	200 units
Cost per unit	₹ 32.43	₹ 20.27
Value of closing inventory	₹ 25,944	₹ 4,054

3.4 Cost Formula

Following are the various cost formulae suggested by the standard:

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

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

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

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

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

Following are cost formulae or techniques of measurement of cost suggested by the Accounting Standard for some special cases:

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

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

Illustration 3

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

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

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

Solution

Calculation of cost of closing inventory

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

3.5 Net Realisable Value (NRV)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

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

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

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

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

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

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

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

Illustration 4

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

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

Solution

Calculation of cost for closing inventory

Particulars	*₹*
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead $\frac{75{,}000 \times 10{,}200}{15{,}000}$	51,000
Cost of Production	2,29,500

Cost of closing inventory per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

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

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

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

3.6 Disclosures

The financial statements should disclose:

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

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

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

(1) raw materials and components,

(2) work in progress,

(3) finished goods,

(4) Stock-in-trade (in respect of goods acquired for trading),

(5) stores and spares,

(6) loose tools, and

(7) Others (specify nature).

Illustration 5

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

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

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

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

Solution

Valuation of Closing Inventory

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

Note: Since, 800 defective skirts were sold, the reduction in the price of the same had not been adjusted from the value of the closing inventory.

3.7 Illustrations

Illustration 6

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

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

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

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

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

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

Solution

(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 inventory of 10,000 kgs of raw material will be valued at ₹ 80 per kg. The finished goods, if on inventory, should be valued at net realisable value since it is expected to be sold below cost.

(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 ₹ 52,632 [(50 MT x (₹ 50,00,000 / 4,750 MT)] will be charged in the statement of profit and loss.

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

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

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

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

Illustration 7

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2016-17, the historical cost and net realizable value of the items of closing inventory are determined as follows:

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

What will be the value of closing inventory?

Solution

As per para 14 of AS 2, the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced.

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

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

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

Illustration 8

Calculate the value of raw materials and closing stock based on the following information:

Raw material X	
Closing balance	*500 units*
	₹ per unit
Cost price including excise duty	*200*
Excise duty (CENVAT credit is receivable on the excise duty paid)	*10*
Freight inward	*20*
Unloading charges	*10*
Replacement cost	*150*
Finished goods Y	
Closing Balance	*1200 units*
	₹ per unit
Material consumed	*220*
Direct labour	*60*
Direct overhead	*40*

Total fixed overhead for the year was ₹ 2,00,000 on normal capacity of 20,000 units.

Calculate the value of the closing stock, when

(i) Net Realizable Value of the Finished Goods Y is ₹ 400.

(ii) Net Realizable Value of the Finished Goods Y is ₹ 300.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

Raw Material X	*₹*
Cost Price	200

Less: CENVAT credit	(10)
	190
Add: Freight Inward	20
Unloading charges	10
Cost	220
Finished goods Y	₹
Materials consumed	220
Direct labour	60
Direct overhead	40
Fixed overheads (2,00,000/20,000)	10
Cost	330

(i) When Net Realisable Value (NRV) of the Finished Goods Y is ₹ 400

NRV is greater than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material and Finished Goods will be valued at cost

Accordingly, value of closing stock will be:

	Qty	*Rate*	*Amount (₹)*
Raw Material X	500	220	1,10,000
Finished Goods Y	1,200	330	3,96,000
Total cost of closing stock			5,06,000

(ii) When Net Realisable Value of the Finished Goods Y is ₹ 300

NRV is less than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV.

Accordingly, value of closing stock will be:

	Qty	*Rate*	*Amount (₹)*
Raw Material X	500	150	75,000
Finished Goods Y	1,200	300	3,60,000
Total cost of closing stock			4,35,000

Note: It has been assumed that Raw Material X is used for production of Finished Goods Y.

<u>Reference</u>: The students are advised to refer the full text of AS 2 "Valuation of Inventories" (revised 1999).

UNIT 4 : AS 3 : CASH FLOW STATEMENTS

4.1 Introduction

This statement came into effect in respect of accounting periods commenced on or after 1.4.1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1.4.2004 for the enterprises, which fall in the category of level I, at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements. Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

4.2 Objective

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

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

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are short term (maximum three months of maturity from the date of acquisition), highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

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

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

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

4.3 Presentation of a Cash Flow Statement

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

4.3.1 Operating Activities

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

Examples of cash flows from operating activities are:

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

4.3.2 Investing Activities

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

Examples of cash flows arising from investing activities include:

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

4.3.3 Financing Activities

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

Examples of cash flows arising from financing activities are:

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

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

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

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

Illustration 1

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

a. Purchase of Machinery.

b. Proceeds from issuance of equity share capital

c. Cash Sales.

d. Proceeds from long-term borrowings.

e. Proceeds from Trade receivables.

f. Cash receipts from Trade receivables.

g. Trading Commission received.

h. Purchase of investment.

i. Redemption of Preference Shares.

j. Cash Purchases.

k. Proceeds from sale of investment

l. Purchase of goodwill.

m. Cash paid to suppliers.

n. Interim Dividend paid on equity shares.

o. Wages and salaries paid.

p. Proceed from sale of patents.

q. Interest received on debentures held as investment.

r. Interest paid on Long-term borrowings.

s. *Office and Administration Expenses paid*

t. *Manufacturing Overheads paid.*

u. *Dividend received on shares held as investments.*

v. *Rent Received on property held as investment.*

w. *Selling and distribution expense paid.*

x. *Income tax paid*

y. *Dividend paid on Preference shares.*

z. *Underwritings Commission paid.*

aa. *Rent paid.*

bb. *Brokerage paid on purchase of investments.*

cc. *Bank Overdraft*

dd. *Cash Credit*

ee. *Short-term Deposits*

ff. *Marketable Securities*

gg. *Refund of Income Tax received.*

Solution

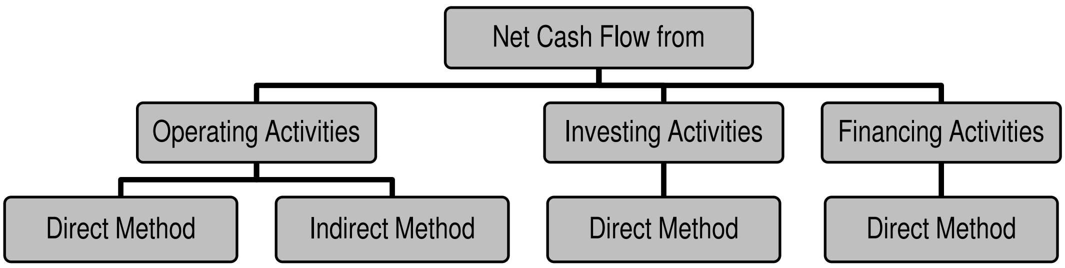
(a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

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

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

(d) Cash Equivalent: ff.

Cash Flow during the Year is



4.4 Reporting Cash Flows from Operating Activities

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

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

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

Below is the format for Cash Flow Statement

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

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

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

Particulars	₹	₹
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	
Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	

Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Illustration 2

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

Summary of Cash Account
for the year ended March 31, 2017

Particulars	*₹*	*Particulars*	*₹*
To Balance b/d	*1,00,000*	*By Cash Purchases*	*1,20,000*
To Cash sales	*1,40,000*	*By Trade payables*	*1,57,000*
To Trade receivables	*1,75,000*	*By Office & Selling Expenses*	*75,000*
To Trade Commission	*50,000*	*By Income Tax*	*30,000*
To Sale of Investment	*30,000*	*By Investment*	*25,000*
To Loan from Bank	*1,00,000*	*By Repay of Loan*	*75,000*
To Interest & Dividend	*1,000*	*By Interest on loan*	*10,000*
		By Balance c/d	*1,04,000*
	5,96,000		*5,96,000*

Solution

Cash Flow Statement of ......
for the year ended March 31, 2017 (Direct Method)

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

Illustration 3

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 2017:

	(₹ in lakhs)
Net Profit	*25,000*
Dividend (including dividend tax) paid	*8,535*
Provision for Income tax	*5,000*
Income tax paid during the year	*4,248*
Loss on sale of assets (net)	*40*
Book value of the assets sold	*185*
Depreciation charged to Profit & Loss Account	*20,000*
Amortisation of Capital grant	*6*
Profit on sale of Investments	*100*
Carrying amount of Investment sold	*27,765*
Interest income received on investments	*2,506*
Interest expenses	*10,000*
Interest paid during the year	*10,520*
Increase in Working Capital (excluding Cash & Bank Balance)	*56,075*
Purchase of fixed assets	*14,560*
Investment in joint venture	*3,850*
Expenditure on construction work in progress	*34,740*
Proceeds from calls in arrear	*2*
Receipt of grant for capital projects	*12*
Proceeds from long-term borrowings	*25,980*
Proceeds from short-term borrowings	*20,575*
Opening cash and Bank balance	*5,003*
Closing cash and Bank balance	*6,988*

Prepare the Cash Flow Statement for the year ended 31st March, 2017, in accordance with AS 3 'Cash Flow Statements' issued by the Institute of Chartered Accountants of India.

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st March, 2017

	(₹ in lakhs)
Cash flows from operating activities	
Net profit before taxation (25,000 + 5,000)	30,000
Adjustments for :	
Depreciation	20,000
Loss on sale of assets (Net)	40
Amortisation of capital grant	(6)
Profit on sale of investments	(100)
Interest income on investments	(2,506)
Interest expenses	10,000
Operating profit before working capital changes	57,428
Changes in working capital (Excluding cash and bank balance)	(56,075)
Cash generated from operations	1,353
Income taxes paid	(4,248)
Net cash used in operating activities	(2,895)
Cash flows from investing activities	
Sale of assets (185 – 40)	145
Sale of investments (27,765 + 100)	27,865
Interest income on investments	2,506
Purchase of fixed assets	(14,560)
Investment in joint venture	(3,850)
Expenditure on construction work-in progress	(34,740)
Net cash used in investing activities	(22,634)
Cash flows from financing activities	
Proceeds from calls in arrear	2
Receipts of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceed from short-term borrowings	20,575
Interest paid	(10,520)
Dividend (including dividend tax) paid	(8,535)
	27,514
Net increase in cash and cash equivalents (27,514 – 22,634 – 2,895)	1,985
Cash and cash equivalents at the beginning of the period	5,003
Cash and cash equivalents at the end of the period	6,988

Illustration 4

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2017 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 31.3.2017

	₹ '000		₹ '000
Balance on 1.4.2016	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 31.3.2017	150
	3,250		3,250

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2017

(Using the direct method)

	₹ '000	₹'000
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	

Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 5

The summarised Balance Sheet of New Light Ltd. for the years ended 31st March, 2016 and 2017 are as follows:

Liabilities	31st March 2016 (₹)	31st March 2017 (₹)	Assets	31st March 2016 (₹)	31st March 2017 (₹)
Equity share capital	11,20,000	15,60,000	Fixed Assets	32,00,000	38,00,000
10% Preference share capital	4,00,000	2,80,000	Less: Depreciation	9,20,000	11,60,000
				22,80,000	26,40,000
Capital Reserve	–	40,000	Investment	4,00,000	3,20,000
General Reserve	6,80,000	8,00,000	Cash	10,000	10,000
Profit and Loss A/c	2,40,000	3,00,000	Other current assets	11,10,000	13,10,000
9% Debentures	4,00,000	2,80,000			
Current liabilities	4,80,000	5,36,000			
Dividend	1,20,000	1,44,000			
Provision for Tax	3,60,000	3,40,000			
	38,00,000	42,80,000		38,00,000	42,80,000

Additional information:

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

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

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

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

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

(vi) *Company decided to value inventory at cost, whereas previously the practice was to value inventory at cost less 10%. The inventory according to books on 31.3.2016 was ₹ 2,16,000. The inventory on 31.3.2017 was correctly valued at ₹ 3,00,000.*

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

Solution

New Light Ltd.

Cash Flow Statement for the year ended 31st March, 2017

		₹	₹
A.	Cash Flow from operating activities		
	Profit after appropriation		
	Increase in profit and loss A/c after inventory adjustment [₹ 3,00,000 – (₹ 2,40,000 + ₹ 24,000)]	36,000	
	Transfer to general reserve	1,20,000	
	Dividend	1,44,000	
	Provision for tax	3,40,000	
	Net profit before taxation and extraordinary item	6,40,000	
	Adjustments for:		
	Depreciation	3,60,000	
	Loss on sale of fixed assets	20,000	
	Decrease in value of fixed assets	16,000	
	Premium on redemption of preference share capital	6,000	
	Premium on redemption of debentures	6,000	
	Operating profit before working capital changes	10,48,000	
	Increase in current liabilities (₹ 5,36,000 –₹ 4,80,000)	56,000	
	Increase in other current assets [₹ 13,10,000 – (₹ 11,10,000 + ₹ 24,000)] (W.N.1)	(1,76,000)	
	Cash generated from operations	9,28,000	
	Income taxes paid	(3,60,000)	
	Net Cash from operating activities		5,68,000
B.	Cash Flow from investing activities		
	Purchase of fixed assets (W.N.3)	(8,56,000)	
	Proceeds from sale of fixed assets	1,00,000	
	Proceeds from sale of investments (W.N.2)	1,20,000	
	Net Cash from investing activities		(6,36,000)
C.	Cash Flow from financing activities		
	Proceeds from issuance of share capital	4,40,000	
	Redemption of preference share capital (₹1,20,000 + ₹ 6,000)	(1,26,000)	
	Redemption of debentures (₹ 1,20,000 + ₹ 6,000)	(1,26,000)	
	Dividend paid	(1,20,000)	

	Net Cash from financing activities		68,000
	Net increase/decrease in cash and cash equivalent during the year		Nil
	Cash and cash equivalent at the beginning of the year		10,000
	Cash and cash equivalent at the end of the year		10,000

Working Notes:

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

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

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

₹ 11,10,000 + ₹ 24,000 = ₹ 11,34,000

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

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

₹ 2,40,000 + ₹ 24,000 = ₹ 2,64,000.

2. **Investment Account**

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

3. **Fixed Assets Account**

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

4. **Accumulated Depreciation Account**

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

Illustration 6

Financial information of Great Ltd. for the year ended 31st March, 2015 and 2016 are as follows:

Summarised Balance Sheets of Great Ltd.
as on 31st March, 2016 and 2015

	2016 ₹	2015 ₹
Assets		
Cash and cash equivalents	*4,500*	*1,500*
Trade receivables	*7,500*	*3,750*
Inventory	*3,000*	*2,250*
Intangible asset (net)	*1,500*	*2,250*
Due from associates	*28,500*	*28,500*
Property, plant and equipment at cost	*18,000*	*33,750*
Accumulated depreciation	*(7,500)*	*(9,000)*
Property, plant and equipment (net)	*10,500*	*24,750*
Total assets	*55,500*	*63,000*
Liabilities		
Accounts payable	*7,500*	*18,750*
Provision for taxation	*7,500*	*4,500*
Total liabilities	*15,000*	*23,250*
Shareholders' equity		
Share capital	*9,750*	*9,750*
Retained earnings	*30,750*	*30,000*
Total shareholders' equity	*40,500*	*39,750*
Total liabilities and shareholders' equity	*55,500*	*63,000*

Summarised Statement of Profit and Loss of Great Ltd.
For the year ended 31st March, 2016

	₹
Sales	*45,000*
Cost of sales	*(15,000)*

Gross operating profit	*30,000*
Administrative and selling expenses	*(3,000)*
Interest expenses	*(3,000)*
Depreciation of property, plant and equipment	*(3,000)*
Amortization of intangible asset	*(750)*
Investment income	*4,500*
Net profit before taxation	*24,750*
Taxes on profit	*(6,000)*
Net profit	*18,750*

Additional information:

1. *All sales made by Great Ltd. are credit sales. All purchases are also credit purchases.*
2. *Interest expense for the year 2015-2016 was ₹ 3,000, which was fully paid during the year.*
3. *The company pays salaries and other employee dues before the end of each month. All administration and selling expenses incurred were paid before 31st March, 2016.*
4. *Investment income comprised dividend income from investments in shares of blue chip companies. This was received before 31st March, 2016.*
5. *Equipment with a net book value of ₹ 11,250 and original cost of ₹ 15,750 was sold for ₹ 11,250.*
6. *The company declared and paid dividends of ₹ 18,000 to its shareholders during 2015-2016.*
7. *Income tax expense for the year 2015-2016 was ₹ 6,000, against which the company paid ₹ 3,000 during 2015-2016 as an estimate.*

Using all the given financial information of Great Ltd., prepare the cash flows statement as per AS 3 under indirect method.

Solution

Cash Flow Statement of Great Ltd.

For the year ended 31st March, 2016

	₹	₹
Cash flows from operating activities		
Net profit before taxation	*24,750*	
Adjustments for:		
Depreciation of property, plant, and equipment	*3,000*	
Amortization of intangible assets	*750*	
Investment income	*(4,500)*	
Interest expense	*3,000*	
Operating profit before working capital changes	27,000	
Increase in accounts receivable	(3,750)	
Increase in inventories	(750)	

Decrease in accounts payable	(11,250)	
Cash provided by operations	11,250	
Income taxes paid	(3,000)	
Net cash from operating activities		8,250
Cash flows from investing activities		
Proceeds from sale of equipment	11,250	
Dividends received	4,500	
Net Cash from investing activities		15,750
Cash flows from financing activities		
Dividends paid	(18,000)	
Interest paid	(3,000)	
Net Cash used in financing activities		(21,000)
Net increase in cash and cash equivalents		3,000
Cash and cash equivalents at the beginning of the year		1,500
Cash and cash equivalents at the end of the year		4,500

Illustration 7

Money Ltd., a non-financial company has the following entries in its Bank Account. It has sought your advice on the treatment of the same for preparing Cash Flow Statement.

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

(1) to suppliers

(2) to employees

(3) to its subsidiaries companies

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

(iii) Dividend paid for the year

(iv) TDS on interest income earned on investments made

(v) TDS on interest earned on advance given to suppliers

(vi) Insurance claim received against loss of fixed asset by fire

Discuss in the context of AS 3 Cash Flow Statement.

Solution

Treatment as per AS 3 'Cash Flow Statement'

(i) Loans and advances given and interest earned

(1)	to suppliers	Cash flows from operating activities
(2)	to employees	Cash flows from operating activities

(3) to its subsidiary companies Cash flows from investing activities

(ii) Investment made in subsidiary company and dividend received

Cash flows from investing activities

(iii) Dividend paid for the year

Cash flows from financing activities

(iv) TDS on interest income earned on investments made

Cash flows from investing activities

(v) TDS on interest earned on advance given to suppliers

Cash flows from operating activities

(vi) Insurance claim received against loss of fixed asset by fire

Extraordinary item to be shown under a separate heading as 'Cash inflow from operating activities'.

4.5 Reporting Cash Flows on Net Basis

Paragraph 21 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets.

Example: If an enterprise pays ₹ 50,000 in acquisition of machinery and realises ₹ 10,000 on disposal of furniture, it is not right to show net cash outflow of ₹40,000. The exceptions to this rule are stated in paragraphs 22 and 24.

As per paragraph 22, cash flows from the following operating, investing or financing activities may be reported on a net basis.

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

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

Paragraph 24 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

(a) Cash flows on acceptance and repayment of fixed deposits

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

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

Non-Cash transactions (Paragraph 40)

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

Business Purchase

The aggregate cash flows arising from acquisitions and disposals of business units should be presented separately and classified as cash flow from investing activities. (Paragraph 37)

(a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)

(b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

    (i) The total purchase or disposal consideration; and

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

Treatment of current assets and liabilities taken over on business purchase

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

4.6 Foreign Currency Cash Flows and Exchange Gains and Losses

The foreign currency monetary assets (e.g. balance with bank, trade receivables etc.) and liabilities (e.g. trade payables) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss (See AS 11 for details).

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated excusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement. (Paragraph 25)

4.7 Disclosures

Paragraph 45 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

Paragraph 47 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise. Such information may include:

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

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

Reference: The students are advised to refer the full text of AS 3 "Cash Flow Statements" (revised 1997).

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

5.1 Introduction

All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard. Thus, the present standard (AS 4) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity.

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

5.2 Contingencies

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. *(Refer to unit 28 for discussion on AS 29)*

5.3 Events Occurring after the Balance Sheet Date

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

For example, for the year ending on 31st March 2017, financial statement is finalized and approved by the company in its AGM held on 04th September 2017. In this case the events taking place between 01st April 2017 to 04th September 2017 are termed as events occurring after the balance sheet date.

Two types of events can be identified

a. those which provide further evidence of conditions that existed at the balance sheet date. For example a trade receivable declared insolvent and estate unable to pay full amount against whom provision for doubtful debt was created.

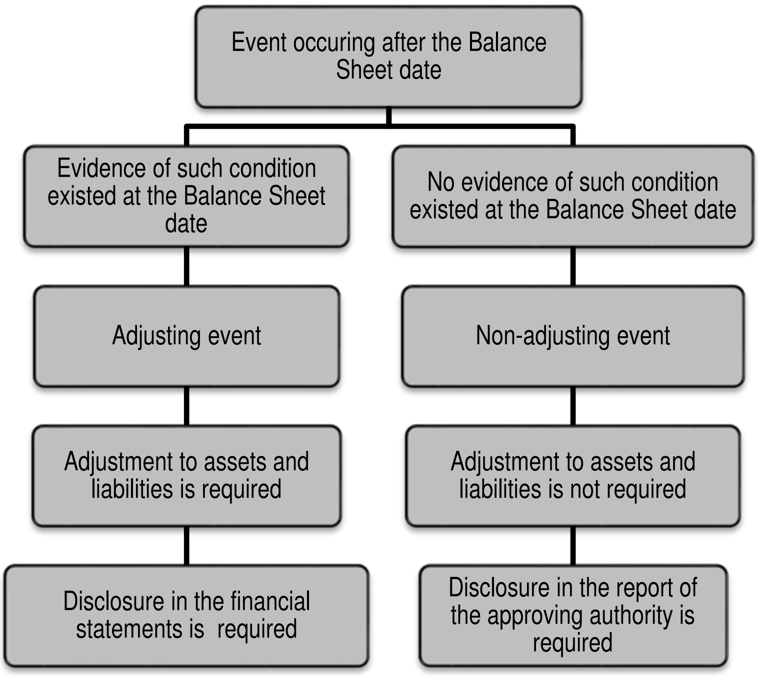
b. those which are indicative of conditions that arose subsequent to the balance sheet date. An event which ceases the enterprise from being going concern.

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

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

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. ***For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes.***

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



5.4 Disclosure

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

(a) The nature of the event;

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

5.5 Illustrations

Illustration 1

Pure Oil Ltd. closed the books of accounts on March 31, 2017 for which financial statement was finalized by the Board of Directors on September 04, 2017. During the month of December 2016, company undertook the project of laying a pipeline across the country and during May 2017 engineers realized that due to unexpected heavy rain, the total cost of the project will be inflated by ₹ 50 lakhs. How this should be provided for in the balance sheet of 2016-17 in accordance to AS 4?

Solution

This event occurred after March 31, 2017 but before September 04, 2017 is an event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it should be disclosed in the directors report.

Illustration 2

In preparing the financial statements of R Ltd. for the year ended 31st March, 2017, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2017 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

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 Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2017. Applying para 15 which clearly states that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 2017 in the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A Limited Company closed its accounting year on 30.6.2017 and the accounts for that period were considered and approved by the board of directors on 20th August, 2017. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2017 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.2017.

Solution

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

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

Illustration 4

While preparing its final accounts for the year ended 31st March, 2017 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 2017 a trade receivable for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2017 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 2017?

Solution

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

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2017. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2017, then mere disclosure required as per para 15, would have been sufficient.

Illustration 5

During the year 2015-2016, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of

₹ 10 lakhs in its financial statements for the year ended 31st March, 2016. On 18th May, 2016, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2016, and approved by the board on 30th May, 2016.

Solution

As per para 8 of AS 4 "Contingencies and Events Occurring After the Balance Sheet Date, adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2015-16 for which the provision was also made by it, the decision of the Court on 18th May, 2016, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 2016, it would be considered as post reporting period i.e. event occurred after the approval of the financial statements. In that case, no adjustment in the financial statements of 2015-16 would have been required.

Illustration 6

For seven companies whose financial year ended on 31st March, 2017, the financial statements were approved by their approving authority on 15th June, 2017.

During 2017-18, the following material events took place:

a. *A Ltd. sold a major property which was included in the balance sheet at ₹ 1,00,000 and for which contracts had been exchanged on 15th March, 2017. The sale was completed on 15th May, 2017 at a price of ₹ 2,50,000.*

b. *On 30th April, 2017, a 100% subsidiary of B Ltd. declared a dividend of ₹ 3,00,000 in respect of its own shares for the year ended on 31st March, 2017.*

c. *On 31st May, 2017, the mail order activities of C Ltd. (a retail trading group) were shut down with closure costs amounting to ₹ 2.5 million.*

d. *On 1st July, 2017 the discovery of sand under D Ltd.'s major civil engineering contract site causes the cost of the contract to increase by 25% for which there would be no corresponding recovery from the customer.*

e. *A fire, on 2nd April, 2017, completely destroyed a manufacturing plant of E Ltd. It was expected that the loss of ₹ 10 million would be fully covered by the insurance company.*

f. *A claim for damage amounting to ₹ 8 million for breach of patent had been received by F Ltd. prior to the year-end. It is the director's opinion, backed by legal advice that the claim will ultimately* *prove to be baseless. But it is still estimated that it would involve a considerable expenditure on legal fees.*

g. The change in foreign exchange rate of 8% between 1st April, 2017 and 1st June, 2017 has resulted in G Ltd.'s foreign assets being reduced by ₹ 1.3 million.

You are required to state with reasons, how each of the above items numbered (a) to (g) should be dealt with in the financial statement of the various companies for the year ended 31st March, 2017.

Solution

Treatment as per AS 4 'Contingencies and Events Occurring After the Balance Sheet Date'

(a)	A Ltd.	The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31.3.2017 and the profit on sale of property ₹ 1,50,000 would be treated as an extraordinary item.
(b)	B Ltd.	The declaration of dividend on 30th April, 2017 of ₹ 3,00,000 would be treated as a non-adjusting event in the financial statements of 2016-17. This is because, the dividend has been declared after the balance sheet date and no conditions existed on the balance sheet date for such declaration of dividend. Further as per AS 9, right to receive dividend is established when it is declared and not before that.
(c)	C Ltd.	A closure not anticipated at the year-end would be treated as a non-adjusting event. Memorandum disclosure would be required for closure of mail order activities since non-disclosure would affect user's understanding of the financial statements.
(d)	D Ltd.	The event took place after the financial statements were approved by the approving authority and is thus outside the purview of AS 4. However, in view of its significance of the transaction, the directors may consider publishing a separate financial statement/additional statement for the attention of the members in general meeting.
(e)	E Ltd.	The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements.
(f)	F Ltd.	On the basis of evidence provided, the claim against the company will not succeed. Thus, ₹ 8 million should not be provided in the account, but should be disclosed by means of a contingent liability with full details of the facts as per AS 9. Provision should be made for legal fee expected to be incurred to the extent that they are not expected to be recovered.

(g)	G Ltd.	The change in exchange rates is a non-adjusting event since it does not relate to the conditions existing at the balance sheet date. However, they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

Reference: The students are advised to refer the full text of AS 4 "Contingencies* and Events occurring after the Balance Sheet Date".

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

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

6.1 Introduction

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

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

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

6.2 Net Profit or Loss for the Period

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

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

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

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

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

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

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

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

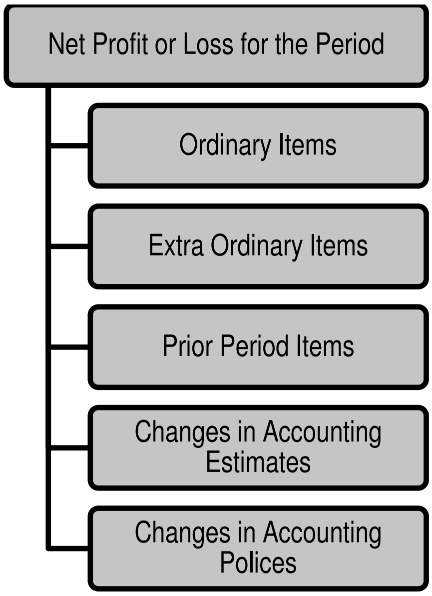
(c) Disposals of items of fixed assets.

(d) Disposals of long-term investments.

(e) Legislative changes having retrospective application.

(f) Litigation settlements.

(g) Other reversals of provisions.



6.3 Prior Period Items

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates.

6.4 Changes in Accounting Estimates

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

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

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

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

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

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

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

6.5 Changes in Accounting Policies

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

The following are not changes in accounting policies:

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

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

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

Accounting Policies can be changed only:

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

6.6 Miscellaneous Illustrations

Illustration 1

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2008 to September, 2015 has been received and paid in February, 2016. However, the same was accounted in the year 2016-17. Comment on the accounting treatment done in the said case.

Solution

The final bill having been paid in February, 2016 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2016. However, it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2016, this material charge has arisen in the current period i.e., year ended 31st March, 2017. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

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

Illustration 2

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only *during current financial year (2016-2017). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2017.*

Solution

Due to major theft of stores in the preceding year (2015-2016) which was detected only during the current financial year (2016–2017), there was overstatement of closing inventory 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 inventory 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.

Alternatively, it may be assumed that in the preceding year, the value of inventory of stores as found out by physical verification of inventories 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, 2017.

Illustration 3

(i) During the year 2016-2017, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

(ii) A Limited company has been including interest in the valuation of closing inventory. In 2016-2017 the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing inventory. This has resulted in a decrease in profits by ₹ 3,00,000. Is a disclosure necessary? If so, draft the same.

(iii) A company signed an agreement with the Employees Union on 1.9.2016 for revision of wages with retrospective effect from 30.9.2015. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2016-17?

Solution

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

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

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

(ii) As per AS 5 (Revised), change in accounting policy can be made for many reasons; one of these is for compliance with an accounting standard. In the instant case, the company has changed its accounting policy in order to conform to 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 2016-2017.

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

(iii) It is given that revision of wages took place on 1st September, 2016 with retrospective effect from 30.9.2015. Therefore wages payable for the half year from 1.10.2016 to 31.3.2017 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

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

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

Illustration 4

While preparing its final accounts for the year ended 31st March, 2017 Rainbow Limited created a provision for Bad and Doubtful debts are 2% on trade receivables. A few weeks later the company found that payments from some of the major trade receivables were not forthcoming. Consequently the company decided to increase the provision by 10% on the trade receivables as on 31st March, 2017 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item? Comment.

Solution

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

In the given case, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade receivables while preparing its final accounts for the year ended 31st March, 2017. Subsequently, the company decided to increase the provision by 10%. As per AS 5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

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

Illustration 5

The company finds that the inventory sheets of 31.3.2016 did not include two pages containing details of inventory worth ₹ 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2017.

Solution

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

Rectification of error in inventory valuation is a prior period item vide Para 4 of AS 5. ₹14.5 lakhs must be added to the opening inventory of 1.4.2016. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Illustration 6

Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organistaion. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

Solution

As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

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

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

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

UNIT 7 : AS 7: CONSTRUCTION CONTRACTS

7.1 Introduction

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

7.2 Definitions of the terms used in the Standard

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

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

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

7.3 Combining and Segmenting Construction Contracts

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

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

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

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

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

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

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

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

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

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

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

7.4 Contract Revenue

Contract revenue should comprise:

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

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

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

    (ii) They are capable of being reliably measured.

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

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

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

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

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

7.5 Contract Costs

Contract costs should comprise:

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

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

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

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

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

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

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

(b) Selling costs;

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

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

7.6 Recognition of Contract Revenue and Expenses

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

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

(a) Total contract revenue can be measured reliably;

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

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

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

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

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

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

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

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

(b) Surveys of work performed; or

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

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

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

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

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

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

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

7.7 Disclosure

An enterprise should disclose:

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

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

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

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

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

(b) The amount of advances received; and

(c) The amount of retentions.

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

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

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

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

7.8 Illustrations

Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2017.

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

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

Solution

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

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

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

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

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

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

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

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

= [605 – 100 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

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

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

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

Illustration 2

On 1st December, 2016, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2017, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2017 as per provisions of Accounting Standard 7 (Revised)?

Solution

	₹
Cost incurred till 31st March, 2017	64,99,000
Prudent estimate of additional cost for completion	32,01,000
Total cost of construction	97,00,000
Less: Contract price	(85,00,000)
Total foreseeable loss	12,00,000

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

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

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

= 67% of ₹ 85,00,000 = ₹ 56,95,000.

<u>Reference</u>: The students are advised to refer the full text of AS 7 "Construction Contracts".

UNIT 8 :AS 9: REVENUE RECOGNITION

8.1 Introduction

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

8.2 Revenue

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

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

(i) Revenue arising from construction contracts;

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

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

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

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

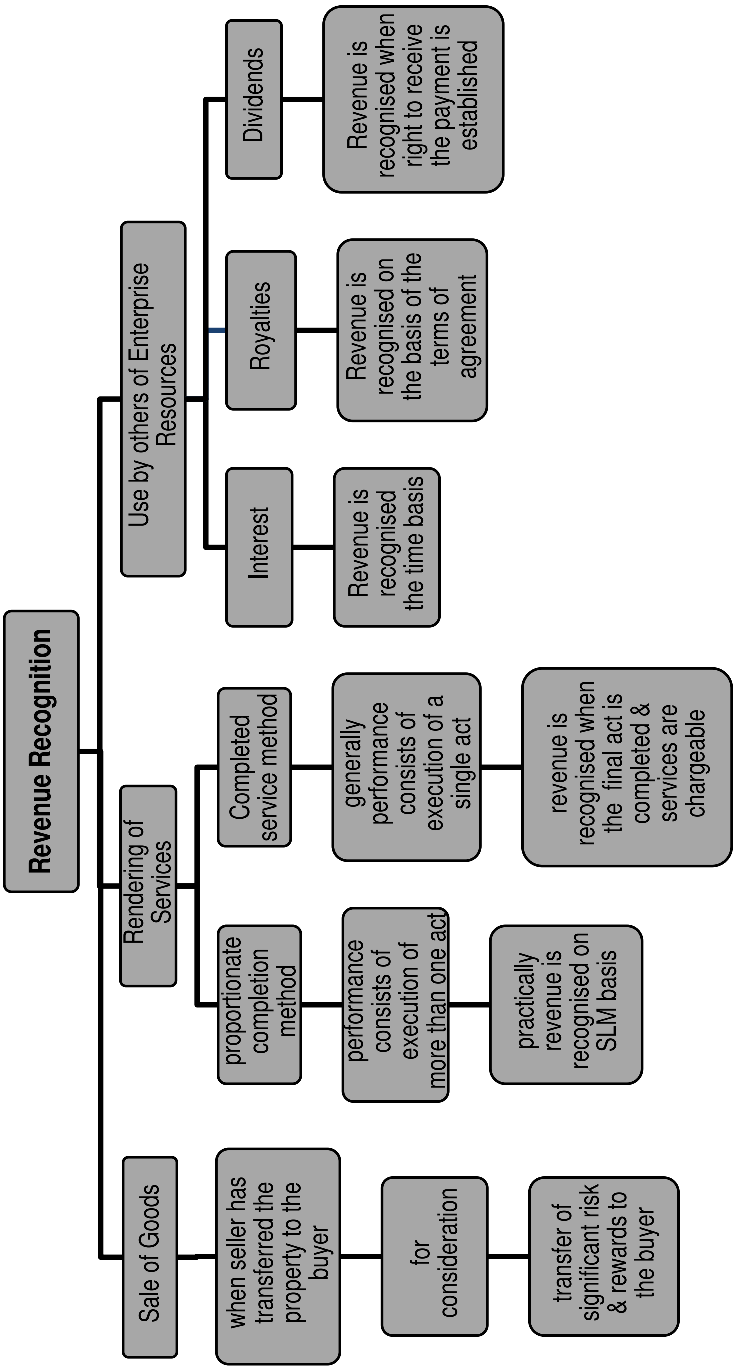
(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

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

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

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

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


Revenue Recognition
Sale of Goods
when seller has transferred the property to the buyer
for consideration
transfer of significant risk & rewards to the buyer
Rendering of Services
proportionate completion method
performance consists of execution of more than one act
practically revenue is recognised on SLM basis
Completed service method
generally performance consists of execution of a single act
revenue is recognised when the final act is completed & services are chargeable
Use by others of Enterprise Resources
Interest
Revenue is recognised the time basis
Royalties
Revenue is recognised on the basis of the terms of agreement
Dividends
Revenue is recognised when right to receive the payment is established

8.3 Sale of Goods

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

8.4 Rendering of Services

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

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

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

8.5 Interest, Royalties and Dividends

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

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

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

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

8.6 Effect of Uncertainties on Revenue Recognition

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

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

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

8.7 Disclosure

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

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

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

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

8.8 Illustrations

Illustration 1

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

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

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

Solution

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

(i) The sale value is fixed and determinable.

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

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

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

Net Profit will be determined at Stage G, when goods are delivered and payment becomes due ₹ 12,000 (30,000 – 18,000).

Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2017. The details are given below:

Quantity of Gold	=	*10,000 TT Bars*
Gold Rate as on March 31, 2017	=	*₹ 275 per TT Bar*
Gold Rate was fixed on June 26, 2017 before the finalization of accounts of company	=	*₹ 273 per TT Bar*

Calculate the amount of inventory regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2017.

Solution

We need to refer to AS 4 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at ₹ 273 per TT Bar, gold will be valued at that rate.

Illustration 3

The Board of Directors decided on 31.3.2017 to increase the sale price of certain items retrospectively from 1st January, 2017. In view of this price revision with effect from 1st January 2017, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2016-2017.Advise.

Solution

Price revision was effected during the current accounting period 2016-2017. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2016-2017 vide para 10 of AS 9.

Illustration 4

Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Ltd. during the year 2016-17. You are required to state whether and on what basis these revenues can be recognised by X Ltd.

Solution

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

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

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

Illustration 5

A claim lodged with the Railways in March, 2015 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2017 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2017.

Solution

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

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

Illustration 6

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2016-2017 the company wants to recognise the entire interest receivable. Do you agree?

Solution

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

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

Illustration 7

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2017, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

Solution

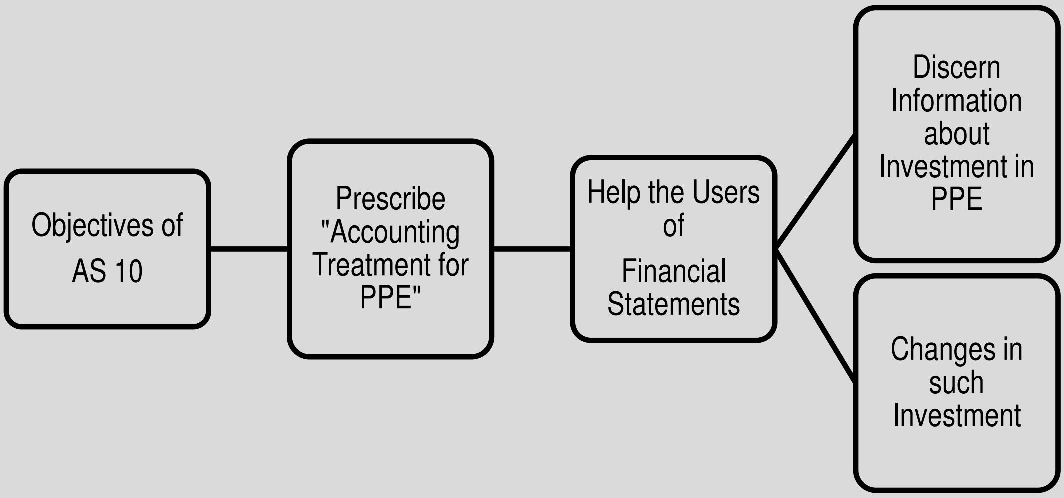
The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd. should record the sale and recognize the profit of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

<u>Reference</u>: The students are advised to refer the full text of AS 9 "Revenue Recognition" (issued 1985).

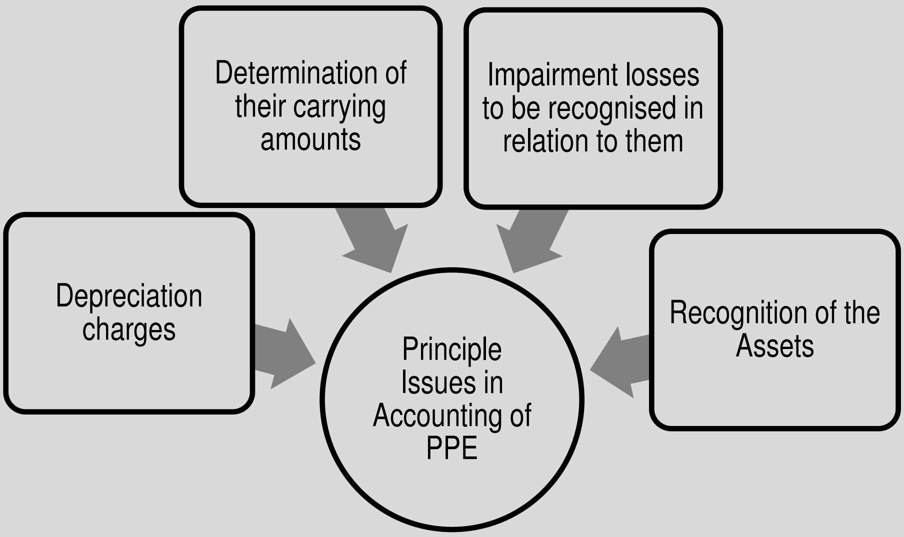
UNIT 9 : AS 10: PROPERTY, PLANT AND EQUIPMENT

9.1 Introduction

The objective of this Standard is to prescribe Accounting treatment for Property, Plant and Equipment (PPE). The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.



The principal issues in Accounting for PPE are:



9.2 Scope of the Standard

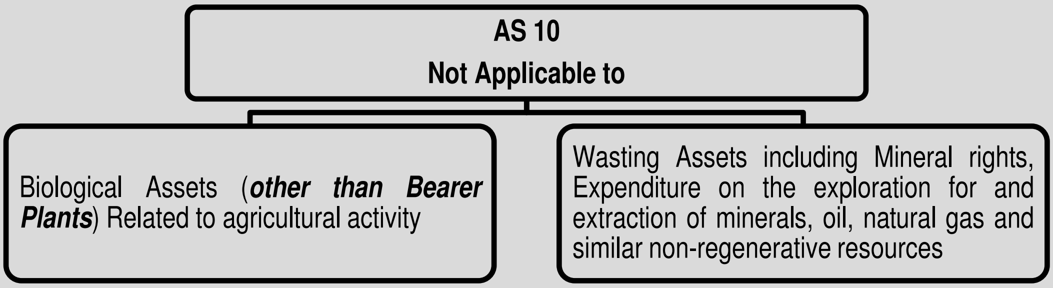
As a general principle, AS 10 should be applied in accounting for PPE.

Exception:

When another Accounting Standard requires or permits a different accounting treatment.

Example: AS 19 on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

This Standard does not apply to:



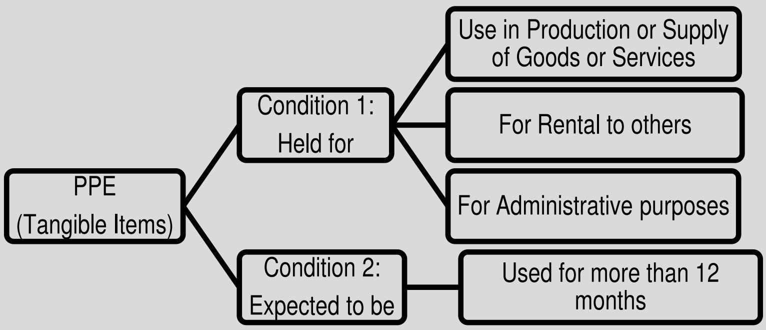
Note: AS 10 applies to Bearer Plants but it does not apply to the produce on Bearer Plants.

Clarifications:

1. AS 10 applies to PPE used to **develop or maintain** the assets described above.
2. Investment property (defined in AS 13), should be accounted for only in accordance with the **Cost model prescribed in this standard.**

9.3 Definition of Property, Plant and Equipment (PPE)

There are 2 conditions to be satisfied for a TANGIBLE item to be called PPE. PPE are ***tangible items*** that:



Note: Intangible items are covered under AS 26.

"Administrative purposes": The term 'Administrative purposes' has been used in **wider sense** to ***include all business purposes.*** **Thus, PPE would include assets used for:**

- Selling and distribution
- Finance and accounting
- Personnel and other functions

of an Enterprise.

Items of PPE may also be acquired for **safety or environmental reasons.**

The acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an enterprise to obtain the future economic benefits from its other assets.

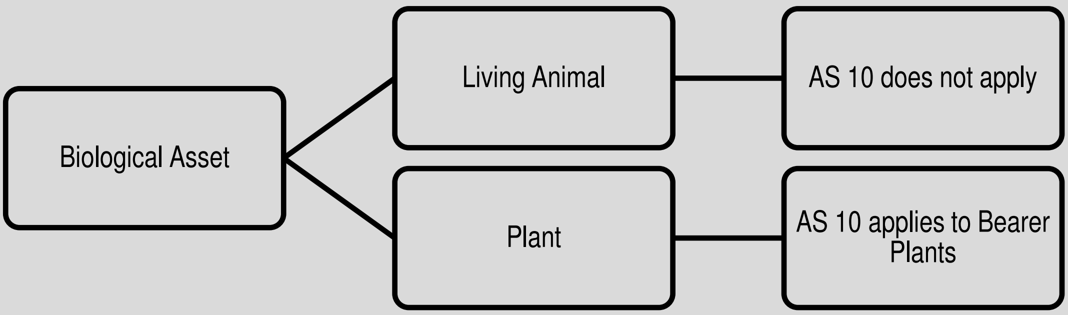
Such items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

Example: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals.

The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28 (Impairment of Assets).

9.4 Other Definitions

1. Biological Asset: An Accounting Standard on "Agriculture" is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on "Agriculture" is issued, accounting for livestock meeting the definition of PPE, will be covered as per AS 10 (Revised).



2. **Bearer Plant:** Is a plant that **(satisfies all 3 conditions):**

Is used in the production or supply	• Of Agricultural produce
Is expected to bear produce	• For more than a period of 12 months
Has a remote likelihood of being sold as Agricultural produce	• Except for incidental scrap sales

Note: When bearer plants are no longer used to bear produce they might be cut down and sold as scrap. For example - use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a Bearer Plant.

The following are not Bearer Plants:

(a) Plants cultivated to be ***harvested*** *as* Agricultural produce

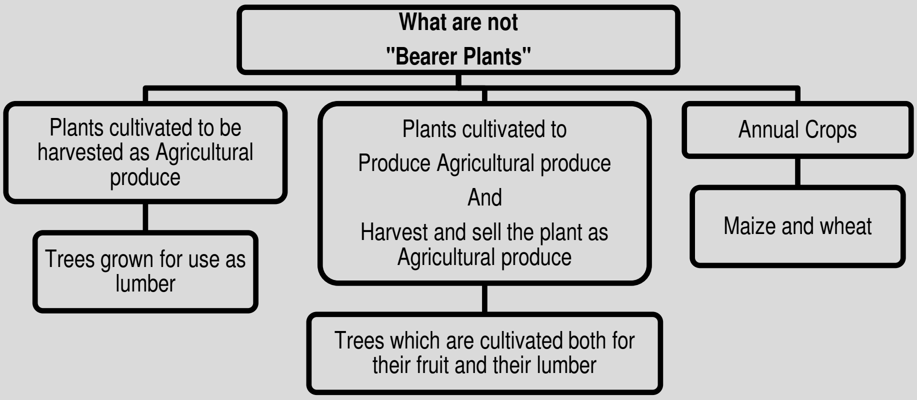
Example: Trees grown for use as lumber

(b) Plants cultivated ***to produce*** Agricultural produce when there is more than a remote likelihood that the entity will ***also harvest and sell*** the plant as agricultural produce, other than as incidental scrap sales

Example: Trees which are cultivated both for their fruit and their lumber

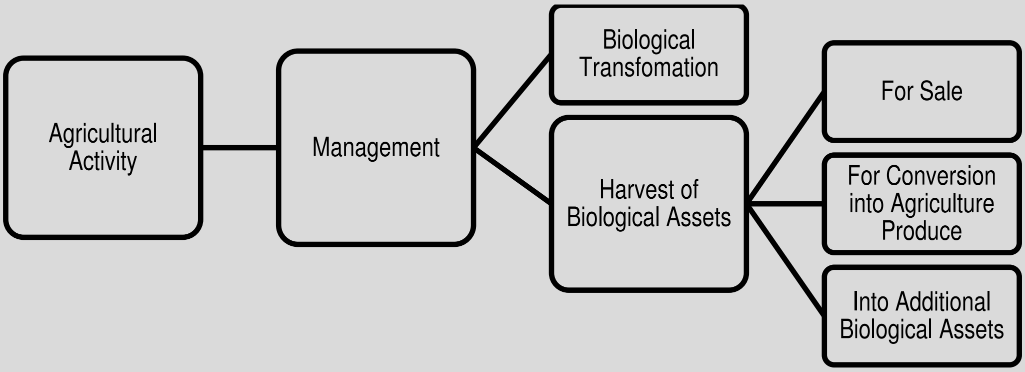
(c) Annual crops

Example: Maize and wheat



Agricultural Produce is the **harvested product** of **Biological Assets** of the enterprise.

3. **Agricultural Activity:** Is the **management** by an Enterprise of:
   - Biological transformation; and
   - Harvest of Biological Assets
- For sale, Or
- For conversion into Agricultural Produce, Or
- Into additional Biological Assets



9.5 Recognition Criteria for PPE

The ***cost of an item of PPE*** should be recognised as an asset ***if, and only if***:

(a) It is probable that future economic benefits associated with the item will flow to the enterprise, and

(b) The cost of the item can be measured reliably.

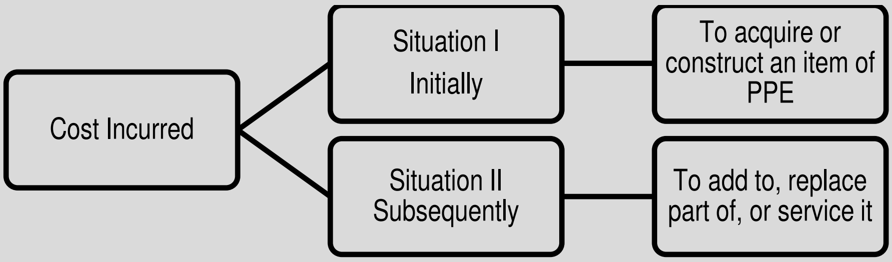
Notes:

1. It may be **appropriate to aggregate individually insignificant items**, such as moulds, tools and dies and to apply the criteria to the aggregate value.
2. An enterprise **may decide to expense an item** which could otherwise have been included as PPE, because the amount of the expenditure is not material.

When do we apply the above criteria for Recognition?

An enterprise evaluates under this recognition principle all its costs on **PPE at the time they are incurred.**

These costs include costs incurred:



9.6 Treatment of Spare Parts, Stand by Equipment and Servicing Equipment

Case I If they meet the definition of PPE as per AS 10:

- Recognised as PPE as per AS 10

Case II If they do not meet the definition of PPE as per AS 10:

- Such items are classified as Inventory as per AS 2

Illustration 1 (Capitalising the cost of "Remodelling" a Supermarket)

Entity A, a supermarket chain, is renovating one of its major stores. The store will have more available space for in store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of remodelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. State whether the remodeling cost will be capitalized or not.

Solution

The expenditure in remodelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of remodelling can be measured reliably, therefore, it should be capitalised.

9.7 Treatment of Subsequent Costs

9.7.1 Cost of day-to-day servicing

Meaning:

Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the **'Repairs and Maintenance'** of the item of PPE.

Accounting Treatment:

An enterprise does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred.

9.7.2 Replacement of Parts of PPE

Parts of some items of PPE may require replacement at regular intervals.

Examples:

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.

3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

Accounting Treatment:

An enterprise recognises in the carrying amount of an item of PPE the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met.

Note: The carrying amount of those parts that are **replaced is derecognised** in accordance with the de-recognition provisions of this Standard.

9.7.3 Regular Major Inspections - Accounting Treatment

When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied.

Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Illustration 2

What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed? (Related to Issue 2 and 3)

Solution

De-recognition of the carrying amount occurs **regardless** of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

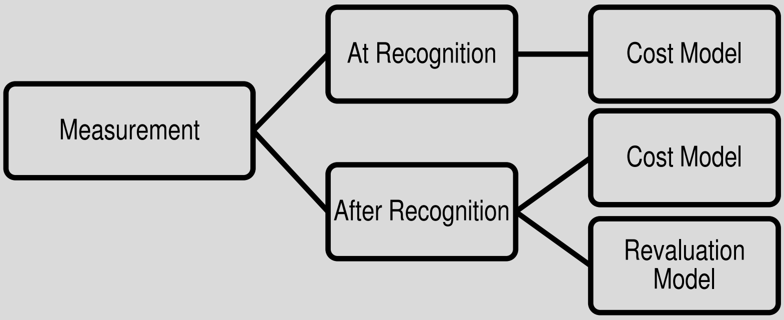
Illustration 3

What will be your answer in the above question, if it is not practicable for an enterprise to determine the carrying amount of the replaced part/inspection?

Solution

It may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/existing inspection component was when the item was acquired or constructed.

9.8 Measurement of PPE

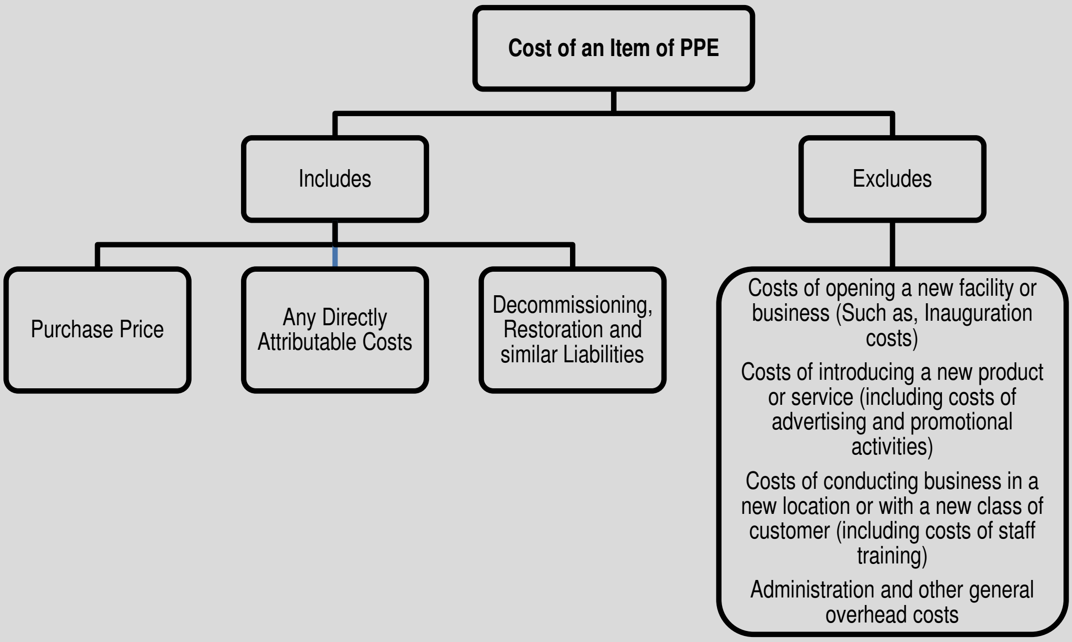


9.9 Measurement at Recognition

An item of PPE that qualifies for recognition as an asset should be measured **at its cost.**

What are the elements of Cost?

Cost of an item of PPE comprises:



Let us understand the above in detail.

A. Purchase Price:

- It includes import duties and non –refundable purchase taxes.
- It requires deduction of Trade discounts and rebates

B. Directly Attributable Costs:

Any costs directly attributable **to bringing** the asset to the '**location and condition'** necessary for it to be capable of operating in the manner intended by management

Recognition of costs in the carrying amount of an item of PPE **ceases** when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Examples of directly attributable costs are:

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs

4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

The following costs are not included in the carrying amount of an item of PPE:

1. Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
2. Initial operating losses, such as those incurred while demand for the output of an item builds up. And
3. Costs of relocating or reorganising part or all of the operations of an enterprise.

Note: Some operations occur in connection with the construction or development of an item of PPE, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities.

Example: Income may be earned through using a building site as a car park until construction starts because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the Statement of Profit and Loss and included in their respective classifications of income and expense.

Illustration 4

Entity A has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period the company will move its production facilities to another (temporary) site. The following incremental costs will be incurred:

1. *Setup costs of ₹ 5,00,000 to install machinery in the new location.*
2. *Rent of ₹ 15,00,000*
3. *Removal costs of ₹ 3,00,000 to transport the machinery from the old location to the temporary location.*

Can these costs be capitalised into the cost of the new building?

Solution

Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired. These costs are not to be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The costs to be incurred by the company do not meet the requirement of AS 10 and therefore, cannot be capitalised.

Illustration 5 (Capitalisation of directly attributable costs)

Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed.

Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?

Solution

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

However, the cost of salaries, utilities and storage of goods are operating expenditures that would be incurred if the supermarket was open. These costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Illustration 6 (Operating costs incurred in the start-up period)

An amusement park has a 'soft' opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is three months later. Management claim that the soft opening is a trial run necessary for the amusement park to be in the condition capable of operating in the intended manner. Accordingly, the net operating costs incurred should be capitalised. Comment.

Solution

The net operating costs should not be capitalised, but should be recognised in the Statement of Profit and Loss.

Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

C. Decommissioning, Restoration and similar Liabilities:

Initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as ‘Decommissioning, Restoration and similar Liabilities’, the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes **other than** to produce inventories during that period.

Exception: An enterprise applies AS 2 “Valuation of Inventories”, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

Note: The obligations for costs accounted for in accordance with AS 2 or AS 10 are recognised and measured in accordance with AS 29 "Provisions, Contingent Liabilities and Contingent Assets".

9.10 Cost of a Self-constructed Asset

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

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see AS 2). Therefore, any **internal profits are eliminated** in arriving at such costs.

2. Cost of **abnormal amounts** of wasted material, labour, or other resources incurred in self constructing an asset is **not included** in the cost of the asset.

3. AS 16 on Borrowing Costs, establishes criteria for the **recognition of interest** as a component of the carrying amount of a self-constructed item of PPE.

4. **Bearer plants** are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.

9.11 Measurement of Cost

Cost of an item of PPE is the **cash price equivalent** at the recognition date.

A. If payment is deferred beyond normal credit terms:

Total payment - Cash price equivalent

- Is recognised as Interest over the period of credit
- unless such interest is capitalised in accordance with AS 16

B. PPE acquired in Exchange for a Non-monetary Asset or Assets Or A combination of Monetary and Non-monetary Assets:

Cost of such an item of PPE is **measured at fair value unless:**

(a) Exchange transaction lacks commercial substance; Or

(b) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

Note:

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.
2. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

Illustration 7 (Consideration received comprising a combination of non-monetary and monetary assets)

Entity A exchanges surplus land with a book value of ₹ 10,00,000 for cash of ₹ 20,00,000 and plant and machinery valued at ₹ 25,00,000. What will be the measurement cost of the assets received?

Solution

Since the transaction has commercial substance. The plant and machinery would be recorded at ₹ 25,00,000, which is equivalent to the fair value of the land of ₹ 45,00,000 less the cash received of ₹ 20,00,000.

Illustration 8 (Exchange of assets that lack commercial substance)

Entity A exchanges car X with a book value of ₹ 13,00,000 and a fair value of ₹ 13,25,000 for cash of ₹ 15,000 and car Y which has a fair value of ₹ 13,10,000. The transaction lacks commercial substance as the company's cash flows are not expected to change as a result of the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?

Solution

The entity recognises the assets received at the book value of car X. Therefore, it recognises cash of ₹ 15,000 and car Y as PPE with a carrying value of ₹ 12,85,000.

C. PPE purchased for a Consolidated Price:

Where several items of PPE are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition.

Note: In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

D. PPE held by a lessee under a Finance Lease:

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS 19 (Leases).

E. Government Grant related to PPE:

The carrying amount of an item of PPE may be reduced by government grants in accordance with AS 12 (Accounting for Government Grants).

9.12 Measurement after Recognition

An enterprise should choose

- **Either** Cost model,
- **Or** Revaluation model

as its accounting policy and should apply that policy to an entire **class of PPE.**

Class of PPE: A class of PPE is a grouping of assets of a **similar nature and use** in operations of an enterprise.

Examples of separate classes:

(a) Land

(b) Land and Buildings

(c) Machinery

(d) Ships

(e) Aircraft

(f) Motor Vehicles

(g) Furniture and Fixtures

(h) Office Equipment

(i) Bearer plants

9.13 Cost Model

After recognition as an asset, an item of PPE should be carried at:

Cost **-** Any Accumulated Depreciation **-** Any Accumulated Impairment losses

9.14 Revaluation Model

After recognition as an asset, an item of PPE whose fair value can be measured reliably should be carried at a revalued amount.

Fair value at the date of the revaluation	-
Less: Any subsequent accumulated depreciation	(-)
Less: Any subsequent accumulated impairment losses	(-)
Carrying value	=

9.14.1 Revaluation for entire class of PPE

If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued.

Reason:

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the Financial Statements that are a mixture of costs and values as at different dates.

Illustration 9 (Revaluation on a class by class basis)

Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.

State whether this is acceptable under AS 10 or not with reasons?

Solution

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. AS 10 permits assets to be revalued on a class by class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement.

All properties within the class of office buildings must, therefore, be carried at revalued amount.

9.14.2 Frequency of Revaluations

Revaluations should be made with **sufficient regularity** to ensure that the carrying amount does not differ materially from that which would be determined using Fair value at the Balance Sheet date.

The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.

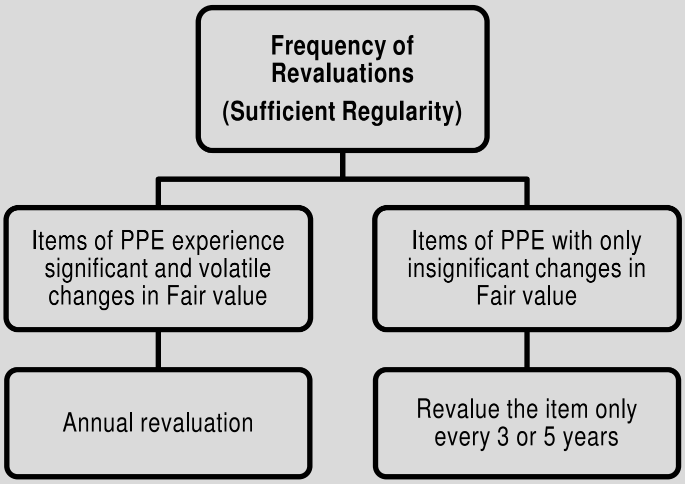
When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

A. Items of PPE experience significant and volatile changes in Fair value

Annual revaluation shall be done.

B. Items of PPE with only insignificant changes in Fair value

Revaluation shall be done at an interval of 3 or 5 years.



9.14.3 Determination of Fair Value

Fair value of items of PPE is usually determined from **market-based evidence** by appraisal that is normally undertaken by professionally qualified valuers.

If there is **no market-based evidence** of fair value because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach.

Example:

Based on

- Discounted cash flow projections, Or
- A depreciated replacement cost approach

Which aims at making a **realistic estimate of the current cost** of acquiring or constructing an item that has the same service potential as the existing item.

9.14.4 Accounting Treatment of Revaluations

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount.

At the date of the revaluation, the asset is treated in one of the following ways:

A. Technique 1: Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

Gross carrying amount

- May be restated by reference to observable market data, or
- May be restated proportionately to the change in the carrying amount.

Accumulated depreciation at the date of the revaluation is

- Adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses

Case Study on Technique I

PPE is revalued to ₹ 1,500 consisting of ₹ 2,500 Gross cost and ₹ 1,000 Depreciation based on observable market data.

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation	1,000	400	600
Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500	600	900
PPE after revaluation	**2,500**	**1,000**	**1,500**

The increase on revaluation is ₹ 900 (i.e., ₹ 1,500 – ₹ 600).

B. Technique 2: Accumulated depreciation Is eliminated against the Gross Carrying amount of the asset

Case Study on Technique II

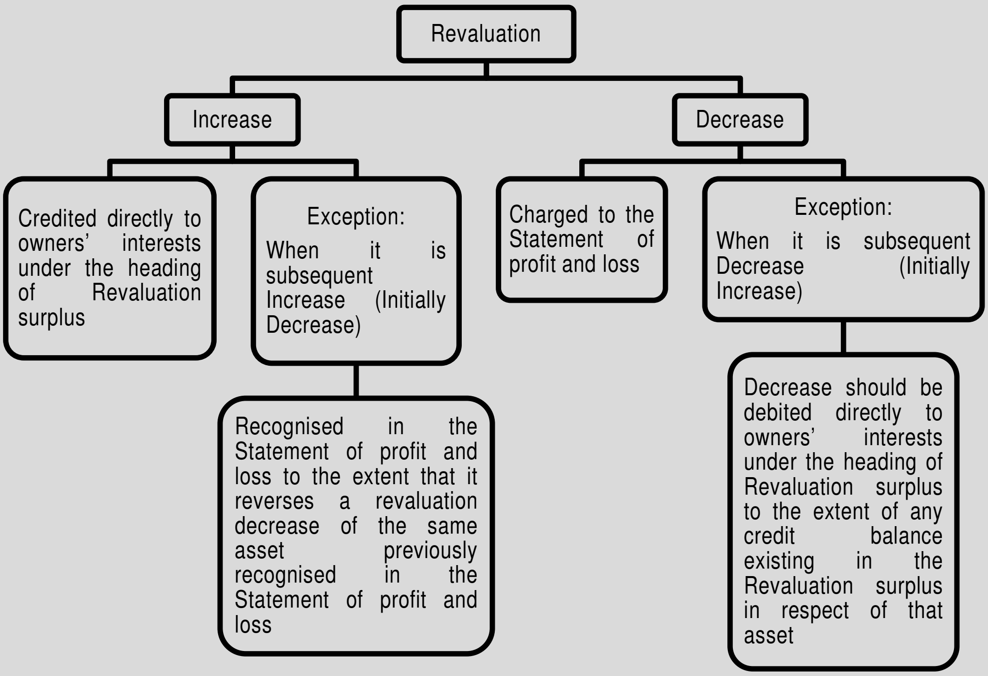
(Taking the information given in the above Example)

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation	1,000	400	600
PPE after revaluation	**1,500**		**1,500**
Revaluation gain	**500**	**400**	

The increase on revaluation is ₹ 900 (i.e., ₹ 500 + ₹ 400).

9.14.5 Revaluation - Increase or Decrease



9.14.6 Treatment of Revaluation Surplus

The revaluation surplus included in owners' interests in respect of an item of PPE may be transferred to the **Revenue Reserves when the asset is derecognised.**

Case I : When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

Case II : Some of the surplus may be transferred as the asset is used by an enterprise:

In such a case, the amount of the surplus transferred would be:

Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

Transfers from Revaluation Surplus to the Revenue Reserves are **not made** through the Statement of Profit and Loss.

9.15 Depreciation

Component Method of Depreciation:

Each part of an item of PPE with a cost that is **significant in relation to the total cost** of the item should be depreciated separately.

Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

Is Grouping of Components possible?

Yes.

A significant part of an item of PPE may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts **may be grouped** in determining the depreciation charge.

Accounting Treatment:

Depreciation charge for each period should be recognised in the Statement of Profit and Loss unless it is included in the carrying amount of another asset.

Examples on Exception:

AS 2: Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories as per AS 2.

AS 26: Depreciation of PPE used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26 on Intangible Assets.

9.16 Depreciable Amount and Depreciation Period

9.16.1 What is "Depreciable Amount"?

Depreciable amount is:

Cost of an asset (or other amount substituted for cost i.e. revalued amount) - Residual value

The depreciable amount of an asset should be **allocated on a systematic basis** over its useful life.

Illustration 10

Entity A has a policy of not providing for depreciation on PPE capitalised in the year until the following year, but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?

Solution

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use.

9.16.2 Review of Residual Value and Useful Life of an Asset

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

Illustration 11 (Change in estimate of useful life)

Entity A purchased an asset on 1st January 2013 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.

On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.

Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution

The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e (1,00,000/10 years).

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.

The remaining useful life is 4 years.

The company should amend the annual provision for depreciation to charge the unamortised cost over the revised remaining life of four years.

Consequently, it should charge depreciation for the next 4 years at ₹ 15,000 per annum i.e. (60,000 / 4 years).

Note: Depreciation is recognised even if the Fair value of the Asset exceeds its Carrying Amount. Repair and maintenance of an asset do not negate the need to depreciate it.

9.16.3 Commencement of period for charging Depreciation

Depreciation of an asset begins when it is **available for use**, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

Illustration 12

Entity B constructs a machine for its own use. Construction is completed on 1st November 2016 but the company does not begin using the machine until 1st March 2017. Comment

Solution

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 2016. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

9.16.4 Cessesation of Depreciation

I. Depreciation ceases to be charged when asset's residual value exceeds its carrying amount

The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero **unless and until** its residual value subsequently decreases to an amount below its carrying amount.

Illustration 13 (Depreciation where residual value is the same as or close to Original cost)

A property costing ₹ 10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.

The estimated residual value in 20 years' time, based on 2016 prices, is:

Case (a) ₹ 10,00,000

Case (b) ₹ 9,00,000.

Calculate the amount of depreciation.

Solution

Case (a)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost.

There is, therefore, no depreciable amount and depreciation is correctly zero.

Case (b)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.

Annual depreciation (on a straight line basis) will be ₹ 5,000 [{10,00,000 – 9,00,000} ÷ 20].

II. Depreciation of an asset ceases at the earlier of:

- The date that the asset is retired from active use and is held for disposal, and
- The date that the asset is derecognised

Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated.

However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

9.16.5 Land and Buildings

Land and buildings are separable assets and are accounted for separately, **even when they are acquired together.**

A. Land: Land has an unlimited useful life and therefore is not depreciated.

Exceptions: Quarries and sites used for landfill.

Depreciation on Land:

I. **If land itself has a limited useful life:**

It is depreciated in a manner that reflects the benefits to be derived from it.

II. **If the cost of land includes the costs of site dismantlement, removal and restoration:**

That **portion of the land asset** is depreciated over the period of benefits obtained by incurring those costs.

B. **Buildings:**

Buildings have a limited useful life and therefore are depreciable assets.

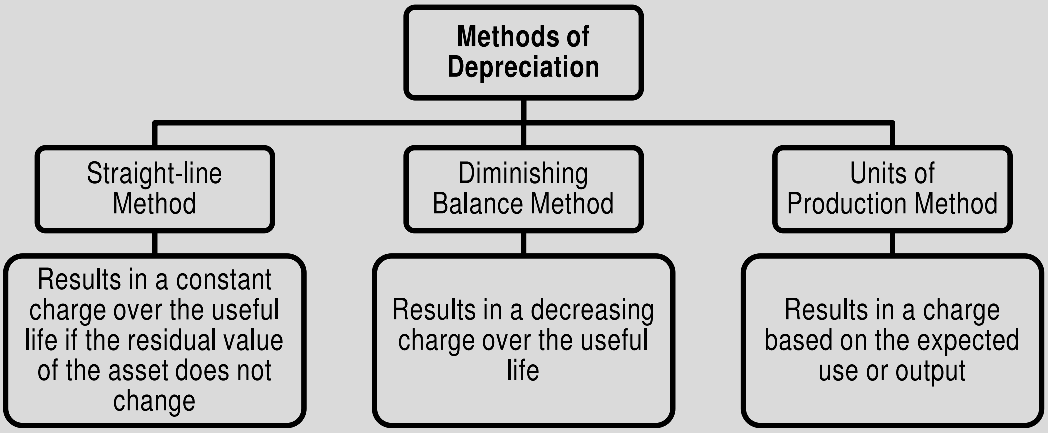
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

9.17 Depreciation Method

The depreciation method used should **reflect the pattern in which the future economic benefits** of the asset are expected to be consumed by the enterprise.

The method selected is applied **consistently from period to period** unless:

- There is a change in the expected pattern of consumption of those future economic benefits; Or
- That the method is changed in accordance with the statute to best reflect the way the asset is consumed.



Review of Depreciation Method:

The depreciation method applied to an asset should be reviewed at **least at each financial year-end** and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern.

Such a change should be accounted for as a **change in an accounting estimate** in accordance with AS 5.

Depreciation Method based on Revenue:

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is **not appropriate.**

Illustration 14 (Determination of appropriate Depreciation Method)

Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products.

However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.

Solution

Management should determine the depreciation method based on production output. The straight-line depreciation method should be adopted, because the production output is consistent from year to year.

Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

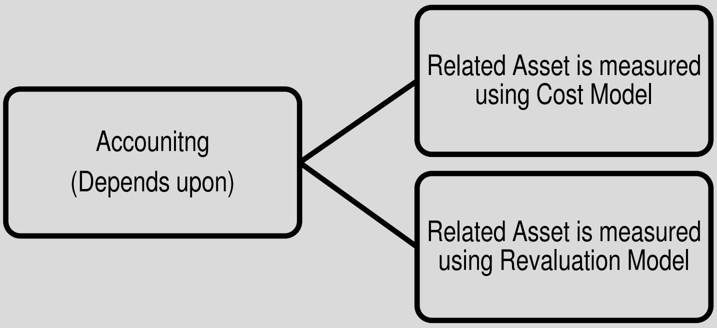
9.18 Changes in Existing Decommissioning, Restoration and other Liabilities

The cost of PPE may undergo changes subsequent to its acquisition or construction on account of:

- Changes in Liabilities
- Price Adjustments
- Changes in Duties
- Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and
- Similar factors

The above are **included in the cost of the asset.**

Accounting for the above changes:



A. If the related asset is measured using the Cost model:

Changes in the Liability should be added to, or deducted from, the cost of the related asset in the current period

Note: Amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the Statement of Profit and Loss.

If the adjustment results in an addition to the cost of an asset:

- Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.

Note: If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with AS 28.

B. If the related asset is measured using the Revaluation model:

Changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:

(i) Decrease in the liability credited directly to revaluation surplus in the owners' interest

Exception:

- It should be recognised in the Statement of Profit and Loss **to the extent** that it reverses a revaluation deficit on the asset that was previously recognised in the Statement of Profit and Loss

Note: In the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess should be recognised immediately in the Statement of Profit and Loss.

(ii) Increase in the liability should be recognised in the Statement of Profit and Loss

Exception:

- It should be debited directly to Revaluation surplus in the owners' interest **to the extent** of any credit balance existing in the Revaluation surplus in respect of that asset

Caution:

A change in the liability is **an indication** that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

What happens if the related asset has reached the end of its useful life?

All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

Note: This applies under both the cost model and the revaluation model.

9.19 Impairment

To determine whether an item of PPE is impaired, an enterprise applies AS 28 on Impairment of Assets.

AS 28 explains how an enterprise:

- Reviews the carrying amount of its Assets
- How it determines the Recoverable Amount of an Asset, and
- When it Recognises, or Reverses the recognition of, an Impairment loss

9.20 Compensation for Impairment

Compensation from third parties for items of PPE that were impaired, lost or given up should be included in the Statement of Profit and Loss when the **compensation becomes receivable.**

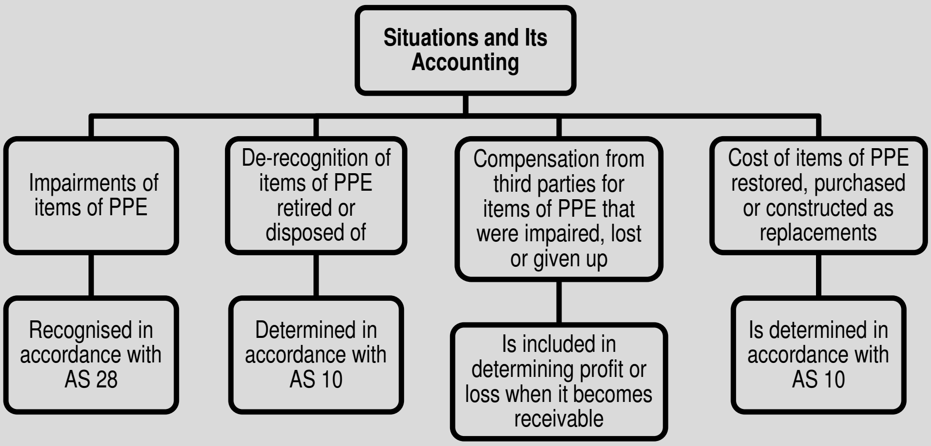


Illustration 15 (Gain on replacement of Insured Assets)

Entity A carried plant and machinery in its books at ₹ 2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost ₹ 20,00,000. The machines were acquired by the insurance company and the company did not receive the ₹ 20,00,000 as cash compensation. State, how Entity A should account for the same?

Solution

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10.

Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

9.21 Retirements

Items of PPE retired from active use and held for disposal should be stated at the lower of:

- Carrying Amount, and
- Net Realisable Value

Note: Any write-down in this regard should be recognised immediately in the Statement of Profit and Loss.

9.22 De-recognition

The carrying amount of an item of PPE should be derecognised:

- On disposal
  - By sale
  - By entering into a finance lease, or
  - By donation, Or
- When no future economic benefits are expected from its use or disposal

Accounting Treatment:

Gain or loss arising from de-recognition of an item of PPE should be included in the **Statement of Profit and Loss when the item is derecognized** unless AS 19 on Leases, requires otherwise on a sale and leaseback (AS 19 on Leases, applies to disposal by a sale and leaseback.)

Where,

Gain or loss arising from de-recognition of an item of PPE

= Net disposal proceeds (if any) - Carrying Amount of the item

Note: Gains should **not** be classified as revenue, as defined in AS 9 'Revenue Recognition'.

Exception:

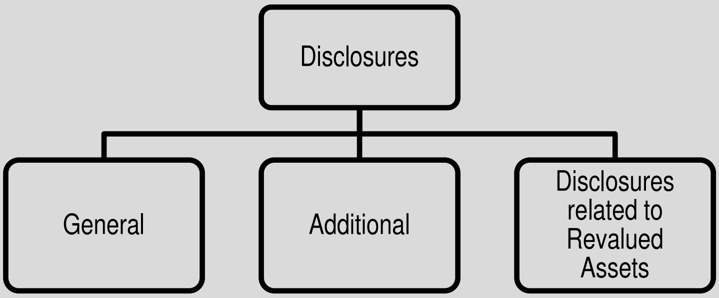
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

Determining the date of disposal of an item:

An enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods.

9.23 Disclosure



9.23.1 General Disclosures:

The financial statements should disclose, for each class of PPE:

(a) The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;

(b) The depreciation methods used;

(c) The useful lives or the depreciation rates used.

In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;

(d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) A reconciliation of the carrying amount at the beginning and end of the period showing:

9.23.2 Additional Disclosures:

The financial statements should also disclose:

(a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

(c) The amount of contractual commitments for the acquisition of property, plant and equipment;

(d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and

(e) The amount of assets retired from active use and held for disposal.

9.23.3 Disclosures related to Revalued Assets:

If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) The effective date of the revaluation;

(b) Whether an independent valuer was involved;

(c) The methods and significant assumptions applied in estimating fair values of the items;

(d) The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and

(e) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

9.24 Transitional Provisions

9.24.1 Previously Recognised Revenue Expenditure

Where an entity has in past recognized an expenditure in the Statement of Profit and Loss which is eligible to be included as a part of the cost of a project for construction of PPE in accordance with the requirements of this standard:

- It may do so **retrospectively** for such a project.

Note: The effect of such retrospective application, should be recognised **net-of-tax in Revenue reserves**.

9.24.2 PPE acquired in Exchange of Assets

The requirements of AS 10 regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be **applied prospectively** only to transactions entered into after this Standard becomes mandatory.

9.24.3 Spare parts

On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2, and are **now required to be capitalised** in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts.

Note: The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

9.24.4 Revaluations

The requirements of AS 10 regarding the revaluation model should be **applied prospectively.**

In case, on the date of this Standard becoming mandatory, an enterprise **does not adopt** the revaluation model as its accounting policy but the carrying amount of item(s) of PPE reflects any previous revaluation it should adjust the amount outstanding in the Revaluation reserve against the carrying amount of that item.

Note: The carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as Revaluation reserve over the carrying amount of that item **should be adjusted** in Revenue reserves.

Reference: The students are advised to refer the full text of AS 10 "Property, Plant and Equipment" (Revised 2016).

UNIT 10 : AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

10.1 Introduction

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

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

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

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

10.2 Scope

This Standard should be applied:

(a) In accounting for transactions in foreign currencies.

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

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

This Standard does not:

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

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

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

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

10.3 Definitions of the terms used in the Standard

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

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

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

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

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

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

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

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

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

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

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

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

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

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

10.4 Initial Recognition

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

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

10.5 Reporting at each balance sheet date

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

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

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

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

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

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

10.6 Recognition of Exchange Differences

Exchange differences arise on:

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

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

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

Note:

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

According to the Notification, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31st March, 2020.

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

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

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

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

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

10.7 Classification of Foreign Operations as Integral or Non-integral

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

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

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

10.8 Translation of Foreign Integral Operations

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

10.9 Translation of Non-Integral Foreign Operations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

10.10 Change in the Classification of a Foreign Operation

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

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

10.11 Tax Effects of Exchange Differences

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

10.12 Forward Exchange Contract

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

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

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

Illustration 1

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

Solution

It is apparent from the facts given in the question that Mr. A entered into forward exchange contract for speculation purpose*.According to paragraphs 38 and 39 of AS 11(Revised) 'The Effects of Changes in Foreign Exchange Rates', gain or loss on forward exchange contracts intended for trading or speculation purpose should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period and the premium or discount on the forward exchange contract is ignored and not recognised separately. In recording such contract, at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Thus, the premium on contract i.e., the difference between the contract rate and the spot rate amounting ₹ 8,000 [US $ 1,00,000 x (₹ 47.10 – ₹ 47.02)] will be ignored and not be recorded in the books. However, the profit on contract i.e. the difference between the sale rate and contract rate amounting ₹8,000 [US$ 1,00,000 x 0.08 (₹ 47.18 – ₹ 47.10)] will be recognized in the books of Mr. A on 31st January.

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*The forward contract is sold before its due date, hence considered as speculative.

Note: *The current market value of the forward contract on 31st December has not been given in the question. Therefore, no gain or loss can be recognised in the books on 31st December. The profit amounting ₹ 8,000 will be recognised in the year of sale only.

10.13 Disclosure

An enterprise should disclose:

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

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

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

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

(a) The nature of the change in classification;

(b) The reason for the change;

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

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

10.14 Presentation of Foreign Currency Monetary Item Translation Difference Account(FCMITDA)

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

10.15 Miscellaneous Illustrations

Illustration 2

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2016 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.2016 and 31.12.2016 respectively. First instalment was paid on 31.12.2016. The entire difference in foreign exchange has been capitalized.

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

Solution

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

Calculation of Exchange Difference:

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

Exchange difference = 75 lakhs US Dollars $\times$ (42.50 – 40.00) = ₹187.50 lakhs

(including exchange loss on payment of first instalment)

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

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

Illustration 3

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

Solution

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

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

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

'Accounting for Taxes on Income'.

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

Note: The above answer has been given on the basis that the foreign branches referred in the question are integral foreign operations.

Illustration 4

Option Ltd. is engaged in the manufacturing of steel. For its steel plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2016, it borrowed US $1 million from International Funding Agency, USA when exchange rate was 1 $ = ₹ 52. The funds were used for acquiring machineries on the same date to be used in three different steel plants. The useful life of the machineries is 10 years and their residual value is ₹ 20,00,000.

Earlier also the company used to purchase machineries out of foreign borrowings. The exchange differences arising on such borrowings were charged to profit and lossaccount andwere notcapitalised even though the company had an option to capitalise it as per notified AS 11 (notification issued by the MCA in 2009).

Now for this new purchase of machinery, Option Ltd, is interested to avail the option of capitalising the same to the cost of asset. Exchange rate on 31st March, 2017 is 1 US $ = ₹ 51. Assume that on 31st March, 2017, Option Ltd. is not having any old Long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2016.

Can Option Ltd. capitalise the exchange difference to the cost of asset on 31st March, 2017? If yes, then calculate the depreciation amount on machineries as on 31st March, 2017.

Solution

Ministry of Corporate Affairs of India, inserted paragraph 46A in notified AS 11 by Notification dated 29th December, 2011, which is relevant for companies. It states that in respect of accounting periods commencing on or after 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 or not (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Option Ltd. had not earlier exercised the option as given by the notification on AS 11, issued in 2009, yet it can avail the option to capitalise the exchange difference to the cost of machinery by virtue of para 46A inserted in the notified AS 11 in December, 2011.

Exchange difference to be capitalised

Cost of the asset in $		$ 10 lakhs
Exhange rate on 1st April, 2016		₹ 52 = 1$
Cost of the asset in ₹	($ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31st March, 2017 (52-51) x $ 1 million	(Gain)	(10 lakhs)
		510 lakhs
Less: Depreciation for 2016-17	(510 lakhs - 20 lakhs)/10 years	(49 lakhs)
		461 lakhs

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates" (revised 2003).

UNIT 11 :AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

11.1 Introduction

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

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

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

This Standard does not deal with:

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

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

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

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

11.2 Accounting Treatment of Government Grants

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

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

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

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

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

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

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

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

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

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

11.3 Recognition of Government Grants

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

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

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

11.4 Non-monetary Government Grants

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

11.5 Presentation of Grants Related to Specific Fixed Assets

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

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

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

Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

11.6 Presentation of Grants Related to Revenue

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

1. directly as a credit to the statement of profit and loss, either separately or under a general heading such as 'other income'; or
2. as a deduction in reporting the related expense.

11.7 Presentation of Grants in the nature of Promoters' contribution

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

11.8 Refund of Government Grants

Government grant sometimes become refundable because certain conditions are not fulfilled and is treated as an extraordinary item (AS 5).

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable.

Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

11.9 Disclosure

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

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

11.10 Miscellaneous Illustrations

Illustration 1

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2017. You are required to advise the company on the following item from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

The company purchased on 01.04.2016 special purpose machinery for ₹ 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

Solution

AS 12 'Accounting for Government Grants' regards two methods of presentation, of grants related to specific fixed assets, in financial statements as acceptable alternatives. Under the first method, the grant can be shown as a deduction from the gross book value of the machinery in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, it can be treated as deferred income which should be recognised in the profit and loss statement over the useful life of 10 years in the proportions in which depreciation on machinery will be charged. The deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description e.g., 'Deferred government grants' to be shown after 'Reserves and Surplus' but before 'Secured Loans'.

The following should also be disclosed:

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

(ii) the nature and extent of government grants recognised in the financial statement of ₹ 5 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets received ₹ 10 crore from the Government in January, 2017 (accounting period being 2016-2017). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2017.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

Illustration 3

On 1.4.2014, ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2017 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd.?

Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing deferred income balance, as appropriate, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(₹ in lakhs)
1st April, 2014	Acquisition cost of machinery (₹ 1,500 – ₹ 300)	1,200.00
31st March, 2015	*Less*: Depreciation @ 20%	(240.00)
	Book value	960.00
31st March, 2016	*Less*: Depreciation @ 20%	(192.00)
	Book value	768.00
31st March, 2017	*Less*: Depreciation @ 20%	(153.60)
1st April, 2017	Book value	614.40
May, 2017	*Add*: Refund of grant	300.00
	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting ₹ 914.40 lakhs is to be provided prospectively over the residual useful life of the asset i.e. years ended 31st March, 2015 and 31st March, 2016.

Illustration 4

Yogya Ltd. received a specific grant of ₹ 300 lakhs for acquiring the plant of ₹ 1,500 lakhs during 2010-11 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2016-2017, due to non-compliance of conditions laid down for the grant of ₹ 300 lakhs, the company had to refund the grant to the Government. Balance in the deferred income on that date was ₹ 210 lakhs and written down value of plant was ₹ 1,050 lakhs.

(i) What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2016-2017 in the Statement of Profit and Loss?

(ii) What should be the treatment of the refund if grant was deducted from the cost of the plant during 2010-11?

Assume depreciation is charged on assets as per Straight Line Method.

Solution

As per para 21 of AS 12, amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

(i) In this case the grant refunded is ₹ 300 lakhs and balance in deferred income is ₹ 210 lakhs, therefore, ₹ 90 lakhs shall be charged to the profit and loss account for the year 2016-2017. There will be no effect on the cost of the fixed asset and depreciation charge will be same as charged in the earlier years.

(ii) As per para 21 of AS 12, the amount refundable in respect of grant which was related to specific fixed assets should be recorded by increasing the book value of the assets by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case the book value of the plant shall be increased by ₹ 300 lakhs. The increased cost of ₹ 300 lakhs of the plant should be amortised over 7 years (residual life). Depreciation charged during the year 2016-2017 shall be 1200/10 + 300/7 = ₹ 162.86 lakhs.

Reference: The students are advised to refer the full text of AS 12 "Accounting for Government Grants" (issued 1991).

UNIT 12 : AS:13 ACCOUNTING FOR INVESTMENTS

12.1 Introduction

This Accounting Standard came into effect for financial statements covering periods commenced on or after April 1, 1995. The standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realizable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should be accounted for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Standard does not deal with:

a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.

b. Operating or finance leases.

c. Investments on retirement benefit plans and life insurance enterprises and

d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act.

12.2 Definition of the terms used in the Standard

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as inventory-in-trade are not 'investments'

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

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

12.3 Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

12.4 Classification of Investments

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

A long term investment is an investment other than a current investment.

12.5 Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties etc. If an investment is acquired, or partly acquired, by the issue of shares or other securities or another asset, the acquisition cost is the fair value of the securities issued or asset given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

12.6 Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value.

Any reduction in realisable value is debited to profit and loss account, however, if realisable value of investment is increased subsequently, the increase in value of current investment to the level of the cost is credited to the profit and loss account.

Long term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

12.7 Investment Properties

An **investment property** is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. ***An investment property is accounted for in accordance with cost model as prescribed in AS 10, 'Property, Plant and Equipment'. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.***.

12.8 Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

12.9 Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

12.10 Disclosure

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

a. The accounting policies followed for valuation of investments.

b. The amounts included in profit and loss statement for:

   i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.

   ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.

   iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

d. The aggregate amount of quoted and unquoted securities separately.

e. Other disclosures as specifically required by the relevant statute governing the enterprise.

Illustration 1

An unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2017 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2017?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2017 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2017.

Illustration 2

X Ltd. on 1-1-2017 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2017 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is permanent in nature. How will you recognize the reduction in financial statements for the year ended on 31-3-2017?

Solution

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2017 to 31.3.2017), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2017 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its shares to one third which is quiet a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be charged to the Statement of profit and loss.

Illustration 3

Sabka Bank has classified its total investment on 31-3-2017 into three categories (a) held to maturity (b) available for sale (c) held for trading.

'Held to maturity' investments are carried at acquisition cost less amortised amount. 'Available for sale' investments are carried at marked to market. 'Held for trading' investments are valued at weekly intervals at market rates or as per the prices declared by FIMMDA. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. Comment whether the policy of the bank is in accordance with AS 13?

Solution

As per para 2(d) of AS 13 'Accounting for Investments', the accounting standard is not applicable to Bank, Insurance Company, Mutual Funds. In this case Sabka Bank is a bank, therefore, AS 13 does not apply to it. For banks, the RBI has issued guidelines for classification and valuation of its investment and Sabka Bank should comply with those RBI Guidelines/Norms. Therefore, though Sabka Bank has not followed the provisions of AS 13, yet it would not be said as non-compliance since, it is complying with the norms stipulated by the RBI.

Reference: The students are advised to refer the full text of AS 13 "Accounting for Investments" (issued 1993).

UNIT 13 : AS 14: ACCOUNTING FOR AMALGAMATIONS

13.1 Introduction

This standard has come into effect in respect of accounting periods commenced on or after 1.4.1995 and is mandatory in nature. AS 14 deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger or purchase.

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

The standard describes the disclosure requirements for both types of amalgamations in the first financial statementsThis statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. We will discuss the other amalgamation aspects in detail in the next paragraphs of this unit.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

13.2 Definition of the terms used in the Standard

- **Amalgamation** means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies ***and includes 'merger'.***
- **Transferor company** means the company which is amalgamated into another company.
- **Transferee company** means the company into which a transferor company is amalgamated.

13.3 Types of Amalgamations

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

13.4 Amalgamation in the Nature of Merger

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

13.5 Amalgamation in the Nature of Purchase

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.

13.6 Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations.

- the pooling of interests method and
- the purchase method.

13.6.1 Pooling of interests Method

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

13.6.2 Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either

- By incorporating the assets and liabilities at their existing carrying amounts or
- By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The

identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

13.7 Treatment of Reserves of the Transferor Company on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.

Adjustments to reserves - Amalgamation in the Nature of Merger

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- Conflicting accounting policies of the transferor and the transferee. A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned. The effects on the financial statements of this change in the accounting policies is reported in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'
- Difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company.

Adjustments to reserves - Amalgamation in the Nature of Purchase

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements.

1. The corresponding debit is "also" to a Reserve Account
2. That Reserve account will show a negative balance
3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".

So the presentation will be as follows:

Notes to Accounts for "Reserves and Surplus"

Description	Amount (Current year)	Amount (Previous Year)
Statutory Reserve (taken over from transferor company)		
General Reserve		
Profit and Loss or Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	(--)	(--)

13.8 Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

13.9 Disclosures

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Names and general nature of business of the amalgamating companies;

b. Effective date of amalgamation for accounting purposes;

c. The method of accounting used to reflect the amalgamation; and

d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

13.10 Miscellaneous Illustrations

Illustration 1

A Ltd. take over B Ltd. on April 01, 2017 and discharges consideration for the business as follows:

(i) Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.

(ii) Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.

(iii) It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

Solution

Particulars	₹
Equity Shares (42,000 x 10)	4,20,000
Preference Share Capital	1,70,000
Add: Premium on Redemption	17,000
Purchase Consideration	6,07,000

Illustration 2

The following are the summarised Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.2017:

(₹in lakhs)

	Big Ltd. ₹	Small Ltd. ₹		Big Ltd. ₹	Small Ltd. ₹
Share Capital	40.0	15.0	Sundry Assets (including cost of shares)	56.0	20.0
Profit & Loss A/c	7.5	--	Goodwill	4.0	5.0
Trade Payables	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 ₹ 2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of ₹ 7,00,000.*

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

(iv) *It is agreed that the goodwill of Big Ltd. would be valued at ₹ 1,50,000 and that of Small Ltd. at ₹ 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 ₹ 50 each credited as ₹ 25 paid.*

You are required to:

(i) *Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2017 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.*

Solution

(i) Balance Sheet of Medium Ltd. as on 31st March, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
Share Capital		45,50,000
(2) **Current Liabilities**		
Trade Payable		25,00,000
Total		70,50,000

II. Assets		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	1	66,50,000
Intangible assets	2	4,00,000
Total		70,50,000

Notes to Accounts:

	(₹)
1. Tangible Assets	
Sundry Assets (₹53,50,000 + ₹13,00,000)	66,50,000
2. Intangible Assets	
Goodwill (₹1,50,000 + ₹2,50,000)	4,00,000

(ii) Statement of Shareholding in Medium Ltd.

	Big Ltd. ₹	*Small Ltd.* ₹
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 ₹ 25 per share)	1,54,718	27,282

Total purchase consideration to be paid to Big Ltd and Small Ltd. (₹ 38,67,950 + ₹ 6,82,050)	₹ 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 ₹	*Small Ltd.* ₹
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		

₹ (56,00,000 – 2,50,000)	53,50,000	
₹ (20,00,000 – 7,00,000)		13,00,000
	55,00,000	15,50,000
Less: Trade payables	(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.

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

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

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

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

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

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

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

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

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

$$= ₹\ 8,52,564 \text{ (approx.)}$$

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

Book Value of one share of Small Ltd. = $\frac{8,52,564}{50,000}$ = ₹ 17.05 (approx.)

Illustration 3

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2017. A new company C Ltd. was formed to take over the business of the existing companies. The summarised Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2017 are given below:

	(₹ in lakhs)			(₹ in lakhs)	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Share Capital			*Fixed Assets*		

Equity Shares of ₹ 100 each	*800*	*750*	*Land and Building*	*550*	*400*
12% Preference shares of ₹ 100 each	*300*	*200*	*Plant and Machinery*	*350*	*250*
Reserves and Surplus			*Investments*	*150*	*50*
Revaluation Reserve	*150*	*100*	*Current Assets, Loans and Advances*		
General Reserve	*170*	*150*			
Investment Allowance Reserve	*50*	*50*	*Inventory*	*350*	*250*
Profit and Loss Account	*50*	*30*	*Trade Receivables*	*300*	*350*
Secured Loans					
10% Debentures (₹ 100 each)	*60*	*30*	*Cash and Bank*	*300*	*200*
Current Liabilities and provisions					
Trade Payables	*420*	*190*			
	2,000	*1,500*		*2,000*	*1,500*

Additional Information:

(1) 10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 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 ₹ 150 per share (face value of ₹ 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 @ ₹ 30 each, having a face value of ₹ 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, 2017 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Solution

Balance Sheet of C Ltd.
as at 1st April, 2017

Particulars	*Note No.*	*(₹in lakhs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	1,200
(b) Reserves and Surplus	2	1,650
(2) **Non-Current Liabilities**		
Long-term borrowings	3	60
(3) **Current Liabilities**		

	Trade payables	8	610
	Total		3,520
II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	i. Tangible assets	4	1,550
	ii. Intangible assets	5	20
	(b) Non-current investments	6	200
	(2) **Current assets**		
	(a) Inventory		600
	(b) Trade receivables	7	650
	(c) Cash and cash equivalents		500
	Total		3,520

Notes to Accounts

		(₹ in lakhs)	*(₹ in lakhs)*
1.	Share Capital		
	Equity share capital (W.N.2)		
	70,00,000 Equity shares of ₹ 10 each	700	
	5,00,000 Preference shares of ₹ 100 each	500	
	(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		1,200
2.	Reserves and surplus		
	Securities Premium Account	1,650	
	Investment Allowance Reserve	100	
	Amalgamation Adjustment Reserve	***(100)***	***1,650***
3.	Long-term borrowings		
	15% Debentures		60
4.	Tangible assets		
	Land and Building	950	
	Plant and Machinery	600	1,550
5.	Intangible assets		
	Goodwill [W.N. 2]		20
6.	Non-current Investments		
	Investments		200
7.	Trade receivables		650
8.	Trade payables		610

Working Notes:

				(₹ *in lakhs*)	
				A Ltd.	*B Ltd.*
(1)	Computation of Purchase consideration				
	(a) Preference shareholders:				
	$\left(\frac{3,00,00,000}{100}\text{ i.e. }3,00,000\text{ shares}\right)\times$ ₹ 150 each			450	
	$\left(\frac{2,00,00,000}{100}\text{ i.e. }2,00,000\text{ shares}\right)\times$ ₹ 150 each				300
	(b) Equity shareholders:				
	$\left(\frac{8,00,00,000\times 5}{100}\text{ i.e. }40,00,000\text{ shares}\right)\times$ ₹ 30 each			1,200	
	$\left(\frac{7,50,00,000\times 4}{100}\text{ i.e. }30,00,000\text{ shares}\right)\times$ ₹ 30 each			____	900
	Amount of Purchase Consideration			1,650	1,200
(2)	Net Assets Taken Over				
	Assets taken over:				
	Land and Building			550	400
	Plant and Machinery			350	250
	Investments			150	50
	Inventory			350	250
	Trade receivables			300	350
	Cash and bank			300	200
				2,000	1,500
	Less: Liabilities taken over:				
	Debentures	40	20		
	Trade payables	420	190		
				460	210
	Net assets taken over			1,540	1,290
	Purchase consideration			1,650	1,200
	Goodwill			110	____
	Capital reserve				90

Reference: The students are advised to refer the full text of AS 14 "Accounting for Amalgamations" (issued 1994).

UNIT 14 : AS 15: EMPLOYEE BENEFITS

14.1 Introduction

The revised Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees (other than inventory compensation for which a separate guidance note is promulgated), many of which were not dealt with by pre-revised AS 15. The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

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

(ii) employee benefits can be paid in cash or in kind;

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

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

Employee benefits include:

(a) Short-term employee benefits (e.g. wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc. (payable within 12 months of the year-end) and non-monetary benefits for current employees;

(b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.);

(c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.); and

(d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

14.2 Applicability

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This standard is applicable predominantly for Level 1 enterprises, and applied to other entities with certain relaxations as mentioned in Appendix III at the end of the Study Material (Volume II).

14.3 Meaning of the term "Employee Benefits"

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

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

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

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

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

14.4 Short-term Employee Benefits

Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered. Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost. Short-term employee benefits are broadly classified into four categories:

(i) regular period benefits (e.g., wages, salaries);

(ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);

(iii) profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and

(iv) non-monetary benefits (e.g., medical care, housing, cars etc.)

The Standard lays down some general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans. The general criteria say that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period and any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences. 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'. No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

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

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

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

(b) Reliable estimate of the obligation can be made.

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

14.5 Post Employment Benefits: Defined Contribution vs Defined Benefits

The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans. **Defined contribution plans** are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further` contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefits plans, the actuarial and investment risk fall on the employer.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

14.6 Is the Gratuity Scheme a Defined Contribution or Defined Benefit Scheme?

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

(a) pay the employee benefits directly when they fall due;

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

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

14.7 Other Long Term Employee Benefits

Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

14.8 Termination Benefits

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

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

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

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

14.9 Accounting Treatment

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

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

(b) *minus* any past service cost not yet recognized;

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

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

(i) the amount so determined; and

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

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

(a) current service cost;

(b) interest cost;

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

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

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

(f) the effect of any curtailments or settlements; and

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

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

14.10 Disclosures

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

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

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

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

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

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. Revised AS 15 (2005) requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

As per the transitional provision of revised AS 15, as regards VRS as paid upto 31 March, 2009, there is a choice to defer it over pay-back period, subject to prohibition on carry forward to periods commencing on or after 1 April, 2010.

14.11 Actuarial Assumptions

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

AS 15 explains that actuarial assumptions comprise:

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

    (i) mortality, both during and after employment;

    (ii) rates of employee turnover, disability and early retirement;

    (iii) the proportion of plan members with dependents who will be eligible for benefits;

    (iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

  (i) the discount rate

  (ii) future salary and benefit levels

  (iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and

  (iv) the expected rate of return on plan assets.

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

14.12 Actuarial Gains and Losses

Actuarial gains and losses comprise:

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

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. While this is the general principle, as per AS 15, in case an enterprise adopts the option to defer the recognition of any subsequent actuarial gains is limited to excess of cumulative (unrecognized gains) over the unrecognized portion of increase in transitional liability.

Illustration 1

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

Solution

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

As on 1st April, 2016 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 2016 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 2017 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 2016-2017 were ₹ 600.

On 1st April, 2016, the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	*9.25*
Realised and unrealised gains on plan assets (after tax)	*2.00*
Fund administrative costs	*(1.00)*
Expected Rate of Return	*10.25*

You are required to find the expected and actual returns on plan assets.

Solution

Computation of Expected and Actual Returns on Plan Assets

		₹
Return on ₹ 1,00,000 held for 12 months at 10.25%		10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)		1,500
Expected return on plan assets for 2016-2017		11,750
Fair value of plan assets as on 31 March, 2017		1,50,000
Less: Fair value of plan assets as on 1 April,2016	1,00,000	
Contributions received	49,000	(1,49,000)
		1,000
Add: Benefits paid		19,000
Actual return on plan assets		20,000

Alternatively, the above question may be solved without giving compound effect torate of return**.**

Illustration 3

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

(a) Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.

(b) The fair value of plan assets on the date is estimated at ₹ 5,100.

(c) The unamortized past service cost is ₹ 180.

(d) Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Solution

Gain from curtailment is estimated as under:

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

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

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

Illustration 4

An employee Roshan has joined a company XYZ Ltd. in the year 2016. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution

Calculation of Defined Benefit Obligation

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

= ₹ 24,00,000

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

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

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

Calculation of Interest Cost to be charged per year

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

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

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

UNIT15 : AS 16: BORROWING COSTS

15.1 Introduction

The standard prescribes the accounting treatment for borrowing costs (i.e. interest and other costs) incurred by an enterprise in connection with the borrowing of funds. Borrowing costs are required to be capitalized as part of a qualifying asset (an asset that takes a substantial period of time to get ready for its intended use), if it is directly attributable towards its acquisition, construction or production. Upon such capitalization, the carrying amount of assets should be assessed as to whether it is greater than its recoverable amount or net realizable value and adjustments are required to be made in accordance with other standards. The amount of borrowing costs eligible for capitalization should be determined in accordance with AS 16 and other borrowing costs (not eligible for capitalization) should be recognized as expenses in the period in which they are incurred. This Standard came into effect in respect of accounting periods commenced on or after 1-4-2000 and is mandatory in nature. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

15.2 Borrowing Costs

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

Borrowing costs may include:

a. Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

b. Amortisation of any discounts or premiums relating to borrowings;

c. Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

d. Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

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

An enterprise should not apply AS 16 to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis over a short period of time, since such inventories are not qualifying assets.

15.3 Qualifying Asset

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

15.4 Substantial Period

The issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

Depending on the circumstances, any of the following may be qualifying assets.

- inventories that take a substantial amount of time to bring them to a saleable condition For example, liquor is often required to be kept in store for more than twelve months for maturing;
- investments properties;
- manufacturing plants; and
- power generation facilities.

The following are not qualifying assets:

- assets that are ready for their intended use or sale when acquired; and
- inventories that are routinely manufactured, or otherwise produced in large quantities on a repetitive basis, over a short period of time.

15.5 Borrowing Costs Eligible for Capitalisation

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided.To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

15.6 Exchange Differences on Foreign Currency Borrowings

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, 'The Effect of Changes in Foreign Exchange Rates'. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 2X16, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 2X16, the exchange rate between the currencies was ₹ 45 per USD. The exchange rate, as at March 31, 2X17, is ₹ 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 2X16. Calculate the borrowing cost to be capitalized as per AS 16.

Solution

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = USD 10,000 x 5% x ₹ 48/USD = ₹ 24,000

(ii) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = ₹ 30,000

(iii) Interest that would have resulted if the loan was taken in Indian currency

= USD 10,000 x 45 x 11% = ₹ 49,500

(iv) Difference between interest on local currency borrowing and foreign currency borrowing

= ₹ 49,500 – ₹ 24,000 = ₹ 25,500

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500.

Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., ₹ 34,500 (₹ 58,500 – ₹ 24,000)) is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11'The Effects of Changes in Foreign Exchange Rates'.

15.7 Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

15.8 Commencement of Capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following these conditions are satisfied:

a. *Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:* Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. *Borrowing costs are being incurred.*

c. *Activities that are necessary to prepare the asset for its intended use or sale are in progress:* The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

15.9 Suspension of Capitalisation

Capitalisation of borrowing costs should generally continue as long as the three conditions listed above are met. If, however, the enterprise suspends activities related to development for an extended period, capitalisation of borrowing costs should also cease unit such time as activities are resumed.

However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

15.10 Cessation of Capitalisation

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

15.11 Disclosure

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

b. The amount of borrowing costs capitalised during the period.

15.12 Illustrations

Illustration 1

Particulars	*Amount (₹)*
Expenditure incurred till 31-03-2016	*7,00,000*
Interest cost capitalized for the financial year 2015-2016	*30,000*
Amount borrowed till 31-03-2016 @ 15%	*4,00,000*
Amount transferred to construction during 2016-2017	*2,00,000*
Cash payment during 2016-2017 out of the above	*1,00,000*
Progress payment received	*5,00,000*
New borrowing during 2016-2017 @ 15%	*3,00,000*

Calculate the amount of borrowing to be capitalized.

Solution

Total Borrowing Cost = 7,00,000 X 0.15 = ₹ 1,05,000

Particulars	*Amount (₹)*
Expenditure incurred including previously capitalized borrowing cost	7,30,000
Cash payment during 2016-2017 out of amount transferred	1,00,000
Remaining amount transferred during 2016-2017	1,00,000

	9,30,000
Less: Progress payment received and recognized (certified)	5,00,000
Uncertified construction cost (not yet recognized)	4,30,000

Total Money borrowed including previously capitalized interest cost = ₹ 7,30,000

Borrowing cost to be capitalized = 4,30,000/7,30,000 x 1,05,000 = ₹ 61,849.32

Illustration 2

PRM Ltd. obtained a loan from a bank for ₹ 50 lakhs on 30-04-2016. It was utilized as follows:

Particulars	*Amount (₹ in lakhs)*
Construction of a shed	*50*
Purchase of a machinery	*40*
Working Capital	*20*
Advance for purchase of truck	*10*

Construction of shed was completed in March 2017. The machinery was installed on the same date. Delivery truck was not received. Total interest charged by the bank for the year ending 31-03-2017 was ₹ 18 lakhs. Show the treatment of interest.

Solution

Qualifying Asset as per AS 16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalized = 18 x 50/120 =₹ 7.5 lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs

= ₹ 10.5 lakhs

Illustration 3

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 2017 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 2016-2017 on the entire Institutional Term Loan of ₹ 580 lakhs.

Solution

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of qualifying asset.

A qualifying asset is an asset that necessary takes a substantial period of time* to get ready for its intended use or sale.

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

Purpose	*Nature*	*Interest to be capitalised*	*Interest to be charged to profit and loss account*
		₹ in lakhs	*₹ in lakhs*
Modernisation and renovation of plant and machinery	Qualifying asset	** $52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	** $52.20 \times \frac{58}{580} = 5.22$	
Working Capital	Not a qualifying asset		$52.20 \times \frac{116}{580} = 10.44$
		41.76	10.44

* A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

** It is assumed in the above solution that the modernization and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognized as expense in the profit and loss account for year ended 31st March, 2017.

Illustration 4

The notes to accounts of X Ltd. for the year 2016-2017 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 ₹ 1,80,80,000 has been capitalized during the year, which includes approximately ₹ 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.

Solution

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. ₹ 1,70,33,465. Thus, there is an excess capitalisation of ₹ 10,46,535. This has resulted in overstatement of profits by ₹ 10,46,535 and amount of fixed assets has also gone up by this amount.

Illustration 5

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

	Plan ₹	Actual ₹
April, 2017	*2,00,000*	*2,00,000*
May, 2017	*2,00,000*	*3,00,000*
June, 2017	*10,00,000*	*–*
July, 2017	*1,00,000*	*–*
August, 2017	*2,00,000*	*1,00,000*
September, 2017	*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 ₹ 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over ₹ 10 lakhs from 1.9.2017. 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.

Solution

XYZ Ltd.

Month	*Actual Expenditure*	*Interest Capitalised*	*Cumulative Amount*	
	₹	₹	₹	
April, 2017	2,00,000	2,000	2,02,000	
May, 2017	3,00,000	5,020	5,07,020	
June, 2017	–	5,070	5,12,090	Note 2
July, 2017	–	5,120	5,17,210	
August, 2017	1,00,000	–	6,17,210	Note 3
September, 2017	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 ₹ 10 lakhs only. Hence, only ₹ 10,000 interest has been capitalised even though actual expenditure exceeds ₹ 10 lakhs.

Alternatively, interest may be charged on total amount of (₹ 6,17,210 + ₹ 7,00,000 = ₹ 13,17,210) for the month of September, 2017 as it is given in the question that overdraft was over ₹ 10 lakhs from 1.9.2017 and not exactly ₹ 10 lakhs. In that case, interest amount ₹ 13,172 will be capitalised for the month of September.

Illustration 6

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2016-2017. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs. As on 31st March, 2017, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

Solution

As per para 9 of AS 13 "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 2017.

<u>Reference</u>: The students are advised to refer the full text of AS 16 "Borrowing Costs" (issued 2000).

UNIT 16 : AS 17: SEGMENT REPORTING

16.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1.4.2001 and is mandatory in nature, from that date, in respect of the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The information is expected to help users of financial statements, to better understand the performance and assess the risks and returns of the enterprise and make more informed judgements about the enterprise as a whole. The standard is more relevant for assessing risks and returns of a diversified or multi-locational enterprise which may not be determinable from the aggregated data.

16.2 Objective

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

(a) Better understand the performance of the enterprise;

(b) Better assess the risks and returns of the enterprise; and

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

16.3 Scope

An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Statement to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.

16.4 Definition of the terms used in the Accounting Standard

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

a. The nature of the products or services.

b. The nature of the production processes.

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

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

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

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

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

a. Similarity of economic and political conditions.

b. Relationships between operations in different geographical areas.

c. Proximity of operations.

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

e. Exchange control regulations and

f. The underlying currency risks.

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

The risks and returns of an enterprise are influenced both by the geographical location of its operations and also by the location of its customers. The definition allows geographical segments to be based on either:

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

b. The location of its customers.

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

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

Segment revenue is the aggregate of

(i) The portion of enterprise revenue that is directly attributable to a segment,

(ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

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

Segment revenue does not include:

a. Extraordinary items as defined in AS 5.

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

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

Segment expense is the aggregate of

(i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,

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

Segment expense does not include:

a. Extraordinary items as defined in AS 5.

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

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

d. Income tax expense; and

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

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

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

Segment assets do not include:

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

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

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

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

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

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

Segment liabilities do not include:

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

16.5 Treatment of Interest for determining Segment Expense

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

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

16.6 Allocation

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

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Statement. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

16.7 Primary and Secondary Segment Reporting Formats

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided paragraphs below:

a. If risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach', then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting forma; and

b. If internal organisational and management structure of an enterprise are based neither on individual products or services or groups of related products/services nor on geographical areas, it should be determined whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and accordingly, choose segments.

16.8 Matrix Presentation

A 'matrix presentation' both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Statement does not require, but does not prohibit, a 'matrix presentation'.

16.9 Business and Geographical Segments

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered for:

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

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

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

16.10 Identifying Reportable Segments (Quantitative Thresholds)

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

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

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

   (i) The combined result of all segments in profit, or

   (ii) The combined result of all segments in loss,

   (iii) Whichever is greater in absolute amount; or

c. Its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

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

A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 percent thresholds.

If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

16.11 Segment Accounting Policies

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. This Statement does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

16.12 Primary Reporting Format

An enterprise should disclose the following for each reportable segment:

a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

b. Segment result;

c. Total carrying amount of segment assets;

d. Total amount of segment liabilities;

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

f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

AS 3, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

16.13 Secondary Segment Information

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

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

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

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

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

a. Segment revenue from external customers;

b. The total carrying amount of segment assets; and

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

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

a. The total carrying amount of segment assets by geographical location of the assets.

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

16.14 Disclosures

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

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

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

Example could be:

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

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

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

Illustration 1

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

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

Solution

Diversifiers Ltd.
Segmental Report

(₹ '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

	Home Sales	*Export Sales (by forging shop division)*	*Export to Rwanda*	*Export to Maldives*	*(₹ '000)* *Consolidated Total*
External sales	90	6,135	300	270	6,795

Illustration 2

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Answer

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz-'Automobile batteries' and 'batteries for Invertors and UPS'.

<u>Reference</u>: The students are advised to refer the full text of AS 17 "Segment Reporting".

UNIT 17 : AS 18: RELATED PARTY DISCLOSURES

17.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1-4-2001 and is mandatory in nature. The standard prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company. Since the standard is more subjective, particularly with respect to identification of related parties [though provisions related to related party concept are given under sections 297 / 299 / 301 of the Companies Act, 1956* and Section 40A (2)(b) of the Income Tax Act, 1961], obtaining corroborative evidence becomes very difficult for the auditors. Thus, successful implementation of AS 18 is dependent upon how transparent the management is and how vigilant the auditors are.

17.2 Objective

The objective of this Standard is to establish requirements for disclosure of:

(a) Related party relationships and

(b) Transactions between a reporting enterprise and its related parties.

17.3 Scope

AS 18 should be applied:

- In reporting related party relationships and transactions between a reporting enterprise and its related parties.
- Only to the related party relationships described in (a) to (e) below.
- To the financial statements of each reporting enterprise as also to consolidate financial statements presented by a holding company.

This Standard deals only with related party relationships described in (a) to (e) below:

a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

* Now sections 188 / 184 / 189 of the Companies Act, 2013 respectively.

d. Key management personnel and relatives of such personnel and

e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

17.4 Definitions of the Terms used in the Accounting Standard

In the context of this Statement, the following are deemed not to be related parties:

a. Two companies simply because they have a director in common, notwithstanding paragraph (d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings).

b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and

c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

   (i) Providers of finance.

   (ii) Trade unions.

   (iii) Public utilities.

   (iv) Government departments and government agencies including government sponsored bodies.

Related party disclosure requirements as laid down in this Statement do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Related party transaction: A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Related party: Parties are consider to be related, if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Illustration 1

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

Solution

A Ltd., B Ltd. & O Ltd. are related to each other. Z Ltd. & O Ltd. are related to each other by virtue of Associate relationship. However, neither A Ltd. nor B Ltd. is related to Z Ltd. and vice versa.

Control: (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of this Statement, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of that company/enterprise. An enterprise is deemed to have the power to appoint, if any of the following conditions is satisfied:

(a) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid or

(b) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise or

(c) The director/member is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise/individual is considered to have a **substantial interest** in another enterprise if that enterprise or individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise.

An Associate: An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

Significant influence: Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

It may be exercised in several ways, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information.

Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case, vice versa. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

Key management personnel: Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of this standard should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the other categories.

Relative: In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Joint Venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

Joint Control– the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

Holding Company– a company having one or more subsidiaries.

Subsidiary - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

Fellow subsidiary– a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

17.5 The Related Party Issue

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties.

The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

As per the Guidance Note on 'Remuneration paid to Key Management Personnel - Whether a Related Party Transaction', remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

17.6 Disclosure

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

This is to enable users of financial statements to form a view about the effects of related party relationships on the enterprise.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) The name of the transacting related party;

(ii) A description of the relationship between the parties;

(iii) A description of the nature of transactions;

(iv) Volume of the transactions either as an amount or as an appropriate proportion;

(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

(viii) Items of a similar nature may be disclosed in aggregate by type of related party.

17.7 Miscellaneous Illustrations

Illustration 2

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2017. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

Solution

As per paragraph 13 of AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

Illustration 3

Mr. Raj a relative of key management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2016 to 30.6.2016. On 1.7.2016, he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2017 for the purposes of AS 18?

Solution

According to para 10 of AS 18 on Related Party Disclosures, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as relative as at the closing date i.e. on 31.3.2017.

Illustration 4

X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2017. After that, the related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

Solution

As per para 23 of AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2017 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.

Reference: The students are advised to refer the full text of AS 18 "Related Party Disclosures".

UNIT 18 : AS 19 : LEASES

18.1 Introduction

This Standard came into effect in respect of all assets leased during accounting periods commenced on or after 1.4.2001 and is mandatory in nature. AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lessor and lessee. The classification of leases adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor and the lessee.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership.

An operating lease is a lease other than finance lease.

At the inception of the lease, assets under finance lease are capitalized in the books of lessee with corresponding liability for lease obligations as against the operating lease, wherein lease payments are recognized as an expense in profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The lessor should recognise receivable at an amount equal to net investment in the lease in case of finance lease, whereas under operating lease, the lessor will present the leased asset under fixed assets in his balance sheet besides recognizing the lease income on a systematic basis (i.e. straight line) over the lease term. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 10.

18.2 Scope

This Standard is applied in accounting for all leases other than:

a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights and

b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights and

c. Lease agreements to use lands.

AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles and computers.

On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

18.3 Definition of the Terms used under AS 19

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

A non-cancellable lease is a lease that is cancellable only:

a. Upon the occurrence of some remote contingency or

b. With the permission of the lessor or

c. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor;

d. Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

a. In the case of the lessee, any residual value guaranteed by or on behalf of the lessee or

b. In the case of the lessor, any residual value guaranteed to the lessor:

   (i) By or on behalf of the lessee or

   (ii) By an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Mr. X took mine on lease from Mr. Y on the terms that he would pay ₹ 10,000 or ₹ 10 per ton extracted during the year, whichever is less. ₹ 10 per ton been contingent cannot be included in minimum lease payment calculation.

Economic life is either:

a. The period over which an asset is expected to be economically usable by one or more users;

b. The number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

a. The period over which the leased asset is expected to be used by the lessee or

b. The number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed residual value is:

a. In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable) and

b. In the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

We can say that:

Residual Value of the Assets = Guaranteed Residual Value + Unguaranteed Residual Value

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:

a. The gross investment in the lease and

b. The present value of

   (i) The minimum lease payments under a finance lease from the standpoint of the lessor and

   (ii) Any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

a. The minimum lease payments under a finance lease from the standpoint of the lessor and

b. Any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices and market rates of interest).

18.4 Classification of Leases

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which individually or in combination would normally lead to a lease being classified as a finance lease are:

a. The lease transfers ownership of the asset to the lessee by the end of the lease term.

b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

c. The lease term is for the major part of the economic life of the asset even if title is not transferred.

d. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset or

e. The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Other indicators that, individually or in combination, could also lead to a lease being classified as a finance lease are:

a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee and

c. The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease after inception, other than by renewing the lease, in a manner that would have resulted in a different classification, had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates or changes in circumstances, however, do not give rise to a new classification of a lease for accounting purposes.

18.5 Leases in the Financial Statements of Lessees

18.5.1 Finance Leases:

Both the leased asset and the related lease obligation (liability) should be recorded in the balance sheet at the inception of a finance lease.

Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

In the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

Initial direct costs are often incurred in connection with specific leasing activities, eg in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the finance lease to the extent that they can be directly attributed to the activities performed by the lessee for a finance lease.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability.

The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

18.5.2 Operating Leases

Rentals payable under an operating lease should be charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not made on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit. For example, where the rental payments for an asset are based on the actual usage of that asset, or are revised periodically to reflect the efficiency of the asset or current market rates, the rentals actually payable may be an appropriate measure.

18.5.3 Disclosure Requirements

Lessees are required to make the following disclosures for F**inance leases:**

- Assets acquired under finance lease as segregated from assets owned;
- For each class of assets, the net carrying amount at the balance sheet date;
- A reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value; (SMC are exempt from this disclosure requirement)
- The total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
  - Not later than one year;
  - Later than one year and not later than five years; and
  - Later than five years;

  (SMCs are exempt from this disclosure requirement)
- Contingent rents recognized as an expense in the period;
- The total of future minimum sublease payments expected to be received under non-cancellable sub-leases at the balance sheet date (SMCs are exempt from this disclosure requirement); and
- A general description of the lessee's material leasing arrangements including, but not limited to, the following:
  - The basis on which contingent rents are determined;
  - The existence and terms of renewal or purchase options and escalation clauses; and
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

(SMCs are exempt from this disclosure requirement)

Note that in addition to the above the disclosure requirements of AS 10 apply equally to assets held under finance leases.

Operating leases:

a. The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

   (i) Not later than one year;

   (ii) Later than one year and not later than five years;

(iii) Later than five years;

b. The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

c. Lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

d. Sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

e. A general description of the lessee's significant leasing arrangements including, but not limited to, the following:

   (i) The basis on which contingent rent payments are determined;

   (ii) The existence and terms of renewal or purchase options and escalation clauses; and

   (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

18.6 Leases in the Financial Statements of Lessors

18.6.1 Finance Lease

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable and sales in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. The transaction is recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded is the present value so computed. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

a. The profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;

b. The finance income over the lease term.

Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged and balance will be adjusted with the finance income over the lease term.

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

18.6.2 Disclosure

The lessor should make the following disclosures for finance leases:

a. Reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
   (i) Not later than one year;
   (ii) Later than one year and not later than five years;
   (iii) Later than five years;
b. Unearned finance income;
c. The unguaranteed residual values accruing to the benefit of the lessor;
d. The accumulated provision for uncollectible minimum lease payments receivable;
e. Contingent rents recognised in the statement of profit and loss for the period;
f. A general description of the significant leasing arrangements of the lessor; and
g. Accounting policy adopted in respect of initial direct costs.

Illustration 1 (finance lease)

'A' leased a machine from 'B' on the following terms:

a. The ownership of the machine will be transferred to 'A' on expiry of the lease period at ₹ 8,900.

b. Installation cost of the machine ₹ 5,000.

c. The cost of the machine is ₹ 1,09,240.

d. Lease agreement is signed for 5 years.

e. Minimum Lease Payment is ₹ 28,000 p.a.

f. First installment is Payable on 01.04.2017.

g. Depreciation is charged @ 25% p.a. on WDV.

You are required to show the complete chart of principle amount and implicit rate of interest for 5 years and also the journal entries in the books of 'A and B' for the period 01.04.2017 to 31.03.2019.

Solution

First calculate the implicit rate of return, i.e. the rate of Present Value at which the PV of Minimum Lease Payment equals to Market Price of the Assets on the date of lease agreement.

Lease Payment	*Present Value Factor @ 12%*	*Present Value of Lease Payment*	*Present Value Factor @ 14%*	*Present Value of Lease Payment*
(a)	*(b)*	*(c= a x b)*	*(d)*	*(e = a x d)*
28,000	1	28,000	1	28,000
28,000	0.893	25,000	0.877	24,561
28,000	0.797	22,321	0.769	21,545
28,000	0.712	19,930	0.675	18,899
28,000	0.636	17,795	0.592	16,578
8,900	0.567	5,050	0.519	4,622
		118,096		114,206

Installment	*Opening Balance*	*Interest Amount*	*Principle Amount*	*Closing Balance*
	(a)			
1	114,240	-	28,000	86,240
2	86,240	12,074	15,926	70,314
3	70,314	9,844	18,156	52,158
4	52,158	7,302	20,698	31,460
5	31,460	4,404	23,596	7,864
	7,864	1,036	7,864	(0)

Journal Entries

In the Books of Mr. A				*In the Books of Mr. B*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
Purchase of Machine on Lease:						
2017						
01-April	Machine on Lease A/c Dr.	114,240		Mr. A A/c Dr.	1,14,240	
	To Mr. B A/c		1,14,240	To Lease Sales A/c		1,14,240
Payment of First Installment:						
	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000

Interest due for the First Year @ 14% p.a.:						
2015						
31-March	Interest A/c Dr.	12,074		Mr. A A/c Dr.	12,074	
	To Mr. B A/c		12,074	To Interest A/c		12,074
Charging Depreciation:						
	Depreciation A/c Dr.	28,560				
	To Machine A/c		28,560			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	40,634		Interest A/c Dr.	12,074	
	To Interest A/c		12,074	To Profit & Loss A/c		12,074
	To Depreciation A/c		28,560			
Payment of Second Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Second Year @ 14% p.a.:						
2016						
31-March	Interest A/c Dr.	9,844		Mr. A A/c Dr.	9,844	
	To Mr. B A/c		9,844	To Interest A/c		9,844
Charging Depreciation:						
	Depreciation A/c Dr.	21,420				
	To Machine A/c		21,420			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	31,264		Interest A/c Dr.	9,844	
	To Interest A/c		9,844	To Profit & Loss A/c		9,844
	To Depreciation A/c		21,420			
Payment of Third Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Third Year @ 14% p.a.:						
2017						
31-March	Interest A/c Dr.	7,302		Mr. A A/c Dr.	7,302	
	To Mr. B A/c		7,302	To Interest A/c		7,302
Charging Depreciation:						
	Depreciation A/c Dr.	16,065				

	To Machine A/c		16,065			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	23,367		Interest A/c Dr.	7,302	
	To Interest A/c		7,302	To Profit & Loss A/c		7,302
	To Depreciation A/c		16,065			
Payment of Fourth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Fourth Year @ 14% p.a.:						
2018						
31-March	Interest A/c Dr.	4,404		Mr. A A/c Dr.	4,404	
	To Mr. B A/c		4,404	To Interest A/c		4,404
Charging Depreciation:						
	Depreciation A/c Dr.	12,049				
	To Machine A/c		12,049			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	16,453		Interest A/c Dr.	4,404	
	To Interest A/c		4,404	To Profit & Loss A/c		4,404
	To Depreciation A/c		12,049			
Payment of Fifth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Last Year @ 14% p.a.:						
2019						
31-March	Interest A/c Dr.	1,036		Mr. A A/c Dr.	1,036	
	To Mr. B A/c		1,036	To Interest A/c		1,036
Charging Depreciation:						
	Depreciation A/c Dr.	9,037				
	To Machine A/c		9,037			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	10,073		Interest A/c Dr.	1,036	
	To Interest A/c		1,036	To Profit & Loss A/c		1,036
	To Depreciation A/c		9,037			
Purchase of Asset on expiry of Lease Term:						
	Mr. B A/c Dr.	8,900		Bank A/c Dr.	8,900	
	To Bank A/c		8,900	To Mr. A A/c		8,900

18.6.3 Operating Leases

The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

Lease income should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Initial direct costs incurred are either deferred and allocated to income over the lease term in proportion to the recognition of rent income or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. For charging depreciation and impairment of assets, relevant Accounting Standards should be followed.

18.6.4 Disclosures

a. For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
   (i) The depreciation recognised in the statement of profit and loss for the period;
   (ii) Impairment losses recognised in the statement of profit and loss for the period;
   (iii) Impairment losses reversed in the statement of profit and loss for the period;
b. The future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
   (i) Not later than one year;
   (ii) Later than one year and not later than five years;
   (iii) Later than five years;
c. Total contingent rents recognised as income in the statement of profit and loss for the period;
d. A general description of the lessor's significant leasing arrangements; and
e. Accounting policy adopted in respect of initial direct costs.

Illustration 2 (Operating lease)

Geeta purchased a computer for ₹ 44,000 and leased out it to Sita for four years on leases basis, after the lease period, value of the computer was estimated to be ₹ 3,000; which she realised after selling it in the second hand market. Lease amount payable at the beginning of each year is ₹ 22,000; ₹ 13,640; ₹ 6,820 &₹ 3,410. Depreciation was charged @ 40% p.a. You are required to pass the necessary journal entries in the books of both Geeta and Sita.

Solution

In the Books of Geeta				*In the Books of Sita*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
Purchase of computers:						
1st	Computer A/c Dr.	44,000				

	To Bank A/c		44,000			
Payment of first year's lease:						
	Bank A/c Dr.	22,000		Lease Rent Paid A/c Dr.	22,000	
	To Lease Rent A/c		22,000	To Bank A/c		22,000
Depreciation for first year:						
	Depreciation A/c Dr.	17,600				
	To Machine A/c		17,600			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	17,600		Profit & Loss A/c Dr.	22,000	
	To Depreciation A/c		17,600	To Lease Rent Paid A/c		22,000
	Lease Rent A/c Dr.	22,000				
	To Profit & Loss A/c		22,000			
Payment of second year's lease:						
2nd	Bank A/c Dr.	13,640		Lease Rent Paid A/c Dr.	13,640	
	To Lease Rent A/c		13,640	To Bank A/c		13,640
Depreciation for second year:						
	Depreciation A/c Dr.	10,560				
	To Machine A/c		10,560			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	10,560		Profit & Loss A/c Dr.	13,640	
	To Depreciation A/c		10,560	To Lease Rent Paid A/c		13,640
	Lease Rent A/c Dr.	13,640				
	To Profit & Loss A/c		13,640			
Payment of third year's lease:						
3rd	Bank A/c Dr.	6,820		Lease Rent Paid A/c Dr.	6,820	
	To Lease Rent A/c		6,820	To Bank A/c		6,820
Depreciation for third year:						
	Depreciation A/c Dr.	6,336				
	To Machine A/c		6,336			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	6,336		Profit & Loss A/c Dr.	6,820	
	To Depreciation A/c		6,336	To Lease Rent Paid A/c		6,820
	Lease Rent A/c Dr.	6,820				
	To Profit & Loss A/c		6,820			

Payment of fourth year's lease:						
4th	Bank A/c Dr.	3,410		Lease Rent Paid A/c. Dr.	3,410	
	To Lease Rent A/c		3,410	To Bank A/c		3,410
Depreciation for fourth year:						
	Depreciation A/c Dr.	3,802				
	To Machine A/c		3,802			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	3,802		Profit & Loss A/c Dr.	3,410	
	To Depreciation A/c		3,802	To Lease Rent Paid A/c		3,410
	Lease Rent A/c Dr.	3,410				
	To Profit & Loss A/c		3,410			
Sale of lease asset:						
	Bank Account Dr.	3,000				
	Loss on Sale A/c Dr.	2,702				
	To Computer A/c		5,702			

18.7 Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Illustration 3

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹ 50 lakhs is equal to fair value.

(b) Fair value is ₹ 60 lakhs.

(c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.

(d) Fair value is ₹ 40 lakhs and sale price is ₹50 lakhs.

(e) Fair value is ₹46 lakhs and sale price is ₹ 50 lakhs

(f) Fair value is ₹35 lakhs and sale price is ₹39 lakhs.

Solution

Following will be the treatment in the given cases:

(a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognize the profit of ₹10 lakhs (i.e. 50 – 40) in its books.

(b) When fair value is ₹ 60 lakhs then also profit of ₹10 lakhs should be immediately recognized by A Ltd.

(c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognized by A Ltd. in its books provided loss is not compensated by future lease payment.

(d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortized over the lease period.

(e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognized in its books and balance profit of ₹4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognized by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period

18.8 Miscellaneous Illustrations

Illustration 4

A Ltd. leased a machinery to B Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machinery	*20.00*
Lease term	*5 years*
Lease Rental per annum	*5.00*
Guaranteed Residual value	*1.00*
Expected Residual value	*2.00*
Internal Rate of Return	*15%*

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Solution

Computation of Unearned Finance Income

As per AS 19 on Leases, ***unearned finance income*** is the difference between (a) the ***gross investment*** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

where:

(a) ***Gross investment*** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

=(Total lease rent + Guaranteed residual value) + Unguaranteed residual value

= [(₹ 5,00,000 × 5 years) + ₹ 1,00,000] + ₹ 1,00,000

= ₹ 27,00,000

(b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV)

Year	*MLP inclusive of URV*	*Internal rate of return (Discount factor 15%)*	*Present Value*	
	₹		₹	
1	5,00,000	.8696	4,34,800	
2	5,00,000	.7561	3,78,050	
3	5,00,000	.6575	3,28,750	
4	5,00,000	.5718	2,85,900	
5	5,00,000	.4972	2,48,600	
	1,00,000	.4972	49,720	
	(guaranteed residual value)			
			17,25,820	(i)
	1,00,000	.4972	49,720	(ii)
	(unguaranteed residual value)			
		(i) + (ii)	17,75,540	(b)

Unearned Finance Income = (a) – (b)

= ₹ 27,00,000–₹ 17,75,540 = ₹ 9,24,460

Journal Entries in the books of B Ltd.

	₹	₹
At the inception of lease		

Machinery account	Dr.	17,25,820*	
To A Ltd.'s account			17,25,820*
(Being lease of machinery recorded at present value of MLP)			
At the end of the first year of lease			
Finance charges account (Refer Working Note)	Dr.	2,58,873	
To A Ltd.'s account			2,58,873
(Being the finance charges for first year due)			
A Ltd.'s account	Dr.	5,00,000	
To Bank account			5,00,000
(Being the lease rent paid to the lessor which includes outstanding liability of ₹ 2,41,127 and finance charge of ₹ 2,58,873)			
Depreciation account	Dr.	1,72,582	
To Machinery account			1,72,582
(Being the depreciation provided @ 10% p.a. on straight line method)			
Profit and loss account	Dr.	4,31,455	
To Depreciation account			1,72,582
To Finance charges account			2,58,873
(Being the depreciation and finance charges transferred to profit and loss account)			

Working Note:

Table showing apportionment of lease payments by B Ltd. between the finance charges and the reduction of outstanding liability.

Year	*Outstanding liability (opening balance)* ₹	*Lease rent* ₹	*Finance charge* ₹	*Reduction in outstanding liability* ₹	*Outstanding liability (closing balance)* ₹
1	17,25,820	5,00,000	2,58,873	2,41,127	14,84,693

*As per para 11 of AS 19, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 20,00,000 is more than the present value amounting ₹ 17,25,820, the machinery has been recorded at ₹ 17,25,820 in the books of B Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

2	14,84,693	5,00,000	2,22,704	2,77,296	12,07,397
3	12,07,397	5,00,000	1,81,110	3,18,890	8,88,507
4	8,88,507	5,00,000	1,33,276	3,66,724	5,21,783
5	5,21,783	5,00,000	78,267	5,21,783	1,00,050*
			8,74,230	17,25,820	

*The difference between this figure and guaranteed residual value (₹ 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

Illustration 5

Global Ltd. has initiated a lease for three years in respect of an equipment costing ₹ 1,50,000 with expected useful life of 4 years. The asset would revert to Global Limited under the lease agreement. The other information available in respect of lease agreement is:

(i) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 20,000.

(ii) The implicit rate of interest is 10%.

(iii) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd.

(i) The annual lease payment.

(ii) The unearned finance income.

(iii) The segregation of finance income, and also,

(iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

Solution

(i) Calculation of Annual Lease Payment*

	₹
Cost of the equipment	1,50,000
Unguaranteed Residual Value	20,000
PV of residual value for 3 years @ 10% (₹ 20,000 x 0.751)	15,020
Fair value to be recovered from Lease Payment(₹ 1,50,000 – ₹ 15,020)	1,34,980
PV Factor for 3 years @ 10%	2.487
Annual Lease Payment (₹ 1,34,980 / PV Factor for 3 years @ 10% i.e. 2.487)	54,275

*Annual lease payments are considered to be made at the end of each accounting year.

(ii) Unearned Financial Income

Total lease payments [₹ 54,275 x 3]	1,62,825
Add: Residual value	20,000
Gross Investments	1,82,825
Less: Present value of Investments (₹ 1,34,980 + ₹ 15,020)	1,50,000
Unearned Financial Income	32,825

(iii) Segregation of Finance Income

Year	*Lease Rentals* ₹	*Finance Charges @10% on outstanding amount of the year* ₹	*Repayment* ₹	*Outstanding Amount* ₹
0	-	-	-	1,50,000
I	54,275	15,000	39,275	1,10,725
II	54,275	11,073	43,202	67,523
III	74,275**	6,752	67,523	--
	1,82,825	32,825	1,50,000	

(iv) Profit and Loss Account (Relevant Extracts)

Credit side		₹
I Year	By Finance Income	15,000
II year	By Finance Income	11,073
III year	By Finance Income	6,752

Balance Sheet (Relevant Extracts)

Assets side	₹	₹
I year Lease Receivable	1,50,000	
Less: Amount Received	39,275	1,10,725
II year Lease Receivable	1,10,725	
Less: Received	(43,202)	67,523
III year :Lease Amount Receivable	67,523	
Less: Amount received	(47,523)	
Residual value	(20,000)	NIL

Notes to Balance Sheet

Year 1	₹
Minimum Lease Payments (54,275 + 54,275)	1,08,550
Residual Value	20,000
	1,28,550
Unearned Finance Income(11,073+ 6,752)	(17,825)

**₹ 74,275 include unguaranteed residual value of equipment amounting ₹ 20,000.

Lease Receivables	1,10,725
Classification:	
Not later than 1 year	43,202
Later than 1 year but not more than 5 years	67,523
Total	1,10,725
Year II:	
Minimum Lease Payments	54,275
Residual Value (Estimated)	20,000
	74,275
Unearned Finance Income	(6,752)
Lease Receivables (not later than 1 year)	67,523
III Year:	
Lease Receivables (including residual value)	67,523
Amount Received	67,523
	NIL

Reference: The students are advised to refer the full text of AS 19 "Leases").

UNIT 19 : AS 20: EARNINGS PER SHARE

19.1 Introduction

AS 20 came into effect in respect of accounting period commenced on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

Every company, which is required to give information under Schedule III to the Companies Act, 2013, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

19.2 Definition of the terms used in the Accounting Standard

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

For this purpose, a financial asset is any asset that is

a. Cash;

b. A contractual right to receive cash or another financial asset from another enterprise;

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

19.3 Basic Earnings per Share

Basic earnings per share is calculated as

$$\frac{\text{Net profit (loss) attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

The calculation is based on all shares outstanding during the period. Whether or not a particular class or tranche of shares ranked for dividends in respect of the period is irrelevant (except in the case of partly paid shares).

The time-weighting factor is:

$$\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}$$

Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

Depending on the relative size of share movements, this might, for example, be based on the number of months for which shares were outstanding.

Illustration 1

Date	*Particulars*	*Purchased*	*Sold*	*Balance*
1st January	*Balance at beginning of year*	*1,800*	*-*	*1,800*
31st May	*Issue of shares for cash*	*600*	*-*	*2,400*
1st November	*Buy Back of shares*	*-*	*300*	*2,100*

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an **amalgamation in the nature of purchase** are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued as part of the consideration in an **amalgamation in the nature of merger** are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Where an enterprise has equity shares of **different nominal values** but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of shares).

In case of a **bonus issue or a share split,** equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 2

Date	*Particulars*	*No. of Share*	*Face Value*	*Paid up Value*
1st January	*Balance at beginning of year*	*1,800*	*₹ 10*	*₹ 10*
31st October	*Issue of Shares*	*600*	*₹ 10*	*₹ 5*

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1,800 x 12/12) + (300 x 2/12) = 1,850 shares.

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 3

Net profit for the year 2016	*₹ 18,00,000*
Net profit for the year 2017	*₹ 60,00,000*
No. of equity shares outstanding until 30th September 2017	*20,00,000*

Bonus issue 1st October 2017 was 2 equity shares for each equity share outstanding at 30th September, 2017

Calculate Basic Earnings Per Share.

Solution

No. of Bonus Issue 20,00,000 x 2 = 40,00,000 shares

Earnings per share for the year 2017 $\frac{₹\ 60,00,000}{(20,00,000 + 40,00,000)} = ₹\ 1.00$

Adjusted earnings per share for the year 2016 $\frac{₹\ 18,00,000}{(20,00,000 + 40,00,000)} = ₹\ 0.30$

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2016, the earliest period reported.

In a **rights issue**, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

Illustration 4

Net profit for the year 2016	*₹ 11,00,000*
Net profit for the year 2017	*₹ 15,00,000*

No. of shares outstanding prior to rights issue *5,00,000 shares*

Rights issue price *₹ 15.00*

Last date to exercise rights *1st March 2017*

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 2017 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

$$\frac{\text{Fair value of shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(₹\ 21.00 \times 5,00,000 \text{ shares}) + (₹\ 15.00 \times 1,00,000 \text{ Shares})}{5,00,000 \text{ Shares} + 1,00,000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} \quad \frac{₹\ (21.00)}{₹\ (20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2016 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2016 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2017 including effects of rights issue:

(5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = ₹ 2.55

19.4 Diluted Earnings Per Share

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration 5

Net profit for the current year	*₹ 1,00,00,000*
No. of equity shares outstanding	*50,00,000*
Basic earnings per share	*₹ 2.00*
No. of 12% convertible debentures of ₹ 100 each	*1,00,000*
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	*₹ 12,00,000*
Tax relating to interest expense (30%)	*₹ 3,60,000*

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000) = ₹ 1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: (50,00,000 + 10,00,000) = 60,00,000 Shares

Diluted earnings per share: (1,08,40,000/60,00,000) = ₹ 1.81

19.5 Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

19.6 Presentation

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

19.7 Disclosure

An enterprise should disclose the following:

a. Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

d. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

Illustration 6

Net profit for the year 2017	*₹ 12,00,000*
Weighted average number of equity shares outstanding during the year 2017	*5,00,000 shares*
Average fair value of one equity share during the year 2017	*₹ 20.00*
Weighted average number of shares under option during the year 2017	*1,00,000 shares*
Exercise price for shares under option during the year 2017	*₹ 15.00*

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings ₹	*Shares*	*Earnings/ Share* ₹
Net profit for the year 2017	12,00,000		
Weighted average no. of shares during year 2017		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00	____	(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

Illustration 7

From the Books of Bharti Ltd., following information are available as on 1.4.2015 and 1.4.2016:

(1)	*Equity Shares of ₹ 10 each*	*1,00,000*
(2)	*Partly paid Equity Shares of ₹ 10 each ₹ 5 paid*	*1,00,000*
(3)	*Options outstanding at an exercise price of ₹ 60 for one equity share ₹ 10 each. Average Fair Value of equity share during both years ₹ 75*	*10,000*
(4)	*10% convertible preference shares of ₹ 100 each. Conversion ratio 2 equity shares for each preference share*	*80,000*
(5)	*12% convertible debentures of ₹ 100. Conversion ratio 4 equity shares for each debenture*	*10,000*
(6)	*10% dividend tax is payable for the years ending 31.3.2017 and 31.3.2016.*	
(7)	*On 1.10.2016 the partly paid shares were fully paid up*	
(8)	*On 1.1.2017 the company issued 1 bonus share for 8 shares held on that date.*	

Net profit attributable to the equity shareholders for the years ending 31.3.2017 and 31.3.2016 were ₹ 10,00,000. Assume Tax rate at 30% for both the years.

Calculate:

(i) *Earnings per share for years ending 31.3.2017 and 31.3.2016.*

(ii) *Diluted earnings per share for years ending 31.3.2017 and 31.3.2016.*

(iii) *Adjusted earnings per share and diluted EPS for the year ending 31.3.2016, assuming the same information for previous year, also assume that partly paid shares are eligible for proportionate dividend only.*

Solution

(i) **Earnings per share**

	Year ended 31.3.2017	*Year ended 31.3.2016*
Net profit attributable to equity shareholders	₹ 10,00,000	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – without considering bonus issue for the year ended 31.3.2017]	2,00,000	1,50,000
Earnings per share	₹ 5	₹ 6.667

(ii) **Diluted earnings per share**

Options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (as per W.N. 2).

Year ended 31.3.2017 *Year ended 31.3.2016*

	Net profit attributable to equity shareholders ₹	*No. of equity shares*	*Net Profit attributable per share ₹*	No. of equity shares *(without considering bonus issue)*	*Net Profit attributable per share ₹*
As reported (for years ended 31.3.2017 and 31.3.2016)	10,00,000	2,00,000	5	1,50,000	6.667
Options		2,000		2,000	
	10,00,000	2,02,000	4.95 Dilutive	1,52,000	6.579 Dilutive
12% Convertible debentures	84,000	40,000		40,000	
	10,84,000	2,42,000	4.48 Dilutive	1,92,000	5.646 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000		1,60,000	
	19,64,000	4,02,000	4.886 Anti-Dilutive	3,52,000	5.58 Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (₹ 4.48 to ₹ 4.886), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share for the year ended 31.3.2017. Therefore, diluted earnings per share for the year ended 31st March, 2017 is ₹ 4.48.

For the year ended 31st March, 2016, Options, 12% Convertible debentures and Convertible preference shares will be considered dilutive and diluted earnings per share will be taken as ₹ 5.58.

	Year ended 31.3.2017	*Year ended 31.3.2016*
Diluted earnings per Share	4.48	5.58

(iii) **Adjusted earnings per share and diluted earnings per share for the year ending 31.3.2016**.

Net profit attributable to equity shareholders	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – considering bonus issue]	1,75,000
Adjusted earnings per share	₹ 5.714

Calculation of adjusted diluted earnings per share

	Net profit attributable to equity shareholders ₹	*No. of equity shares (after considering bonus issue)*	*Net profit attributable per share* ₹
As reported	10,00,000	1,75,000	5.714
Options		2,000	
	10,00,000	1,77,000	5.65 Dilutive
12% Convertible Debentures	84,000	40,000	
	10,84,000	2,17,000	4.995 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000	
	19,64,000	3,77,000	5.21 Anti –Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 4.995 to ₹ 5.21), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, adjusted diluted earnings per share for year ended 31.3.2016 is ₹ 4.995.

Adjusted diluted earnings per share ₹ 4.995

Working Notes:

1. **Weighted average number of equity shares**

		31.3.2017 No. of Shares	*31.3.2016 No. of Shares*
(a)	Fully paid equity shares	1,00,000	1,00,000
(b)	Partly paid equity shares*		50,000
	Partly paid equity shares	25,000	
	Fully paid equity shares	50,000	
	(Partly paid shares converted into fully paid up on 1.10.2016)		

(c)	Bonus Shares**	25,000	
	Weighted average number of equity shares	2,00,000	1,50,000
	(without considering bonus issue for year ended 31.3.2016)		
	Bonus Shares		25,000
	Weighted average number of equity shares (after considering bonus issue for year ended 31.3.2016)		1,75,000

*Since partly paid equity shares are entitled to participate in dividend to the extent of amount paid, 1,00,000 equity shares of ₹ 10 each, ₹ 5 paid up will be considered as 50,000 equity shares for the year ended 31st March, 2016.

On 1st October, 2016 the partly paid shares were converted into fully paid up. Thus, the weighted average equity shares (for six months ended 30th September, 2016) will be calculated as

$$50,000 \times \frac{6}{12} = 25,000 \text{ shares}$$

Weighted average shares (for six months ended 31st March, 2017) will be calculated as

$$1,00,000 \times \frac{6}{12} = 50,000 \text{ shares}$$

**Total number of fully paid shares on 1st January, 2017

Fully paid shares on 1st April, 2016	1,00,000
Partly paid shares being made fully paid up on 1st October, 2016	1,00,000
	2,00,000

The company issued 1 bonus share for 8 shares held on 1st January, 2017.

Thus, 2,00,000/8 = 25,000 bonus shares will be issued.

Bonus is an issue without consideration, thus it will be treated as if it had occurred prior to the beginning of 1st April, 2015, the earliest period reported.

2. Increase in earnings attributable to equity shareholders on conversion of potential equity shares

	Increase in earnings *(1)*	*Increase in number of equity shares* *(2)*	*Earnings per incremental share* *(3) = (1) ÷ (2)*
	₹		₹
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration			
[10,000 × (75 – 60)/75]		2,000	Nil
Convertible Preference Shares			

Increase in net profit attributable to equity shareholders as adjusted by attributable dividend tax [(₹ 10 × 80,000) + 10% (₹ 10 × 80,000)]	8,80,000		
No. of incremental shares (2 × 80,000)		1,60,000	5.50
12% Convertible Debentures			
Increase in net profit [(₹ 10,00,000 × 0.12 × (1 – 0.30)]	84,000		
No. of incremental shares (10,000 × 4)		40,000	2.10

Note: Grossing up of preference share dividend has been ignored here.

Illustration 8

X Ltd. supplied the following information. You are required to compute the basic earnings per share:

(Accounting year 1.1.2016– 31.12.2016)		
Net Profit	*:*	*Year 2016: ₹ 20,00,000*
	:	*Year 2017 : ₹ 30,00,000*
No. of shares outstanding prior to Right Issue	*:*	*10,00,000 shares*
Right Issue	*:*	*One new share for each four outstanding i.e., 2,50,000 shares.*
		Right Issue price – ₹ 20
		Last date of exercise rights – 31.3.2017.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2017	*:*	*₹ 25*

Solution

Computation of Basic Earnings Per Share
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2016 ₹	*Year 2017 ₹*
EPS for the year 2016 as originally reported $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ = (₹ 20,00,000 / 10,00,000 shares)	2.00	

EPS for the year 2016 restated for rights issue = [₹ 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
EPS for the year 2017 including effects of rights issue $\frac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$ $\frac{₹\ 30,00,000}{11,97,500 \text{ shares}}$		2.51 (approx.)

Working Notes:

1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the excercise}}$$

$$= \frac{(₹\ 25 \times 10,00,000 \text{ shares}) + (₹\ 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}} = \frac{₹\ 3,00,00,000}{12,50,000 \text{ shares}} = ₹\ 24$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{₹\ 25}{₹\ 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

<u>Reference</u>: The students are advised to refer the full text of AS 20 "Earnings per Share"

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* Refer working note 2.

UNIT 20: AS 21: CONSOLIDATED FINANCIAL STATEMENTS

20.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1-4-2001. AS 21 lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. A parent who presents consolidated financial statements should present their statements in accordance with this standard but in its separate financial statements, investments in subsidiaries should be accounted as per AS 13.

20.2 Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated Financial Statement is prepared by the holding/parent company to provide financial information regarding the economic resources controlled by its group and results achieved with these resources. This consolidated financial statement is prepared by the parent company in addition to the financial statement prepared by the parent company for only its own affairs. Hence parent company prepares two financial statements, one for only its own affairs and one for taking the whole group as one unit in the form of consolidated financial statement. Consolidated financial statements usually comprise the following:

- Consolidated Balance Sheet
- Consolidated Profit & Loss Statement
- Notes to Accounts, other statements and explanatory material
- Consolidated Cash Flow Statement, if parent company presents its own cash flow statement.

While preparing the consolidated financial statement, all other ASs and Accounting Policies will be applicable as they are applied in parent company's own financial statement.

A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign. Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

20.3 Scope

This standard applies to the financial statement prepared by the parent company including the financial information of all its subsidiaries taken as one single financial unit. One should refer to this AS for the investment in subsidiaries to be disclosed in the financial statement prepared by the parent company separately. But this standard does not deal with:

a. Methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (AS 14).

b. Accounting for investments in associates (AS 13) and

c. Accounting for investments in joint ventures (AS 13).

20.4 Definitions of the Terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Minority interest** is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

20.5 Circumstances under which Consolidated Financial Statements are Prepared

AS 21 should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

AS 21 does not mandate which enterprises are required to prepare consolidated financial statements – but specifies the rules to be followed where such financial statements are prepared.

Consolidated Financial Statement will be prepared by the parent company for all the companies that are controlled by the parent company either directly or indirectly, situated in India or abroad except in the following cases:

a. Control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

   In view of the above, merely holding all the shares as 'inventory-in-trade', is not sufficient to be considered as temporary control. It is only when all the shares held as 'inventory-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, that control would be considered to be temporary within the meaning of the paragraph.

The term 'Near Future' is a period not exceeding 12 months in normal case. For the above purpose, one should note the intention at the time of making the investment, if the intention is to continue with the equity for longer period then even though it is disposed off within 12 months, investee company would still be considered as subsidiary. On the other hand, if intention at the time of purchase is dispose it in near future, but the parent company was not able to dispose of the shares even after the end of 12 months, shares will continue to be considered as inventory.

b. Or subsidiary company operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the parent.

When the parent company has some restrictions on bringing the resources of the subsidiary company to its main resources then consolidated financial statement is not required, as the control is not resulting in extra cash flow to parent company other than as mere investment in share of any other company i.e. dividend, bonus shares.

Therefore, in both the above cases, investment of parent company in the share of its subsidiary company is treated as investment according to AS 13.

Exclusion of subsidiary company will be only for any of the above reasons but a company cannot be treated as outside the group just because the main business of the subsidiary company is not in line with the business of parent company.

20.6 Subsidiaries with Dissimilar Activities

AS 21 states that it is inappropriate to exclude subsidiaries from consolidation on the ground that their business activities are substantially different from those of the parent and/or the rest of the group. As long as the parent retains control over such subsidiaries, they are required to be consolidated. Information regarding the different nature of the activities of a subsidiary can be appropriately disclosed by listed companies in accordance with AS 17 Segment Reporting.

20.7 Loss of Control

When a parent loses control, the investee no longer meets the definition of subsidiary, and so it is no longer consolidated.

Where a parent loses control over a subsidiary, the investment will be accounted for under AS 13 Accounting for Investments from the date of loss of control, provided that the investor does not retain significant influence (in which case the investment will be accounted for under AS 23)

20.8 Existence of Control

Control Exists when Parent Company has either:

a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

For example, A Ltd. holds 75% shares in B Ltd., then B Ltd. is subsidiary of A Ltd., in other words A Ltd. is the parent company.

If A Ltd. is holding 25% shares in C Ltd., then there is no holding-subsidiary relationship between them. But if along with A Ltd., B Ltd. also holds 30% shares in C Ltd., then A Ltd. holding in C Ltd. is 55%, though indirectly, and A Ltd. is parent company of both B Ltd. and C Ltd.

b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

Point to be noted here is that, the control over composition of board or governing body is for economic benefit. If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

An enterprise is considered to control the composition of the board of directors or governing body of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body.

An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

(i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

(ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

If A Ltd. is proved to be a subsidiary company of B Ltd. by virtue of point (a) and also a subsidiary of C Ltd. as per point (b), then the problem arises that which company is liable to prepare Consolidated Financial Statement taking A Ltd. as its subsidiary. For this purpose, both B Ltd. and C Ltd. will prepare such Consolidated Financial Statement, group being constituted of themselves and A Ltd.

In addition to the above points, one should also consider the following points:

Determination of control in any company or organization, does not depend only on the share in capital, many a times even when the share in capital is less than 50% but still we consider the parent-subsidiary relationship as the voting power granted under special circumstances is more than 50%.

For example, ICICI Bank advanced loan of ₹ 40 crores to A Ltd., whose share capital is ₹ 10 crores only. As per the loan agreement, in case company defaults to repay the principal or to pay the interest on due date three times, ICICI Bank will have right to participate in the decision making of the company and this right will come to an end with the repayment of the loan amount with all its interest. On happening of the event, ICICI Bank got the voting right in the company meetings (Board and AGM) and as its advances to company is 80% of shares plus advances, bank carry 80% voting right and we can say that there exists a parent-subsidiary relationship, where A Ltd. is subsidiary of ICICI Bank.

Control is said to come into existence from the date when the conditions of such control are satisfied. If company does have control over the function of another company but consolidated financial statement is not prepared for the reason that there is restriction of impairing the resources then later, on removal of such restriction control will be said to come into existence but not from the date of such removal but from the date when such investments led to control.

20.9 Consolidation Procedures

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line-by-line basis by adding together like items of assets, liabilities, income and expenses and then certain adjustments are made.

The consolidation adjustments required will vary depending on the circumstances. The adjustments include (but are not restricted to);

- The elimination of the cost of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary;
- recognition of goodwill or capital reserve, depending on whether the cost of the parent's investment in each subsidiary is greater than or less than the parent's portion of equity of each subsidiary at the date on which investment in the subsidiary is made;
- the identification of the minority interest in the profit or loss of consolidated subsidiaries for the reporting period;
- the identification of the minority interest in the net assets of consolidated subsidiaries for the reporting period;
- the elimination of all intra-group balances and intra-group transactions, and the resulting unrealised profits and losses;
- adjustment of the consolidated results for dividends related to outstanding cumulative preference shares of a subsidiary that are held by minority interests regardless of whether the dividends have been declared.

20.10 Cost of Control

- ♦ The cost of investment of the parent in each of its subsidiaries and the parent's share in equity of each subsidiary should be eliminated. For the purpose equity and investment as on the date of each investment is taken.

- On the date of investment if the cost of investment to the parent is more than share of equity in that particular subsidiary, the difference is taken as Goodwill in the consolidated statement.
- On the date of investment if the cost of investment to the parent is less than share of equity in that particular subsidiary, the difference is taken as Capital Reserve in the consolidated statement.

20.11 Illustrations

Illustration 1

A Ltd. acquired 60% shares of B Ltd. @ ₹ 20 per share. Following are the extract of Balance Sheet of B Ltd.:

	₹
10,00,000 Equity Shares of ₹ 10 each	*1,00,00,000*
10% Debentures	*10,00,000*
Trade payables	*55,00,000*
Fixed Assets	*70,00,000*
Investments	*45,00,000*
Current Assets	*68,00,000*
Loans & Advances	*22,00,000*

On the same day B Ltd. declared dividend at 20% and as agreed between both the companies fixed assets were to be depreciated @ 10% and investment to be taken at market value of ₹ 60,00,000. Calculate the Goodwill or Capital Reserve to be recorded in Consolidated Financial Statement.

Solution

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	70,00,000	
Less: Value written off (70,00,000 x 10%)	(7,00,000)	63,00,000
Investments at Market value		60,00,000
Current Assets		68,00,000
Loans & Advances		22,00,000
Total Assets		2,13,00,000
Less: Total Liabilities: Trade payables	55,00,000	
10% Debentures	10,00,000	(65,00,000)
Equity		1,48,00,000
Majority Share in Equity (1,48,00,000 x 60%)		88,80,000

Less: Cost of Investment (10,00,000 x 60%) x 20	1,20,00,000	
Less: Dividend Received (6,00,000 x 2)	(12,00,000)	(1,08,00,000)
Goodwill		19,20,000

- Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.
- Goodwill and capital reserve of different subsidiaries can be adjusted to a net figure by the parent in consolidated financial statement.
- Goodwill of consolidated financial statement need not be written off to consolidated profit and loss account but test of impairment (Refer to AS 28) is made each time a consolidated financial statement is prepared.
- When share application money and allotment money is paid separately on different dates, then as per AS 21, date on which investment led to acquisition to control of subsidiary should be taken as date of investment, i.e., date of allotment.
- On the basis of above discussion, if control is gained in the subsidiary by a series of investments, then the date of the investment which led to holding-subsidiary relationship is taken into consideration and step by step calculations are made for each following investments.

Illustration 2

A Ltd. purchased 40% stake of B Ltd. for ₹ 12 per share. After two years A Ltd. decided to purchase another 40% share in B Ltd. B Ltd. has 1,00,00,000 equity shares of ₹ 10 each as fully paid up shares. The purchase deal was finalised on the following terms:

- *Purchase price per share to be calculated on the basis of average profit of last three years capitalised at 7.5%. Profits for last three years are ₹ 35 lacs, ₹ 65 lacs and ₹ 89 lacs.*
- *Total assets of B Ltd. of ₹ 11,50,00,000. Assets to be appreciated by ₹ 40,00,000.*
- *Of the External Trade payables for ₹ 2,50,00,000 one trade payable to whom ₹ 10,00,000 was due has expired and nothing is to be paid to settle this liability.*
- *B Ltd. will declare dividend @ 15%.*

Calculate the Goodwill or Capital Reserve for A Ltd. in Consolidated Financial Statement.

Solution

Calculation of Purchase Consideration

Particulars	₹
Profits for Last 3 years: First	89,00,000
Second	65,00,000
Third	35,00,000
Total profits for last 3 years	1,89,00,000
Average Profits (1,89,00,000/3)	63,00,000

Total value of B Ltd. (63,00,000/7.5%)	8,40,00,000
Number of Shares in B Ltd.	1,00,00,000
Value per Share	8.40
Purchase Consideration (1,00,00,000 x 40%) x 8.4	3,36,00,000

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	11,50,00,000	
Add: Appreciation in value of the asset	4,0,00,000	11,90,00,000
Less: Trade payables	2,50,00,000	
Less: Amount to be written off	(10,00,000)	(2,40,00,000)
Net Asset		9,50,00,000
Share in Net Asset (9,50,00,000 x 80%)		7,60,00,000
Less: Cost of Investment: Purchase Consideration	3,36,00,000	
Less: Dividend Received (10,00,00,000 x 40% x 15%)	(60,00,000)	
	2,76,00,000	
Add: Investment (1,00,00,000 x 40% x 12)	4,80,00,000	(7,56,00,000)
Capital Reserve		4,00,000

20.12 Minority Interest

- From the net income of the subsidiary, amount proportionate to minority interest is calculated and adjusted with the group income i.e. it is deducted from the profit & loss account balance and added to minority interest, so that the income of the group belonging to the parent is identified separately.
- Care should be taken to adjust for the cumulative preference dividend and profits belonging to the preference shares (if any) in the minority interest for the preference shares not held by the consolidated group. This adjustment should be made irrespective of whether or not dividends have been declared.
- Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
  (i) The amount of equity attributable to minorities at the date on which investment in a subsidiary is made and
  (ii) The minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.
- If carrying amount and cost of investment are different, carrying amount is considered for the purpose.

Illustration 3

Following are the Balance Sheet of A Ltd. and B Ltd.

	₹ '000			₹ '000	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity Shares	*6,000*	*5,000*	*Goodwill*	*100*	*20*
6% Preference shares	*-*	*1,000*	*Fixed Assets*	*3,850*	*2,750*
General Reserve	*1,200*	*800*	*Investment*	*1,620*	*1,100*
Profit & Loss Account	*1,020*	*1,790*	*Inventory*	*1,900*	*4,150*
Trade payables	*3,850*	*3,410*	*Trade receivables*	*4,600*	*4,080*
Dividend payable	*600*	*500*	*Cash & Bank*	*600*	*400*
	12,670	*12,500*		*12,670*	*12,500*

A Ltd. purchased 3/4th interest in B Ltd. at the beginning of the year at the premium of 25%. Following are the other information available:

a. *Profit & Loss Account of B Ltd. includes ₹ 1,000 thousands bought forward from the previous year.*

b. *The directors of both the companies have declared a dividend of 10% on equity share capital for the previous and current year.*

From the above information calculate Pre and Post Acquisition Profits, Minority Interest and Cost of Control.

Solution

Calculation of Pre and Post Acquisition Profits

Particulars	*Pre-acquisition Profits*	(₹) *Post-acquisition Profits*
Profit & Loss Account	10,00,000	7,90,000
General Reserve	800,000	-
	18,00,000	7,90,000
Less: Minority Interest (1800/4)	(4,50,000)	
(790/4)		(1,97,500)
Consolidated Balance Sheet	13,50,000	5,92,500

Calculation of Minority Interest

Particulars	₹
Paid up Equity Share Capital (50,00,000/4)	12,50,000
Paid up Preference Share Capital	10,00,000

Pre-acquisition Profits	4,50,000
Post-acquisition Profits	1,97,500
Minority Interest	28,97,500

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Cost of Investment in Subsidiary (50,00,000 x 75% x 125%)	46,87,500	
Less: Dividend Received (50,00,000 x 75% x 10%)	(3,75,000)	43,12,500
Less: Paid up Capital	37,50,000	
Pre-acquisition Profits	13,50,000	(51,00,000)
Capital Reserve		7,87,500

- The losses applicable to the minority are deducted from the minority interest unless minority interest is nil. Any further loss is adjusted with the consolidated group interest except to the extent that the minority has a binding obligation to, and can make the losses good. Subsequently, when the subsidiary makes profits, minority share in profits is added to majority share to the extent minority interest losses were absorbed by majority share.

  For example, 25% minority interest has the share in net equity ₹ 40 lacs and company made cumulative losses since the date of investment ₹ 200 lacs. 25% of ₹ 200 lacs i.e., ₹ 50 lacs is minority share in losses. Losses upto ₹ 40 lacs will be adjusted with the minority interest and further loss of ₹ 10 lacs will be adjusted with the majority interest. Hence in the Consolidated Balance Sheet for the relevant year, minority interest on the liabilities side will be NIL.

  In the next year, if subsidiary company makes a profit say, ₹ 60 lacs. Minority interest comes to ₹ 15 lacs, out of these 15 lacs, first ₹ 10 lacs will be added to majority interest as recovery of losses absorbed in past and balance ₹ 5 lacs will appear in Consolidated Balance Sheet as part of the Minority Interest.

20.13 Other Points

General rules: In order to present financial statements for the group in a consolidated format, the effect of transactions between group enterprises should be eliminated. AS 21 requires that intra-group transactions (including sales, expenses and dividends) and the resulting unrealised profits and losses be eliminated in full.

Liabilities due to one group enterprise by another will be set off against the corresponding asset in the other group enterprise's financial statements; sales made by one group enterprise to another should be excluded both from turnover and from cost of sales or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying enterprise has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets reduced to cost to the group.

For transactions between group enterprises, unrealised profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

Unrealised profit in inventories: Where a group enterprise sells goods to another, the selling enterprise, as a separate legal enterprise, records profits made on those sales. If these goods are still held in inventory by the buying enterprise at the year end, however, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

When the goods are sold by a parent to a subsidiary (downstream transaction), all of the profit on the transaction is eliminated, irrespective of the percentage of the shares held by the parent. In other words, the group is not permitted to take credit for the share of profit that is attributable to any minority.

Where the goods are sold by a subsidiary, in which there is a minority interest, to another group enterprise (upstream transaction), the whole of the unrealised profit should also be eliminated.

Unrealised profit on transfer or non-current assets

- Similar to the treatment described above for unrealised profits in inventories, unrealised inter-company profits arising from intra-group transfers of fixed assets are also eliminated from the consolidated financial statements. **Intra Group Transactions:** The effect of any unrealised profits from intra-group transactions should be eliminated from consolidated financial statement. Effect of losses from intra-group transactions need not be eliminated only when the cost is not recoverable.

  For example, A Ltd. sold goods for ₹ 1,25,000 to B Ltd., another subsidiary under same group at the gross profit of 20% on sales. On the date of consolidated balance sheet, B Ltd. has goods worth ₹ 25,000 as inventory from the same consignment. The unrealised profits of ₹ 5,000 (25,0000 x 20%) will be deducted from the closing inventory and it will be valued as ₹ 20,000 i.e. at cost to A Ltd. for the purpose of Consolidated Financial Statement.

- **Reporting Date:** For the purposes of preparing consolidated financial statements, the financial statements of all subsidiaries should, wherever practicable, be prepared:
  - To the same reporting date; and
  - For the same reporting period as of the parent.

- If practically it is not possible to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the parent, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.
- **Accounting Policies:** Accounting policies followed in the preparation of the financial statements of the parent, subsidiaries and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different companies in the group are not uniform, then adjustments should be made in the items of the subsidiaries to bring them in line with the accounting policy of the parent. Here we will not disturb the figures or policies in respective books, but while including the items in consolidated financial statement, adequate adjustments will be made.

  For example, parent company A Ltd. is valuing the inventory on weighted average basis and its inventory is valued as ₹ 100 lacs but its subsidiary B Ltd. is following FIFO method and its inventory is valued at ₹ 20 Lacs. Inventory of B Ltd. will be valued under weighted average method say, ₹ 25 lacs. Now for the purpose of consolidated financial statement, inventory of B Ltd. will be taken as ₹ 25 lacs and the inventory disclosed in consolidated trading account on credit side and in consolidated balance sheet assets side will be ₹ 125 lacs. Hence adequate adjustments are made for this ₹ 5 lac in consolidated financial statement.

  If it is not practical to make such adjustments for uniform accounting policies in preparing the consolidated financial statements, then the fact should be disclosed together with the amounts of each items in the consolidated financial statement to which the different accounting policies have been applied.

  Let us take above example, in case it is not possible practically to adjust ₹ 5 lacs in the inventory of B Ltd. for the purpose of consolidated financial statement, then item will be disclosed in Consolidated Trading Account (Credit Side) and Consolidated Balance Sheet (Asset Side) as follow:

Closing Inventory of A Ltd. (Weighted Average Method)	100 lacs	
Closing Inventory of B Ltd. (FIFO Method)	20 lacs	120 lacs

20.14 Disposal of Holding

The results of operations of a subsidiary are included in the consolidated financial statement as from the date on which parent-subsidiary relationship comes into existence and are included in the consolidated statement of profit and loss until the date of cessation of the relationship. On disposal of the investment, consolidated profit and loss account will include the transactions till the date the parent-subsidiary relationship ceases to exist. The difference between the proceeds from the disposal of investment and the parent's share in the net asset of the subsidiary on the basis of the carrying amount, on the date of disposal is recorded in the consolidated profit and loss account. While calculating the share of parent in the net asset of the subsidiary on the date of disposal, adjustment is made for the minority interest calculated as above.

In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

Investment in the subsidiary, in the separate financial statement of the parent is recorded according to the provisions of AS 13.

Illustration 4

A Ltd. had acquired 80% share in the B Ltd. for ₹ 25 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		(28,00,000)
		2,00,000
Less: Goodwill in the Consolidated Financial Statement		
Cost of investment	25,00,000	
Less: A Ltd.'s Share in net asset on the date (22 lacs x 80%)	(17,60,000)	(7,40,000)
Loss on sale of investment		5,40,000

Illustration 5

A Ltd. had acquired 80% share in the B Ltd. for ₹ 15 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		28,00,000
		2,00,000
Add:: Capital Reserve in the Consolidated Financial Statement		
A Ltd.'s Share in net asset on the date (22 lacs x 80%)	17,60,000	
Less: Cost of investment	(15,00,000)	2,60,000
Profit on sale of investment		4,60,000

20.15 Disclosure

In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

a. In the consolidated financial statement, a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

b. In consolidated financial statements, where applicable:

   (i) The nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

   (ii) The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and

   (iii) The names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

20.16 Transitional Provisions

On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

20.17 Accounting for Taxes on Income in the Consolidated Financial Statements

While preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

The amounts of tax expense appearing in the separate financial statements of a parent and its subsidiaries do not require any adjustment for the purpose of consolidated financial statements. In view of this, while preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements is the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

Reference: The students are advised to refer the full text of AS 21 "Consolidated Financial Statements" (issued 2001).

UNIT 21 : AS 22: ACCOUNTING FOR TAXES ON INCOME

21.1 Introduction

AS 22 was issued in 2001 and is mandatory in nature for:

a. All the accounting periods commenced on or after 01.04.2001, in respect of the following:

   (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

   (ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.

b. All the accounting periods commenced on or after 01.04.2002, in respect of companies not covered by (a) above.

c. All the accounting periods commenced on or after 01.04.2003, in respect of all other enterprises.

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

21.2 Need

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

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

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

21.3 Definitions

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

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

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

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

Deferred tax is the tax effect of timing differences.

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

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

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

21.4 Recognition

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

Permanent differences do not result in deferred tax assets or deferred tax liabilities. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

21.5 Re-assessment of Unrecognised Deferred Tax Assets

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

21.6 Measurement

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws. Deferred tax assets and liabilities should not be discounted to their present value.

21.7 Review of Deferred Tax Assets

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

21.8 Disclosure

Statement of profit and loss

Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, under company law requirements, the amount of Indian income tax and other Indian taxation on profits, including, wherever practicable, with Indian income tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income tax and distinguishing, wherever practicable, between income tax and other taxation should be disclosed.

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

Balance sheet

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

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

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

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

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

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

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

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

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

21.9 Transitional Provision

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 (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning.

The Background material on AS 22 further clarifies that in case an enterprise does not have adequate revenue reserves to adjust the accumulated balance of deferred tax liability, it should be adjusted to the extent not adjusted against revenue reserves, against opening balance of profit and loss account. Where the opening balance of profit and loss is also inadequate, it should be shown, to the extent not adjusted, as 'Debit balance in Profit and Loss Account' on the asset side of the balance sheet. The accumulated deferred tax liability cannot be adjusted against securities premium.

21.10 Relevant Explanations to AS 22

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

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

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

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

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

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

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

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

Virtual certainty supported by convincing evidence

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

21.11 Miscellaneous Illustrations

Illustration 1

From the following details of A Ltd. for the year ended 31-03-2017, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Particulars	*₹*
Accounting Profit	*6,00,000*
Book Profit as per MAT	*3,50,000*

Profit as per Income Tax Act	*60,000*
Tax rate	*20%*
MAT rate	*7.50%*

Solution

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

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

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

Tax expense= Current Tax +Deferred Tax

₹ 1,20,000 = ₹ 12,000+ Deferred tax

Therefore, Deferred Tax liability as on 31-03-201

= ₹ 1,20,000 – ₹ 12,000 = ₹ 1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-2017

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

= ₹ 12,000 + ₹ 1,08,000 + ₹ 14,250

= ₹ 1,34,250

Illustration 2

Ultra Ltd. has provided the following information.

Depreciation as per accounting records =₹ 2,00,000

Depreciation as per tax records =₹ 5,00,000

Unamortised preliminary expenses as per tax record = ₹ 30,000

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

Solution

Calculation of difference between taxable income and accounting income

Particulars	*Amount (₹)*
Excess depreciation as per tax ₹ (5,00,000 – 2,00,000)	3,00,000
Less: Expenses provided in taxable income	(30,000)
Timing difference	2,70,000

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

Therefore deferred tax liability = 50% x 2,70,000 = ₹ 1,35,000

Illustration 3

XYZ is an export oriented unit and was enjoying tax holiday upto 31.3.2016. No provision for deferred tax liability was made in accounts for the year ended 31.3.2016. While finalising the accounts for the year ended 31.3.2017, the Accountant says that the entire deferred tax liability upto 31.3.2016 and *current year deferred tax liability should be routed through Profit and Loss Account as the relevant Accounting Standard has already become mandatory from 1.4.2001. Do you agree?*

Solution

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.

Illustration 4

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.2015. For the years ending 31.3.2016 and 31.3.2017, it made profits of ₹ 1,00,000 and ₹ 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 31.3.2015, 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 2016 and 2017 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2015, 2016 and 2017.

Solution

Statement of Profit and Loss

	31.3.2015 ₹	*31.3.2016* ₹	*31.3.2017* ₹
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

Illustration 5

The following particulars are stated in the Balance Sheet of M/s Exe Ltd. as on 31.03.2016:

	(₹ in lakhs)
Deferred Tax Liability (Cr.)	*20.00*
Deferred Tax Assets (Dr.)	*10.00*

The following transactions were reported during the year 2016-2017:

(i)	*Tax Rate*	*50%*
(ii)	*Depreciation – as per Books*	*50.00*
	Depreciation – for Tax purposes	*30.00*
	There were no additions to Fixed Assets during the year.	
(iii)	*Items disallowed in 2015-2016 and allowed for Tax purposes in 2016-2017*	*10.00*
(iv)	*Interest to Financial Institutions accounted in the Books on accrual basis, but actual payment was made on 30.09.2017*	*20.00*
(v)	*Donations to Private Trusts made in 2016-2017*	*10.00*
(vi)	*Share issue expenses allowed under 35(D) of the I.T. Act, 1961 for the year 2016-2017 (1/10th of ₹ 50.00 lakhs incurred in 2015-2016)*	*5.00*
(vii)	*Repairs to Plant and Machinery ₹ 100.00 lakhs was spread over the period 2016-2017 and 2017-2018 equally in the books. However, the entire expenditure was allowed for Income-tax purposes.*	

Indicate clearly the impact of above items in terms of Deferred Tax liability/Deferred Tax Assets and the balances of Deferred Tax Liability/Deferred Tax Asset as on 31.03.2017.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset

Transactions	*Analysis*	*Nature of difference*	*Effect*	*Amount*
Difference in depreciation	Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years.	Responding timing difference	Reversal of DTL	₹ 20 lakhs × 50% = ₹ 10 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	₹ 10 lakhs × 50% = ₹ 5 lakhs

Interest to financial institutions	It is allowed as deduction under section 43B of the IT Act, if the payment is made before the due date of filing the return of income (i.e. 31st October, 2017).	No timing difference	Not applicable	Not applicable
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not applicable	Not applicable
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	₹ 5 lakhs × 50% = ₹ 2.5 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	₹ 50 lakhs × 50% = ₹ 25 lakhs

Deferred Tax Liability Account

			₹ *in lakhs*				₹ *in lakhs*
31.3.2017	To	Profit and Loss account (Depreciation)	10.00	1.4.2016	By	Balance b/d	20.00
	To	Balance c/d	35.00		By	Profit and Loss Account (Repairs to plant)	25.00
			45.00				45.00
				1.4.2017	By	Balance b/d	35.00

Deferred Tax Asset Account

			₹ *in lakhs*				₹ *in lakhs*
1.4.2016	To	Balance b/d	10.00	31.3.2017	By	Profit and Loss Account: Items disallowed in 2015-2016 and allowed as per I.T. Act in 2016-2017	5.00
					By	Share issue expenses	2.50
					By	Balance c/d	2.50
			10.00				10.00
1.4.2017	To	Balance b/d	2.50				

Reference: The students are advised to refer the full text of AS 22 "Accounting for Taxes on Income" (issued 2001).

UNIT 22 : AS 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

22.1 Introduction

AS 23, came into effect in respect of accounting periods commenced on or after 1-4-2002. AS 23 describes the principles and procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

22.2 Objective

The objective of this Standard is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statement. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group. For disclosing investment in associates in the separate financial statement of the investor itself, one should follow AS 13.

22.3 Definitions of the terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant influence is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies. This definition excludes the subsidiaries or joint venture from the scope of an associate but apart from these any other enterprises, which are significantly influenced by the investor, is an associate for the purpose of this standard. Any enterprise having 20% or more control over voting power or any interest directly or indirectly in any other enterprise will be assumed to have significantly influencing the other enterprise unless proved otherwise. Similarly any enterprise that does not have 20% or more control then it is assumed not having significant influence on the enterprise unless proved otherwise.

An enterprise can influence the significant economic decision making by many ways like:

- ♦ Having some voting power.

- Representation on the board of directors or governing body of the investee.
- Participation in policy-making processes.
- Interchange of managerial personnel.
- Provision of essential technical information.
- Influencing inter-company transactions i.e. sale of goods and services, sharing technical knowledge etc.

As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee.

As with the classification of any investment, the substance of the arrangement in each case should be considered. If it can be clearly demonstrated that an investor holding 20% or more of the voting power of the investee does not have significant influence, the investment will not be accounted for as an associate.

A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

If the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. The presence of one or more of the indicators as above may indicate that an investor has significant influence over a less than 20% owned corporate investee.

Control exists when parent company has either:

a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

   If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

   An enterprise is considered to control the composition of the board of directors of a company or governing body in case of an enterprise other than a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

   (i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

(ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

To understand the above definitions let us take few examples:

Example1: A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company i.e. a holding company and B Ltd. with more than 20% share though minor is a business associate.

Example 2: A Ltd. holding 90% share in B Ltd. and 10% in C Ltd., and also B Ltd. holding 11% shares in C Ltd. In this case, A Ltd. is parent of B Ltd. but due to total of direct and indirect holding of (10 + 11) 21% in C Ltd., C Ltd. is an associate of A Ltd. Though for consolidated financial statement purpose, these holding will be 19.9% (10% + 90% of 11%), as rest 1.1% belongs to minority interest.

22.4 Associates Accounted for using the Equity method

The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

From the definition, following broad conclusions can be drawn:

a. In CFS, investment is to be recorded at cost.

b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve.

c. Distributions received from an investee reduce the carrying amount of the investment.

d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve.

e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.

Illustration 1

A Ltd. acquire 45% of B Ltd. shares on April 01, 2016, the price paid was ₹ 15,00,000. Following are the extract of balance sheet of B Ltd.:

Paid up Equity Share Capital	*₹ 10,00,000*
Securities Premium	*₹ 1,00,000*
Reserve & Surplus	*₹ 5,00,000*

B Ltd. has reported net profits of ₹ 3,00,000 and paid dividends of ₹ 1,00,000. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2017.

Solution

Calculation of the carrying amount of Investment as per equity method

Particulars	₹	₹
Equity Shares	10,00,000	
Security Premium	1,00,000	
Reserves & Surplus	5,00,000	
Net Assets	16,00,000	
45% of Net Asset	7,20,000	
Add: 45% of Profits for the year	1,35,000	
	8,55,000	
Less: Dividend Received	45,000	8,10,000
Less: Cost of Investment		(15,00,000)
Goodwill		6,90,000

Consolidated Balance Sheet (Extract)

Assets	₹	₹
Investment in B Ltd.	810,000	
Add: Goodwill	690,000	1,500,000

22.5 Circumstances under which Equity Method is followed

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

   In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13.

An investor should discontinue the use of the equity method from the date that:

a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.

b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

22.6 Application of the Equity Method

- Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS 21.
- Investment in an associate should be recorded as equity from the date when such relation comes in effect.
- Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve.

  Case 1: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 33,000 and Total Equity on the date of acquisition ₹ 2,00,000.

A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Less: Cost of Investment	₹ (33,000)
Capital Reserve	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Less: Capital reserve	(11,000)	33,000

  Case 2: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 55,000 and Total Equity on the date of acquisition ₹ 2,00,000.

Cost of Investment	₹ 55,000
Less: A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Goodwill	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Add: Goodwill	11,000	55,000

- An enterprise having share of profits of more than 50% in other company, they are said to be in Parent-Subsidiary relationship. However, if the share in profits is more than 20% but upto 50% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be increased further say from 25% to 30%. Adjustment should be made with each transaction.

Case 1: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,45,000

Net asset on April 01st₹ 8,50,000 and on October 01 ₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

15% share in net asset	₹ 1,50,000
Cost of investment	₹ 1,45,000
Capital Reserve	₹ 5,000
Total goodwill (15,000 – 5,000)	₹ 10,000

Case 2: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,55,000

Net asset on April 01st₹ 8,50,000 and on October 01st₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

Cost of investment	₹ 1,55,000
15% share in net asset	₹ 1,50,000
Goodwill	₹ 5,000
Total goodwill (15,000 + 5,000)	₹ 20,000

Case 3: A Ltd. acquired 25% stake of B Ltd. on April 01 and further 5% on October 01 of the same year. Other information is as follow:

Cost of Investment for 25% ₹ 1,50,000 and for 5% ₹ 20,000

Net asset on April 01st₹ 5,00,000.

Profit for the year ₹ 90,000 earned in the ratio 2:1 respectively.

Calculations for April 01:

Cost of investment	₹ 1,50,000
25% share in net asset	₹ 1,25,000
Goodwill	₹ 25,000

Calculations for October 01:

Profits for the first half (90,000/3) x 2	₹ 60,000
Additional share of A Ltd.	5%
Pre-acquisition profits i.e. capital reserve (60,000 x 5%)	₹ 3,000
5% share in net asset	₹ 25,000
Cost of investment	₹ 20,000
Capital Reserve	₹ 5,000
Cost of Investment on April 01st	₹ 1,50,000
Less: Goodwill	₹ 25,000
Carrying Amount on April 01st	₹ 1,25,000
Add: Additional Share in Net Asset on October 01st	₹ 25,000
Add: Capital share of Profits for first half	₹ 3,000
Add: Revenue shares of Profits for first half (60,000 x 25%)	₹ 15,000
Add: Revenue shares of Profits for second half (30,000 x 30%)	₹ 9,000
Total Carrying Amount on March 31st	₹ 1,77,000

- If there is any transaction between the Investor Company and investee concern then the unrealised profits on such goods to the extent of investor's share should be eliminated from consolidated financial statement. As in the above example, the profits calculated on the goods lying with the buyer on the date of statement, will be eliminated to the extent of investor's share i.e. 22%.
- Any loss on such transactions are not eliminated to the extent that such loss is not recoverable. Otherwise such losses are written off from consolidated financial statement fully.

Illustration 2

A Ltd. acquired 40% share in B Ltd. on April 01, 2014 for ₹ 10 lacs. On that date B Ltd. had 1,00,000 equity shares of ₹ 10 each fully paid and accumulated profits of ₹ 2,00,000. During the year 2014-2015, B Ltd. suffered a loss of ₹ 10,00,000; during 2015-2016 loss of ₹ 12,50,000 and during 2016-2017 again a loss of ₹ 5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Equity Shares	10,00,000
Reserves & Surplus	2,00,000
Net Assets	12,00,000
40% of Net Asset	4,80,000
Less: Cost of Investment	(10,00,000)
Goodwill	5,20,000

Consolidated Balance Sheet (Extract) as on April 01, 2014

Assets	₹	₹
Investment in B Ltd.	4,80,000	
Add: Goodwill	5,20,000	10,00,000

Calculation of Carrying Amount of Investment in the year ended on 2014-2015

Particulars	₹
Investment in B Ltd.	4,80,000
Add: Goodwill	5,20,000
Cost of Investment	10,00,000
Less: Loss for the year (10,00,000 x 40%)	(4,00,000)
Carrying Amount of Investment	6,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2015

Assets	₹	₹
Investment in B Ltd.	80,000	
Add: Goodwill	5,20,000	6,00,000

Calculation of Carrying Amount of Investment in the year ended on 2015-2016

Particulars	₹
Carrying Amount of Investment	6,00,000
Less: Loss for the year (12,50,000 x 40%)	(5,00,000)
Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2016

Assets	₹	₹
Investment in B Ltd.	-	
Add: Goodwill	1,00,000	1,00,000

Calculation of Carrying Amount of Investment in the year ended on 2016-2017

Particulars	₹
Carrying Amount of Investment	1,00,000
Less: Loss for the year (5,00,000 x 40%)	(2,00,000)
Carrying Amount of Investment	(1,00,000)

Consolidated Balance Sheet (Extract) as on March 31, 2017

Assets	₹	₹
Investment in B Ltd.		-

- As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements. In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than six months.
- Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.

The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

22.7 Contingencies

In accordance with AS 4, the investor discloses in the consolidated financial statements:

a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

b. Those contingencies that arise because the investor is severally liable for the liabilities of the associate.

22.8 Disclosure

- In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.

- Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor’s share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor’s share of any extraordinary or prior period items should also be separately disclosed.
- The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.
- In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate’s financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.
- If an associate is not accounted for using the equity method the reasons for not doing the same.
- Goodwill/capital reserve arising on the acquisition of an associate by an investor should be disclosed separately though it is included in the carrying amount of the investment.

22.9 Transitional Provisions

On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Statement, the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Statement since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

22.10 Relevant Explanations to AS 23

Treatment of Proposed Dividend in Associates in Consolidated Financial Statements:

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

Consideration of Potential Equity Shares for Determining whether an Investee is an Associate, Accounting for Investments in Associates in Consolidated Financial Statements:

The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

Reference: The students are advised to refer the full text of AS 23 “Accounting for Investments in Associates in Consolidated Financial Statements” (issued 2001).

UNIT 23 : AS 24: DISCONTINUING OPERATIONS

23.1 Introduction

AS 24, is mandatory in nature in respect of accounting periods commenced on or after 1-4-2004 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard would be mandatory in nature in respect of accounting periods commenced on or after 1-4-2005. Earlier application of the accounting standard would be encouraged.

This standard is applicable to all discontinuing operations, representing separate major line of business or geographical area of operations of an enterprise.

23.2 Objective

The objective of this Statement is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

23.3 Discontinuing Operation

A discontinuing operation is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:

   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or

   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or

   (iii) Terminating through abandonment and

b. That represents a separate major line of business or geographical area of operations.

c. That can be distinguished operationally and for financial reporting purposes.

A reportable business segment or geographical segment as defined in AS 17 'Segment

Reporting', would normally satisfy criterion (b) of the above definition, that is, it would represent a separate major line of business or geographical area of operations. A part or such a segment may also satisfy criterion (b) of the above definition. For an enterprise that operates in a single business or geographical segment and, therefore, does not report segment information, a major product or service line may also satisfy the criteria of the definition.

The sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

a. Gradual or evolutionary phasing out of a product line or class of service.

b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.

c. Shifting of some production or marketing activities for a particular line of business from one location to another and

d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

a. The operating assets and liabilities of the component can be directly attributed to it.

b. Its revenue can be directly attributed to it.

c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

23.4 Initial Disclosure Event

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or

b. The enterprise's board of directors or similar governing body has both

   (i) approved a detailed, formal plan for the discontinuance and

   (ii) made an announcement of the plan.

a detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

23.5 Recognition and Measurement

For recognizing and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

23.6 Presentation and Disclosure

23.6.1 Initial Disclosure

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

a. A description of the discontinuing operation(s).

b. The business or geographical segment(s) in which it is reported as per AS 17.

c. The date and nature of the initial disclosure event.

d. The date or period in which the discontinuance is expected to be completed if known or determinable.

e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.

g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

23.6.2 Disclosures other than Initial Disclosures Note

All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

Disclosures as required by AS 4 'Contingencies and Events Occurring After the Balance Sheet Date', are made if an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise.

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and

b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes. The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed. Any disclosures required by this Statement should be presented separately for each discontinuing operation.

The disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, 'Interim Financial Reporting', including:

a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and

b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

Reference: The students are advised to refer the full text of AS 24 "Discontinuing Operations"

UNIT 24 : AS 25: INTERIM FINANCIAL REPORTING

24.1 Introduction

AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, trade payables and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

A statute governing an enterprise or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

24.2 Definitions of the terms used under the Accounting Standard

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

24.3 Content of an Interim Financial Report

A complete set of financial statements normally includes Balance sheet, Statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Standard requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported. AS 25 does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Standard as well as those required by other Accounting Standards. Minimum components of an Interim Financial Report includes condensed Financial Statement.

24.4 Form and Content of Interim Financial Statements

If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement.

Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20 then it has to present basic and diluted earnings per share as per AS 20 on the face of Statement of Profit and Loss complete or condenses for an interim period also.

24.5 Selected Explanatory Notes

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

a. A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.

b. Explanatory comments about the seasonality of interim operations.

c. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that is unusual because of their nature, size, or incidence as per AS 5.

d. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.

e. Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares.

f. Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares.

g. Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements).

h. The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and

i. Material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

24.6 Periods for which Interim Financial Statements are required to be presented

Interim reports should include interim financial statements (whether condensed or complete) for the periods listed in the following table:

Statement	*Current*	*Comparative*
Balance sheet	End of current interim period	End of immediately preceding financial year
Statement of profit and loss	Current interim period and cumulatively for the year-to-date	Comparable interim period and year-to-date of immediately preceding financial year
Cash flow statement	Cumulatively for the current financial year-to-date	Comparable year-to-date of immediately preceding financial year

24.7 Materiality

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.

Illustration 1

Sincere Corporation is dealing in seasonal product sales pattern of the product, quarter wise is as follows:

1st quarter 30th June	*10%*
2nd quarter 30th September	*10%*

3rd quarter 31st December	*60%*
4th quarter 31st March	*20%*

Information regarding the 1st quarter ending on 30th June, 2017 is as follows:

Sales	*80 crores*
Salary and other expenses	*60 crores*
Advertisement expenses (routine)	*4 crores*
Administrative and selling expenses	*8 crores*

While preparing interim financial report for first quarter Sincere Corporation wants to defer ₹ 10 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view.

Solution

Particulars	*(₹ In crores)*	
Result of first quarter ending 30th June, 2017		
Turnover	80	
Other Income	Nil	
Total (a)		80
Less: Changes in inventories		Nil
Salaries and other cost		60
Administrative and selling Expenses (4+8)		12
Total (b)		72
Profit (a)-(b)		8

According to AS 25 the Income and Expense should be recognized when they are earned and incurred respectively. Therefore seasonal incomes will be recognized when they occur. Thus the company's view is not as per AS 25.

Illustration 2

The accounting year of X Ltd. ends on 30th September, 2017 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year beginning on 1-10-2016 and ends on 30-9-2017, the quarterly income is as under:-

1st quarter ending on 31-12-2016	*₹ 200 crores*
2nd quarter ending on 31-3-2017	*₹ 200 crores*
3rd quarter ending on 30-6-2017	*₹ 200 crores*
4th quarter ending on 30-9-2017	*₹ 200 crores*
Total	*₹ 800 crores*

Average actual tax rate for the financial year ending on 31-3-2017 is 20% and for financial year ending 31-3-2017 is 30%. Calculate tax expense for each quarter.

Solution

Calculation of tax expense

1st quarter ending on 31-12-2016	200 ×20%	₹ 40 lakhs
2nd quarter ending on 31-3-2016	200 ×20%	₹ 40 lakhs
3rd quarter ending on 30-6-2016	200 ×30%	₹ 60 lakhs
4th quarter ending on 30-9-2016	200 ×30%	₹ 60 lakhs

24.8 Disclosure in Annual Financial Statements

AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

24.9 Accounting Policies

24.9.1 Same Accounting Policies as annual financial statements

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

To illustrate:

a. The principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

b. A cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

c. Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual effective income tax rate changes.

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

24.9.2 Changes in Accounting Policies

Preparers of interim reports in compliance with AS 25 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes.

If there has been any change in accounting policy since the most recent annual financial statements, the interim report is required to include a description of the nature and effect of the change.

24.10 Revenue Received Seasonally or Occasionally

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

24.11 Cost Incurred Unevenly During the Financial Year

Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

A cost that does not meet the definition of an asset at the end of an interim period is not deferred in the interim balance sheet either to await future information as to whether it has met the definition of an asset, or to smooth earnings over interim periods within a financial year. Thus, when preparing interim financial statements, the enterprise's usual recognition and measurement practices are followed. The only costs that are capitalized are those incurred after the specific point in time at which the criteria for recognition of the particular class of asset are met. Deferral of costs as assets in an interim balance sheet in the hope that the criteria will be met before the year-end is prohibited.

24.12 Use of Estimates

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed.

24.13 Restatement of Previously Reported Interim Periods

One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

24.14 Transitional Provision

On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year:

a. Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

b. Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

24.15 Applicability of AS 25 to Interim Financial Results

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

24.16 Miscellaneous Illustrations

Illustration 3

Accountants of Poornima Ltd. show a net profit of ₹ 7,20,000 for the third quarter of 2016 after incorporating the following:

(i) Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.

(iii) Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.

Ascertain the correct quarterly income.

Solution

In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence, no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000 – ₹ 20,000).

Illustration 4

Intelligent Corporation (I–Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 31st March 15%	30th June 15%	30th September 50%	31st December 25%

For the First quarter ending 31st March, 2016, I–Corp. gives you the following information:

	₹ crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter, 'I–Corp.' wants to defer ₹ 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

Solution

Result of the first quarter ended 31st March, 2016

		(₹ in crores)
Turnover		50
Add: Other Income		Nil
Total		50
Less: Change in inventories	Nil	
Salaries and other cost	30	
Administrative and selling expenses (8 + 2)	10	40
Profit		10

As per AS 25 on Interim Financial Reporting, the income and expense should be recognised when they are earned and incurred respectively. As per para 38 of AS 25, the costs should be anticipated or deferred only when

(i) it is appropriate to anticipate that type of cost at the end of the financial year, and

(ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

Reference: The students are advised to refer the full text of AS 25 "Interim Financial Reporting": (issued 2002).

UNIT 25 : AS 26: INTANGIBLE ASSETS

25.1 Introduction

AS 26, came into effect in respect of expenditure incurred on intangible items during accounting periods commenced on or after 1-4-2003 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. From the date of this Standard becoming mandatory for the concerned enterprises, AS 8; AS 6 & AS 10 stand withdrawn for the aspects relating to Intangible Assets. Infact, AS 8 and AS 6 has been completely withdrawn by the issuing authority and AS 10 has been fully revised in 2016 as standard on 'Property, Plant and Equipment'.

The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

25.2 Scope

This standard should be applied by all enterprises in accounting intangible assets, except

(a) intangible assets that are covered by another AS,

(b) financial assets,

(c) rights and expenditure on the exploration for or development of minerals, oil, natural gas and similar non-regenerative resources,

(d) intangible assets arising in insurance enterprise from contracts with policy holders,

(e) expenditure in respect of termination benefits.

Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

25.3 Definitions

An asset is a resource:

a. Controlled by an enterprise as a result of past events and

b. From which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An active market is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

A financial asset is any asset that is:

a. Cash,

b. A contractual right to receive cash or another financial asset from another enterprise,

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or

d. An ownership interest in another enterprise.

25.4 Intangible Assets

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

The key components of the definition are:

- Identifiability; and
- Asset (the definition of which encompasses control).

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks. Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

25.5 Identifiability

The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity, though 'separability' is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

25.6 Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quit the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

25.7 Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

25.8 Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence and

b. The cost of the asset can be measured reliably.

These recognition criteria apply to both costs incurred to acquire an intangible asset and those incurred to generate an asset internally. However, the standard also imposes certain additional criteria for the recognition of internally-generated intangible assets.

When assessing the probability of expected future economic benefits, reasonable and supportable assumptions should be used, representing management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

An intangible asset should be measured initially at cost.

25.9 Separate Acquisition

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25.10 Acquisition as Part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14. In accordance with this Standard:

a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

25.11 Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.

This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

25.12 Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into **Research Phase & Development Phase.** If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

25.13 Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

25.14 Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development or from the development phase should be recognised if, and only if, an enterprise can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and

f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and

d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

An enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets.

An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

This Statement takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

25.15 Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a. Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset and

d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset:

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset.

25.16 Items to be Recognised as an Expense

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or

b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

AS 26 states that the following types of expenditure which should always be recognised as an expense when it is incurred:

- Research;
- Start-up activities (start-up costs), unless the expenditure qualifies to be included in the cost of a tangible fixed asset. Start-up costs include:
- Preliminary expenses incurred in establishment of a legal entity; such as legal and secretarial costs;
- Expenditure to open a new facility or business (ie pre-opening costs); and
- Expenditure prior to starting new operations or launching new products or processes (ie pre-operating costs);
- Training activities;
- Advertising and promotional activities; and
- Relocating or re-organising part or all of an enterprise.

It does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognized as expenses cannot be reclassified as cost of intangible asset in later years.

25.17 Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and

b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

25.18 Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

25.19 Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

25.20 Residual Value

The residual value of an intangible asset should be assumed to be zero unless:

a. There is a commitment by a third party to purchase the asset at the end of its useful life or

b. There is an active market for the asset and:

   (i) Residual value can be determined by reference to that market and

   (ii) It is probable that such a market will exist at the end of the asset's useful life.

25.21 Review of Amortisation Period and Amortisation Method

During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. Therefore, the amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

25.22 Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28, which will be discussed in the later units of this chapter. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition. In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

a. An intangible asset that is not yet available for use and

b. An intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under AS 28 and impairment losses recognised accordingly.

If the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the required impairment test and makes the disclosure required.

25.23 Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

25.24 Disclosure

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

a. The useful lives or the amortisation rates used.

b. The amortisation methods used.

c. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

d. A reconciliation of the carrying amount at the beginning and end of the period showing:

   i. Additions, indicating separately those from internal development and through amalgamation.

   ii. Retirements and disposals.

   iii. Impairment losses recognised in the statement of profit and loss during the period.

   iv. Impairment losses reversed in the statement of profit and loss during the period.

   v. Amortisation recognised during the period and

   vi. Other changes in the carrying amount during the period.

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

25.25 Transitional Provisions

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under this Statement and the period determined has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined has not expired on the date of this Statement coming into effect and:

a. If the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

b. If the remaining period as per the accounting policy followed by the enterprise:

   (i) Is shorter as compared to the balance of the period determined, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

   (ii) Is longer as compared to the balance of the period determined, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

25.26 Illustrations

Illustration 1

Dell International Ltd. is developing a new production process. During the financial year 31st March, 2016, the total expenditure incurred on this process was ₹ 40 lakhs. The production process met the criteria for recognition as an intangible asset on 1st December, 2015. Expenditure incurred till this date was ₹ 16 lakhs.

Further expenditure incurred on the process for the financial year ending 31st March 2017, was ₹ 70 lakhs. As at 31-3-2017, the recoverable amount of know-how embodied in the process is estimated to be ₹ 62 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

(a) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2016? (Ignore depreciation for this purpose)

(b) What is the carrying amount of the intangible asset as at 31st March 2016?

(c) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2017? (Ignore depreciation for this purpose)

(d) What is the carrying amount of the intangible asset as at 31st March 2017?

Solution

(a) ₹ 16 lakhs

(b) Carrying amount as on 31-3-2016 will be the expenditure incurred after 1-12-2015 = ₹ 24 lakhs

(c) Book cost of intangible asset as on 31-3-2017 is as follows

Total Book cost = ₹ (70 + 24) lakhs = ₹ 94 lakhs

Recoverable amount as estimated = ₹ 62 lakhs

Difference to be charged to Profit and Loss account = ₹ 32 lakhs

(d) ₹ 62 lakhs.

Illustration 2

A Pharma Company spent ₹ 33 lakhs during the accounting year ended 31st March, 2017 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of ₹ 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2017.

Illustration 3

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortization cost of the patent for each of the years.

Solution

Swift Limited amortised ₹ 10,00,000 per annum for the first two years i.e. ₹ 20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	*Net cash flows* ₹	*Amortization Ratio*	*Amortization Amount* ₹
I	-	0.125	10,00,000[1]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000

[1] It has been assumed that the company had amortized the patent at ₹ 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note: The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

Illustration 4

During 2016-2017, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

	Amount (₹)
Completion of detailed programme and design	*25,000*
Coding and Testing	*20,000*
Other coding costs	*42,000*
Testing costs	*12,000*
Product masters for training materials	*13,000*
Duplication of computer software and training materials, from product masters (2,000 units)	*40,000*
Packing the product (1,000 units)	*11,000*

What amount should be capitalized as software costs in the books of the company, on Balance Sheet date?

Solution

As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model. In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000.

Reference: The students are advised to refer the full text of AS 26 "Intangible Assets" (issued 2002).

UNIT 26 : AS 27: FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

26.1 Introduction

AS 27, came into effect in respect of accounting periods commenced on or after 01.04.2002. This standardset out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. The standard deals with three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, apply only when consolidated financial statements are prepared by venturer. Otherwise, AS 13 will be applicable in venturer's separate financial statements. An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

26.2 Scope

This Standard should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

26.3 Definitions

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:

- **Two or more parties coming together:** Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
- **Venturers undertake some economic activity:** Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.

- **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.
- **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.

Joint control is the contractually agreed sharing of control over an economic activity.

Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

A **venturer** is a party to a joint venture and has joint control over that joint venture.

An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

26.4 Contractual Arrangement

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 23 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture.

Irrespective of the form of the contract, the content of the contract ideally should include the following points:

- The activity, duration and reporting obligations of the joint venture.
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers.
- Capital contributions by the venturers.
- The sharing by the venturers of the output, income, expenses or results of the joint venture.

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer. For example, IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer. Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer. For example, Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives.

Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

26.5 Forms of Joint Ventures

Joint ventures may take many forms and structures, this Statement identifies them in three broad types - **Jointly Controlled Operations (JCO), Jointly Controlled Assets (JCA) and Jointly Controlled Entities (JCE).** Any structure which satisfies the following characteristics can be classified as joint ventures: (a) Two or more venturers are bound by a contractual arrangement and (b) The contractual arrangement establishes joint control.

26.6 Jointly Controlled Operations (JCO)

Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of fixed and employees for joint venture business and their own business. Since there is no separate legal entity and venturers don't recognize the transactions separately, they do not maintain a separate set of books for joint venture. All the transactions of joint venture are recorded in their books only. Following are the key features of JCO:

a. Each venturer has his own separate business.

b. There is no separate entity for joint venture business.

c. All venturers are creating their own assets and maintain them.

d. Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.

e. There is a common agreement between all of them.

f. Venturers use their assets for the joint venture business.

g. Venturers met the liabilities created by them for the joint venture business.

h. Venturers met the expenses of the joint venture business from their funds.

i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Since the jointly controlled operation is not purchasing assets or raising finance in its own right, the assets and liabilities used in the activities of the joint venture are those of the ventures. As such, they are accounted for in the financial statements of the venture to which they belong. The only accounting issue that arises is that the output from the project is to be shared among the venturers and, therefore, there must be some mechanism for specifying the allocation of the proceeds and the sharing of any joint expenses.

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Everything is recorded in their personal business only. Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

Illustration 1

Mr. A, Mr. B and Mr. C entered into a joint venture to purchase a land, construct and sell flats. Mr. A purchased a land for ₹ 60,00,000 on 01.01.2016 and for the purpose he took loan from a bank for ₹ 50,00,000 @ 8% interest p.a. He also paid registering fees ₹ 60,000 on the same day. Mr. B supplied the materials for ₹ 4,50,000 from his godown and further he purchased the materials for ₹ 5,00,000 for the joint venture. Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be ₹ 9,00,000. On 30.06.2016 each of the venturer agreed to take away one flat each to be valued at ₹ 10,00,000 each flat and rest were sold by them as follow: Mr. A for ₹ 40,00,000; Mr. B for ₹ 20,00,000 and Mr. C for ₹ 10,00,000. Loan was repaid on the same day by Mr. A alongwith the interest and net proceeds were shared by the partners equally.

You are required to prepare the draft Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

Solution

Draft Consolidated Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Purchase of Land:			By Sale of Flats:		
Mr. A		60,00,000	Mr. A	40,00,000	
To Registration Fees:			Mr. B	20,00,000	
Mr. A		60,000	Mr. C	10,00,000	70,00,000
To Materials:			By Flats taken by Venturers:		
Mr. B		9,50,000	Mr. A	10,00,000	
To Other Expenses:			Mr. B	10,00,000	
Mr. C		9,00,000	Mr. C	10,00,000	30,00,000
To Bank Interest:					
Mr. A		2,00,000			
To Profits:					
Mr. A	6,30,000				
Mr. B	6,30,000				
Mr. C	6,30,000	18,90,000			
		1,00,00,000			1,00,00,000

In the Books of Mr. A

Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank Loan (Purchase of Land)	50,00,000	By Bank (Sale of Flats)	40,00,000
To Bank:(Purchase of Land)	10,00,000	By Land & Building	10,00,000
To Bank (Registration Fees)	60,000	By Bank (Received from Mr. B)	14,20,000
To Bank (Bank Interest)	2,00,000	By Bank (Received from Mr. C)	4,70,000
To Profit on JV	6,30,000		
	68,90,000		68,90,000

In the Books of Mr. B
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Purchases (Material Supplied)	4,50,000	By Bank (Sale of Flats)	20,00,000
To Bank (Materials)	5,00,000	By Land & Building	10,00,000
To Profit on JV	6,30,000		
To Bank (Paid to Mr. A)	14,20,000		
	30,00,000		30,00,000

In the Books of Mr. C
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank (Misc. Expenses)	9,00,000	By Bank (Sale of Flats)	10,00,000
To Profit on JV	6,30,000	By Land & Building	10,00,000
To Bank (Paid to Mr. A)	4,70,000		
	20,00,000		20,00,000

26.7 Jointly Controlled Assets (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- There is no separate legal identity.
- There is a common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.

- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

For example, ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

For the joint venture, each venturer will record his share of joint assets as ***classified according to the nature of the assets rather than as an investment,*** and any expenditure incurred or revenue generated will be recorded with other items similar to JCO. Following are the few differences between JCO and JCA for better understanding:

- In JCO venturers uses their own assets for joint venture business but in JCA they jointly owns the assets to be used in joint venture.
- JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

Illustration 2

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gas from one place to another that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings ₹ 12,00,000 to be depreciated @ 5% p.a., Pipeline for ₹ 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for ₹ 3,00,000 to be depreciated @ 40% p.a. and various vehicles of ₹ 9,00,000 to be depreciated @ 20% p.a.

They also decided to equally bear the total expenditure incurred on the maintenance of the pipeline that comes to ₹ 6,00,000 each year.

You are required to show the consolidated financial balance sheet and the extract of draft Profit & Loss Account and Balance Sheet for each venturer.

Solution

Consolidated Balance Sheet

		Note	(₹)
I	Equity and liabilities		
	Shareholders' funds:		
	Share Capital	1	71,40,000
			71,40,000
II	Assets		
	Non-current Assets		
	Fixed assets:		
	Tangible assets	2	71,40,000
			71,40,000

Notes to Accounts (₹)

1.	Share capital		
	A Ltd.	2,380,000	
	B Ltd.	2,380,000	
	C Ltd.	2,380,000	7,140,000
2.	Tangible assets		
	Land & Building:		
	A Ltd.	380,000	
	B Ltd.	380,000	
	C Ltd.	380,000	1,140,000
	Plant & Machinery:		
	A Ltd.	1,700,000	
	B Ltd.	1,700,000	
	C Ltd.	1,700,000	5,100,000
	Computers:		
	A Ltd.	60,000	
	B Ltd.	60,000	
	C Ltd.	60,000	180,000
	Vehicles:		
	A Ltd.	240,000	
	B Ltd.	240,000	
	C Ltd.	240,000	720,000

In the Books of A Ltd.
Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	*1*	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	380,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	1,700,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	240,000
			23,80,000

In the Books of B Ltd.
Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	1	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of C Ltd.
Extract of Draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	1	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	

	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

26.8 Jointly Controlled Entities (JCE)

This is the format where venturer creates a new entity for their joint venture business. All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement. This contractual agreement also determines the joint control of the venturer.

Being a separate entity, separate set of books is maintained for the joint venture and in the individual books of venturers the investment in joint venture is recorded as investment (AS 13). Joint venture can be a foreign company operating in India through an Indian concern say Gremo Insurance of Germany contributes 49% of the assets in joint venture in India with Indo Bank Ltd. of India. They agreed to share the net results in 1:1 ratio. The main objective of the joint venture is to exploits the technical expertise of Gremo Insurance and Goodwill of Indo Bank Ltd. It can also be two or more local concerns opening an organization or firm or company contributing their assets to this new joint venture concern and share the profits of the operation in the agreed ratio.

Illustration 3

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will sell import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trail balance of the joint venture at the end of the first year:

Particulars	*Dr. (₹)*	*Cr.(₹)*
Purchases	*9,00,000*	
Other Expenses	*3,06,000*	
Sales		*13,05,000*
Fixed Assets	*6,00,000*	
Current Assets	*2,00,000*	

Unsecured Loans		*2,00,000*
Current Liabilities		*1,00,000*
Capital		*4,01,000*

Closing inventory was valued at ₹ 1,00,000.

You are required to prepare the Consolidated Financial Statement.

Solution

Consolidated Profit & Loss Account

Particulars	*Note No.*	*(₹)*
Revenue from operations	1	13,05,000
Total Revenue (A)		13,05,000
Less: Expenses		
Purchases	2	9,00,000
Other expenses	3	3,06,000
Changes in inventories of finished goods	4	(1,00,000)
Total Expenses (B)		11,06,000
Profit Before Tax (A-B)		1,99,000

Consolidated Balance Sheet

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	5	4,01,000
	Reserves and Surplus	6	1,99,000
	2. Non-current liabilities		
	Long term borrowings	7	2,00,000
	3. Current Liabilities	8	1,00,000
			9,00,000
II	Assets		
	Non-current Assets		
	Fixed assets	9	6,00,000
	Current Assets		
	Inventories	10	1,00,000
	Other current assets	11	2,00,000
			9,00,000

Notes to Accounts

	Particulars		(₹)
1.	Revenue from operations		
	Sales:		
	A Ltd.	7,25,000	
	B Ltd.	5,80,000	13,05,000
2.	Purchases		
	A Ltd.	5,00,000	
	B Ltd.	4,00,000	9,00,000
3.	Other expenses		
	A Ltd.	1,70,000	
	B Ltd.	1,36,000	3,06,000
4.	Closing Inventory		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
5.	Share Capital:		
	A Ltd.	1,96,490	
	B Ltd.	2,04,510	4,01,000
6.	Reserves and Surplus		
	Profit & Loss Account:		
	A Ltd.	99,500	
	B Ltd.	99,500	1,99,000
7.	Long Term Borrowings		
	Unsecured Loans:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000
8.	Current Liabilities:		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
9.	Fixed Assets:		
	A Ltd.	3,00,000	
	B Ltd.	3,00,000	6,00,000
10.	Inventories		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000

11.	Other Current Assets:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000

26.9 Consolidated Financial Statements of a Venturer

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

a. Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

   In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

A venturer should discontinue the use of the proportionate consolidation method from the date that:

a. It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.

b. The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturers.

From the date of discontinuing the use of the proportionate consolidation method,

a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.

b. If interest is 20% or more but upto 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.

c. For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.

d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

a. Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.

b. Venturer's share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.

For example, Mr. A enters into a joint venture with Mr. B and has contributed 33% of the total fixed assets and has share of 40% in current assets and current liabilities. Its share in net result is 50%. Consolidated Balance Sheet will be prepared by Mr. A as follow:

Consolidated Balance Sheet

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	1	1,00,000
	2. Current Liabilities	2	50,000
			1,50,000
II	Assets		
	Non-current Assets		
	Fixed assets	3	75,000
	Current Assets	4	75,000
			1,50,000

Notes to Accounts

1.	Share Capital:		
	A	33,000	
	B	67,000	1,00,000
2.	Current Liabilities:		
	A	20,000	
	B	30,000	50,000
3.	Fixed Assets:		
	A	25,000	
	B	50,000	75,000
4.	Current Assets:		
	A	30,000	
	B	45,000	75,000

Similar to above all the items of expenses and income will also be classified line by line for each item. The whole basis of this provision is to bring transparency in the books of account. If there is any special clause for sharing of expenses, income or any other item that should be clearly disclosed in the consolidated financial statement.

c. Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21.

d. As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.

e. Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances.

   If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.

f. Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.

g. On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve.

   In case the carrying amount of investment is different than cost of investment, we take carrying amount for the purpose of the above calculation.

h. An investor who don't have joint control in the entity is like associate as discussed in AS 23, therefore the treatment of losses will be similar to AS 23. If investor's share in loss of the joint entity is in excess of his interest in net asset, this excess loss will be recognized by the venturers. In future when entity starts reporting profits, investor's share of profits will be provided to venturer till total amount is equivalent to absorbed losses.

Illustration 4

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all the three companies:

Particulars	*A Ltd.*	*B Ltd.*	*C Ltd.*
Share Capital	*1,000,000*	*750,000*	*500,000*
Reserve & Surplus	*1,800,000*	*1,600,000*	*1,200,000*
Loans	*300,000*	*400,000*	*200,000*
Current Liabilities	*400,000*	*250,000*	*100,000*
Fixed Assets	*3,050,000*	*2,625,000*	*1,950,000*

Investment in JV	*250,000*	*250,000*	*-*
Current Assets	*200,000*	*125,000*	*50,000*

Prepare the balance sheet of A Ltd. and B Ltd. under proportionate consolidation method.

Solution

Balance Sheet of A Ltd.

		Note No.	(₹)
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		10,00,000
	Reserves and Surplus	1	24,00,000
	2. Non-current liabilities	2	4,00,000
	3. Current Liabilities	3	4,50,000
	TOTAL		42,50,000
II	Assets		
	Non-current Assets		
	Fixed assets:	4	40,25,000
	Current Assets	5	2,25,000
			42,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	18,00,000	
	C Ltd.	6,00,000	24,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	3,00,000	
	C Ltd.	1,00,000	4,00,000
3.	Current Liabilities:		
	A Ltd.	4,00,000	
	C Ltd.	50,000	4,50,000
4.	Fixed Assets:		
	A Ltd.	30,50,000	
	C Ltd.	9,75,000	40,25,000

5.	Current Assets:		
	A Ltd.	2,00,000	
	C Ltd.	25,000	2,25,000

Balance Sheet of B Ltd.

		Note No.	(₹)
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		7,50,000
	Reserves and Surplus	1	22,00,000
	2. Non-current liabilities	2	5,00,000
	3. Current Liabilities	3	3,00,000
			37,50,000
II	Assets		
	1. Non-current Assets		
	Fixed assets	4	36,00,000
	2. Current Assets	5	1,50,000
			37,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	16,00,000	
	C Ltd.	6,00,000	22,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	4,00,000	
	C Ltd.	1,00,000	5,00,000
3.	Current Liabilities:		
	A Ltd.	2,50,000	
	C Ltd.	50,000	3,00,000
4.	Fixed Assets:		
	A Ltd.	26,25,000	
	C Ltd.	9,75,000	36,00,000
5.	Current Assets:		
	A Ltd.	1,25,000	
	C Ltd.	25,000	1,50,000

26.10 Transactions between a Venturer and Joint Venture

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

In case the joint venture is in the form of separate entity then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

26.11 Reporting Interests in Joint Ventures in the Financial Statements of an Investor

The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement it is recognized as per AS 13, AS 21 or AS 23 as appropriate.

26.12 Operators of Joint Ventures

Payment to operators is recognized as expense in CFS and in the books of the operators as per AS 9, Revenue Recognition. The operator may any of the venturer, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.

26.13 Disclosures

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

b. Its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Reference: The students are advised to refer the full text of AS 27 "Financial Reporting of Interests in Joint Ventures" (issued 2002).

UNIT 27: AS 28: IMPAIRMENT OF ASSETS

27.1 Introduction

AS 28 came into effect in respect of accounting period commenced on or after 1-4-2004 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard came into effect in respect of accounting periods commenced on or after 1-4-2005 and is mandatory in nature from that date.

This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account.

27.2 Scope

The standard should be applied in accounting for impairment of all assets except

1. inventories (AS 2),
2. assets arising under construction contracts (AS 7),
3. financial assets including investments covered under AS 13, and deferred tax assets (AS 22).

There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

Therefore, AS 28 applies to (among other assets):

- Land and buildings;
- Plant and machinery;
- Investment property;
- Intangible assets;
- Goodwill;
- Assets carried at revalued amounts under AS 10.

27.3 Assessment

An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.

c. Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d. The carrying amount of the net assets of the reporting enterprise is more than its market capitalization.

Internal sources of information

a. Evidence is available of obsolescence or physical damage of an asset.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date and

c. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated.

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 6, even if no impairment loss is recognised for the asset.

27.4 Measurement of Recoverable Amount

Recoverable amount for an asset is defined by the statement as the higher of net selling price or value of use. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. Otherwise, if it is not possible to determine the selling price we take value in use of assets as it's recoverable amount.

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs, unless either:

a. The asset's net selling price is higher than its carrying amount; or

b. The asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

The best evidence for net selling price is a price in the bidding sales agreement for the disposal of the assets or similar assets. In the absence of this net selling price is estimated from the transactions for the assets in active market, if the asset has the active market. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

Value in Use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Estimating the value in use of an asset involves the following steps:

a. Estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

b. Applying the appropriate discount rate to these future cash flows.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount

Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Depreciation **(Amortisation**) is a systematic allocation of the depreciable amount of an asset over its useful life.

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

Useful life is either:

- The period of time over which an asset is expected to be used by the enterprise; or
- The number of production or similar units expected to be obtained from the asset by the enterprise.

27.5 Basis for Estimates of Future Cash Flows

Cash flow projections should be based on the most recent budgets/forecasts for a maximum of five years. Financial budgets/forecasts over a period longer than five years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.

27.6 Composition of Estimates of Future Cash Flows

Estimates of future cash flows should include (i) Projections of net cash inflows from the continuing use of the asset and (ii) Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Care should be taken for the following points:

a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included.

b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included.

c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded.

d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered.

e. Any future capital expenditure enhancing the capacity of the assets should be excluded.

f. Any increase in expected cash inflow from the above expenditure should also be excluded.

g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments.

Foreign Currency Future Cash Flows are estimated in the currency it will be generated and after they are discounted for the time value of money, we convert them in the reporting currency on the basis of AS 11.

Discount Rate

The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

27.7 Recognition and Measurement of an Impairment Loss

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is carried on at the same book value. But when this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss should be written off immediately as expenses to Profit & Loss Account. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account. Depreciation for the coming years on the assets are recalculated on the basis of the new carrying amount, residual value and remaining useful life of the asset, according to AS 10.

27.8 Identification of the Cash-Generating Unit to which an Asset Belongs

A *cash generating unit* is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

27.9 Recoverable Amount and Carrying Amount of a Cash-Generating Unit

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e. carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

27.10 Goodwill

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test

27.11 Corporate Assets

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset:

a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

27.12 Impairment Loss for a Cash-Generating Unit

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

a. First, to goodwill allocated to the cash-generating unit (if any); and

b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

a. Its net selling price (if determinable);

b. Its value in use (if determinable); and

c. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

27.13 Reversal of an Impairment Loss

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss. Indications of a potential decrease in an impairment loss are mainly mirror the indications of a potential impairment loss discussed above as external and internal indicators. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

27.14 Reversal of an Impairment Loss for an Individual Asset

If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately. If impairment loss was adjusted with the Revaluation Reserve; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

27.15 Reversal of an Impairment Loss for a Cash-Generating Unit

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

b. Then, to goodwill allocated to the cash-generating unit (if any),

27.16 Reversal of an Impairment Loss for Goodwill

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

b. Subsequent external events have occurred that reverse the effect of that event.

27.17 Impairment in case of Discontinuing Operations

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;

b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

27.18 Disclosure

For each class of assets, the financial statements should disclose:

a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

c. The amount of impairment losses recognised directly against revaluation surplus during the period; and

d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

a. The events and circumstances that led to the recognition or reversal of the impairment loss;

b. The amount of the impairment loss recognised or reversed;

c. For an individual asset:

   (i) The nature of the asset; and

   (ii) The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

d. For a cash-generating unit:

   (i) A description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

(ii) The amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

(iii) If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

a. The main classes of assets affected by impairment losses (reversals of impairment losses);

b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

27.19 Transitional Provisions

On the date of this Statement becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Statement. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Statement becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves. Any impairment loss arising after the date of this Statement becoming mandatory should be recognised in accordance with this Statement (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

27.20 Illustrations

Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to fixed asset on 31-12-2016. The discount rate is 15%.

Year	*Cash Flow (₹ in lakhs)*
2017	*4000*
2018	*6000*
2019	*6000*
2020	*8000*
2021	*4000*

Residual value at the end of 2021	=	*₹ 1000 lakhs*
Fixed Asset purchased on 1-1-2017	=	*₹ 40,000 lakhs*
Useful life	=	*8 years*
Net selling price on 31-12-2016	=	*₹ 20,000 lakhs*

Calculate on 31-12-2016:

(a) Carrying amount at the end of 2016

(b) Value in use on 31-12-2016

(c) Recoverable amount on 31-12-2016

(d) Impairment loss to be recognized for the year ended 31-12-2016

(e) Revised carrying amount

(f) Depreciation charge for 2017

Solution

Calculation of value in use

Year	*Cash Flow*	*Discount as per 15%*	*Discounted cash flow*
2017	4,000	0.870	3,480
2018	6,000	0.756	4,536
2019	6,000	0.658	3,948
2020	8,000	0.572	4,576
2021	4,000	0.497	1,988
2021	(residual) 1,000	0.497	497
			19,025

(a) **Calculation of carrying amount:**

Original cost = ₹ 40,000 lakhs

Depreciation for 3 years = [(40,000-1000)×3/8] = ₹ 14,625 lakhs

Carrying amount on 31-12-2016 = [40,000-14,625] = ₹ 25,375 lakhs

(b) **Value in use = ₹ 19,025 lakhs**

Net Selling Price = ₹ 20,000 lakhs

Recoverable amount = higher of value in use and net selling price i.e. ₹ 20,000 lakhs.

(c) **Recoverable amount** = ₹ 20,000 lakhs

(d) **Impairment Loss** = ₹ (25,375-20,000) = ₹ 5,375 lakhs

(e) **Revised carrying amount** = ₹ (25,375-5,375) = ₹ 20,000 lakhs

(f) **Depreciation charge for 2017** = (20,000-1000)/5 = ₹ 3,800 lakhs

Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.2017. Its balance useful life is 5 years and residual value at the end of 5 years is ₹ 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:

For the year ended on	*Estimated cash flow (₹ in lakhs)*
31.3.2018	50
31.3.2019	30
31.3.2020	30
31.3.2021	20
31.3.2022	20

Calculate "value in use" for plant if the discount rate is 10% and also calculate the recoverable amount if net selling price of plant on 31.3.2017 is ₹ 60 lakhs.

Solution

Present value of future cash flow

Year ended	*Future Cash Flow*	*Discount @ 10% Rate*	*Discounted cash flow*
31.3.2018	50	0.909	45.45
31.3.2019	30	0.826	24.78
31.3.2020	30	0.751	22.53
31.3.2021	20	0.683	13.66
31.3.2022	20	0.620	12.40
			118.82
Present value of residual price on 31.3.2022 = 5 × 0.620			3.10
Present value of estimated cash flow by use of an asset and residual value, which is called "value in use".			121.92

If net selling price of plant on 31.3.2017 is ₹ 60 lakhs, the recoverable amount will be higher of ₹ 121.92 lakhs (value in use) and ₹ 60 lakhs (net selling price), hence recoverable amount is ₹ 121.92 lakhs.

Reference: The students are advised to refer the full text of AS 28 "Impairment of Assets" (issued 2002).

UNIT 28 : AS 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

28.1 Introduction

AS 29 came into effect in respect of accounting periods commenced on or after 1-4-2004. The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments (not carried at fair value) and insurance enterprises (other than those arising from contracts with policyholders).

The standard will not apply to provisions/liabilities resulting from executor contracts and those covered under any other accounting standard.

This Standard is mandatory in nature from that date:

a. In its entirety, for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

   i. Enterprises whose equity or debt securities are listed whether in India or outside India.

   ii. Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

   iii. Banks including co-operative banks.

   iv. Financial institutions.

   v. Enterprises carrying on insurance business.

   vi. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crore. Turnover does not include 'other income'.

   vii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 10 crore at any time during the accounting period.

   viii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

b. In its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

   i. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 40 lakhs but does not exceed ₹ 50 crore. Turnover does not include 'other income'.

ii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 1 crore but not in excess of ₹ 10 crore at any time during the accounting period.

iii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

c. In its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

28.2 Scope

This Standard should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than

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

b. Those resulting from executory contracts;

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

d. Those covered by another Accounting Standard.

Where another Accounting Standard like 7; 9; 15; 19; 22 & 24 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of this Standard.

28.3 Definitions

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

Examples of executory contracts include:

- Employee contracts in respect of continuing employment;
- Contracts for future delivery of services such as gas and electricity;
- Obligations to pay local authority charges and similar levies; and
- Most purchase orders.

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

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

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

A Contingent liability is:

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

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

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

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

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

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

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

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

(a) The scope of a business undertaken by an enterprise; or

(b) The manner in which that business is conducted.

28.4 Provisions

A provision should be recognised when:

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

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

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

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

28.5 Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

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

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

28.6 Past Event

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

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

28.7 Probable Outflow of Resources Embodying Economic Benefits

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

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

28.8 Reliable Estimate of the Obligation

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

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

28.9 Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

28.10 Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

28.11 Measurement -Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the **enterprise, supplemented by experience** of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value ***except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.*** The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

28.12 Future Events

It is only those obligations arising from past events that exist independently of the enterprise's future actions (ie the future conduct of its business) that are recognised as provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

28.13 Expected Disposal of Assets

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

28.14 Reimbursements

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

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

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

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

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

28.15 Changes in Provisions

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

28.16 Use of Provisions

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

28.17 Application of the Recognition and Measurement Rules

28.17.1 Future Operating Losses

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

28.17.2 Restructuring

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

(a) Sale or termination of a line of business;

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

(c) Changes in management structure, for example, eliminating a layer of management; and

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

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

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

(a) Necessarily entailed by the restructuring; and

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

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

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

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

As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

28.18 Disclosure

For each class of provision, an enterprise should disclose:

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

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

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

(d) Unused amounts reversed during the period.

SMCs are exempt from the disclosure requirements of AS 29

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

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

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

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

SMCs are exempt from the disclosure requirements of AS 29

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

(a) An estimate of its financial effect,

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

(c) The possibility of any reimbursement.

28.19 Transitional Provisions

As per the amendment made in AS 29 in the year, 2016 all the existing provisions for decommissioning, restoration and similar liabilities should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.

28.20 Miscellaneous Illustrations

Illustration 1

At the end of the financial year ending on 31st December, 2017, 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 (₹)*
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.

Solution

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 remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000

= ₹ 36,000 + ₹ 20,000

= ₹ 56,000

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

= ₹ 30,000 + ₹ 42,000

= ₹ 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 ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Reference: The students are advised to refer the full text of AS 29 "Provisions, Contingent Liabilities and Contingent Assets" (issued 2003).

UNIT 29 : GUIDANCE NOTES

29.1 Introduction

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time.

Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

29.2 Status of Guidance Notes

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

29.3 Guidance Notes on Accounting Aspects

The following is the list of applicable guidance notes on accounting aspects:

1. GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements.
2. GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting.

3. GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax.
4. GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty.
5. Guidance Note on Accounting Treatment for MODVAT/ CENVAT.
6. GN(A) 18 (Issued 2005) Guidance Note on Accounting for Employee Share-base Payments.
7. GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961.
8. GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25.
9. Guidance Note on Applicability of AS 25 to Interim Financial Results.
10. Guidance Note on Turnover in case of Contractors.
11. Guidance Note on Schedule III to the Companies Act, 2013.
12. ***Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities.***
13. ***Guidance Note on Accounting for Derivative Contracts.***
14. ***Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013.***

The students are advised to go through the full text of all the Guidance Notes from the Accounting Pronouncements given along with this Study Material. Students may also check the following link for the full text of the Guidance Notes on our Institute's website:

http://www.icai.org/post.html?post_id=1399

29.4 An Overview of Guidance Notes

GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. The terms have been defined in this guidance note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings when used in the context of certain special enactments. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting

This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting. The Guidance Note explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality *vis-a-vis* accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have also been given in the Guidance Note.

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS 1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax

Corporate Dividend Tax (CDT) is in addition to the income-tax chargeable in respect of the total income of a domestic company and was introduced under The Finance Act, 1997. The Guidance Note on Accounting for Corporate Dividend Tax explains the salient features of Corporate Dividend tax (CDT). As per the Guidance Note, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty

Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. The subject of accounting of excise duty has, so far, beset with certain controversies, yet, the ICAI with the issuance of this Guidance Note, has recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established. Subsequent to the issuance of that Guidance Note, the nature of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on 'Valuation of Inventories' issued by the Institute of Chartered Accountants of India. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as 'CENVAT'). In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses. As per the recommendations given in the Guidance Note, Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost and if the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

GN(A) 25 Guidance Note on Accounting Treatment for MODVAT/CENVAT

The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT are also explained in the guidance note. For accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India.

GN(A) 18 (Issued 2005) Guidance Note on Accounting for Employee Share-based Payments

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An employee share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended here in below is based on the fair value method.

An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 9 to 11). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07. This Guidance Note deals with various aspects of accounting and presentation of MAT paid and the credit available in this regard. The Guidance Note describes the salient features of MAT credit and its accounting treatment. MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. MAT credit is a deferred tax asset for the purposes of AS 22. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period. Where a company recognises MAT credit as an asset on the basis of the considerations specified in the guidance note, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph the guidance note. According to paragraph 6 of Accounting Standards Interpretation (ASI) 6*, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports. Accounting for interim period income-tax expense is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25

* Now Explanation to AS 22.

that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

GN(A) 28 Guidance Note on Applicability of AS 25 to Interim Financial Results

This Guidance Note deals with the issue whether Accounting Standard (AS) 25, Interim Financial Reporting, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

GN(A) 29 Guidance Note on Turnover in Case of Contractors

This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, Construction Contracts (revised 2002), can be considered as 'turnover'.

The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

Guidance Note on Schedule III to the Companies Act, 2013

The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Schedule III. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities.

The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure of expenditure on activities relating to corporate social responsibility.

The Guidance Note does not deal with identification of activities that constitute CSR activities but only provides guidance on accounting for expenditure on CSR activities in line with the requirements of the generally accepted accounting principles including the applicable Accounting Standards.

The Act clearly lay down that the expenditure on CSR activities is to be disclosed only in the Board's Report in accordance with the Rules made thereunder. In view of this, no provision for the amount which is not spent, i.e., any shortfall in the amount that was expected to be spent as per the provisions of the Act on CSR activities and the amount actually spent at the end of a reporting period, may be made in the financial statements. The proviso to section 135 (5) of the Act, makes it clear that if the specified amount is not spent by the company during the year, the Directors' Report should disclose the reasons for not spending the amount.

However, if a company has already undertaken certain CSR activity for which a liability has been incurred by entering into a contractual obligation, then in accordance with the generally accepted principles of accounting, a provision for the amount representing the extent to which the CSR activity was completed during the year, needs to be recognized in the financial statements.

Where a company spends more than that required under law, a question arises as to whether the excess amount 'spent' can be carried forward to be adjusted against amounts to be spent on CSR activities in future period. Since '2% of average net profits of immediately preceding three years' is the minimum amount which is required to be spent under section 135 (5) of the Act, the excess amount cannot be carried forward for set off against the CSR expenditure required to be spent in future.

A company may decide to undertake its CSR activities approved by the CSR Committee with a view to discharge its CSR obligation as arising under

section 135 of the Act in the following three ways:

(a) making a contribution to the funds as specified in Schedule VII to the Act; or

(b) through a registered trust or a registered society or a company established under section 8 of the Act (or section 25 of the Companies Act, 1956) by the company, either singly or along with its holding or subsidiary or associate company or along with any other company or holding or subsidiary or associate company of such other company, or otherwise; or

(c) in any other way in accordance with the Companies (Corporate Social Responsibility Policy) Rules, 2014, e.g. on its own.

In case a contribution is made to a fund specified in Schedule VII to the Act, the same would be treated as an expense for the year and charged to the statement of profit and loss. In case the amount is spent in the manner as specified in paragraph10 (b) above the same will also be treated as expense for the year by charging off to the statement of profit and loss. The accounting for expenditure incurred by the company otherwise e.g. on its own would be accounted for in accordance with the principles of accounting as explained hereinafter.

In case the expenditure incurred by the company is of such nature which may give rise to an 'asset', a question may arise as to whether such an 'asset' should be recognised by the company in its balance sheet. In this context, it would be relevant to note the definition of the term 'asset'.

Invariably future economic benefits from a 'CSR asset' would not flow to the company as any surplus from CSR cannot be included by the company in business profits in view of Rule 6(2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014.

In some cases, a company may supply goods manufactured by it or render services as CSR activities. In such cases, the expenditure incurred should be recognised when the control on the goods manufactured by it is transferred or the allowable services are rendered by the employees. The goods manufactured by the company should be valued in accordance with the principles prescribed in Accounting Standard (AS) 2, Valuation of Inventories. The services rendered should be measured at cost. Indirect taxes (like excise duty, service tax, VAT or other applicable taxes) on the goods and services so contributed will also form part of the CSR expenditure.

Where a company receives a grant from others for carrying out CSR activities, the CSR expenditure should be measured net of the grant.

Rule 6 (2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that "the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company". any surplus arising out of CSR project or programme or activities shall be recognised in the statement of profit and loss and since this surplus cannot be a part of business profits of the company, the same should immediately be recognised as liability for CSR expenditure in the balance sheet and recognised as a charge to the statement of profit and loss. Accordingly, such surplus would not form part of the minimum '2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its Corporate Social Responsibility Policy'.

It is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with paragraphs 10-14 above should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.

Guidance Note on Accounting for Derivative Contracts.

The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities.

This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:

(i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.

(ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.

The accounting for derivatives covered by this Guidance Note is based on the following key principles:

(i) All derivative contracts should be recognised on the balance sheet and measured at fair value.

(ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.

(iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.

(iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.

(v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements

Hedge accounting may be required due to accounting mismatches in:

- Measurement –
- Recognition

Types of hedge accounting

This Guidance Note recognises the following three types of hedging;

- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
- the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- the hedge of a net investment in a foreign operation.

Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current.

Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013

This Guidance Note is issued with the objective to provide guidance on certain significant issues that may arise from the practical application of Schedule II with a view to establish consistent practice with regard to the accounting for depreciation.

This Guidance Note includes relevant provisions of Schedule II and provides guidance on implementing the requirements of Schedule II.

Schedule II to the Companies Act, 2013, specifies useful lives for the purpose of computation of depreciation. The said Schedule II was further amended by the Ministry of Corporate Affairs (MCA) through its notifications G.S.R. 237(E) dated March 31, 2014 and G.S.R. 627(E) dated August 29, 2014, respectively. As compared to Schedule XIV to the Companies Act, 1956, Schedule II, instead of specifying rates of depreciation for various assets, specifies that depreciation should be provided on the basis of useful life of an asset. While Schedule XIV was prescriptive in nature as it specified the minimum rate of depreciation, Schedule II provides indicative useful lives for various assets. As a consequence, the companies are in a position to charge depreciation based on the useful life of an asset supported by technical advice, even though such lives are higher or lower than those specified in the said schedule. In view of this, depreciation charged as per the useful life is true commercial depreciation bringing the financial statements prepared accordingly closer to those prepared in accordance with international standards.

the useful lives as given under Part 'C' of Schedule II for various types of assets are indicative only and are not minimum or maximum. Where the useful lives of various specific assets are the same as those under Schedule II, the company should use these useful lives. In case the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former should be applied by the company for providing depreciation. The disclosures in this regard should be made as described later in this Guidance Note. The process of determination of useful life is explained in the chart below. A company has to determine the useful life at the beginning of the year for all fixed assets, existing as at the end of the immediately preceding period and for newly acquired assets, as and when acquired. All fixed assets existing at the beginning of the year should be classified into assets for which no extra shift depreciation is applicable which would include continuous process plant (CPP) and assets for which extra shift depreciation applies. Of the assets for which extra shift depreciation applies, assets which are going to be used on single shift, double shift or triple shift are segregated. This segregation is required as the extra shift depreciation is applicable only to those assets whose useful life is determined on single shift basis. After segregation, the remaining useful life of the asset is estimated. A company recognises depreciation expense based on the useful life estimated by the management. Where the useful life estimated by the management is different from that specified by Schedule II, the same is disclosed in notes.

Illustration

A Limited is a company incorporated under the Companies Act, 1956, engaged in the business of manufacturing of toys. A Limited purchased a unit of machinery costing ₹ 60 lakhs as on April 01, 2014. As per Schedule II the general useful life of the assets is15 years. However, as per A Ltd.'s estimation, the useful life of the asset is 20 years supported by the technical advice.

Should the company use the useful life as 15 years or 20 years?

Solution

In this case, keeping in view the requirements under Schedule II, A Ltd. should depreciate the machinery over its useful life of 20 years as determined by the company and not over 15 years as indicated in Schedule II. A limited should also provide disclosures in this regard as recommended later in this Guidance Note in the notes to accounts to justify the reason for difference between the indicative use life and A's estimated useful life.

Illustration

B Limited had considered the minimum rates of depreciation mentioned in Schedule XIV for depreciating all its fixed assets till March 31, 2014. Based on the rates mentioned for SLM and WDV in Schedule XIV, B Limited had derived the useful lives for the assets. Schedule II of the Companies Act, 2013 is now applicable to B Limited w.e.f. April 1, 2014.

Whether B Limited needs to follow the useful lives mentioned in the Schedule II or derived useful lives considered till March 31, 2013 can be considered?

Solution

W.e.f. April 1, 2014, B limited should estimate the remaining useful lives of its assets based on the definition of useful life in Schedule II and the factors specified in AS 6 for recognising depreciation in the statement of profit and loss. There is no relevance of the derived useful life as per Schedule XIV. However, if B Limited estimates useful lives different from those specified in Schedule II, it should disclose such differences in the financial statements and provide justification in this behalf duly supported by technical advice.

Note 8 to Schedule II defines the expression 'Continues Process Plant' as:

"Continuous process plant" means a plant which is required and designed to operate for twenty-four hours a day.

The words "required and designed to operate twenty-four hours a day" are very significant and should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a CPP is such that there is a requirement to run it continuously for twenty-four hours a day. If it is not so run, there are significant shut-down and/or start-up costs. If such a plant is shut-down, there may be significant spoilage of materials-in-process/ some damage to the plant itself/significant energy loss. It is, however, possible that due to various reasons, e.g., lack of demand, maintenance etc., such a plant may be shut down for some time. The shut-down does not change the inherent technical nature of the plant.

CPP is distinct from the repetitive process plant or assembly-line type plants. These plants are not CPP since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate twenty-four hours a day, e.g., an automobile manufacturing plant.

It is noted that extra shift depreciation does not apply to CPP and the assets which have been marked as No Extra Shift Depreciation (NESD) under Schedule II. The concept of extra shift depreciation applies only to those assets for which the useful life has been estimated on single shift basis at the beginning of the year

Where a company, which estimated the useful life of an asset on single shift basis at the beginning of the year, used the asset on double or triple shifts during the year, the depreciation expense should be increased by 50% or 100% as the case may be for that period. Further, for such assets, the company at the beginning of the next year should determine whether the asset used in extra shift during the past year was on sporadic basis and is expected to be used on sporadic basis in future also. In such a case, the useful life to be on single shift basis and if in future the asset is used on double or triple shift then as in the past, the depreciation expense for the double or triple shift should be increased by 50% or 100% as the case may be for the period of use. In case the company estimates that the use of the asset for extra shift would not be on sporadic basis i.e. the extra shift working for the asset would be on regular or continuous basis, it should reassess its useful life considering its use on extra shift basis. The reassessed useful life should then be used for the purpose of charging depreciation expense henceforth.

a result of application of Schedule II, a company may use UOP method, where appropriate, keeping in view the various factors mentioned in paragraph 12 of AS 6. UOP method is generally considered appropriate where the number of units that can be produced or serviced from the use of the asset is the major limiting factor for the use of the asset rather than the time.

with the introduction of UOP method in Schedule II, a company may change from SLM or WDV method to UOP method. In such cases, in accordance with AS 6, depreciation on the underlying asset should be calculated retrospectively using the UOP method from the date the asset came into use to the company with adjustment of any surplus or deficiency arising from change in method to the statement of profit and loss as such change is required by the statute. However, as a first time application of Schedule II, if a company changes its method of depreciation from WDV to SLM or vice versa, the same cannot be justified as required by law as both the methods were allowed under Schedule XIV and AS 6. In accordance with AS 6, a shift from WDV to SLM or vice versa can only be applied by the company if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the company. In such a case also, any surplus or deficiency arising from change in method should be adjusted to the statement of profit and loss in accordance with AS 6. It may also be noted that in case of change in method of depreciation, transitional provisions given under Note 7 (b) of Schedule II will not apply.

Illustration:

A Limited is a company incorporated under the Companies Act and engaged in the business of oil exploration. Keeping in view the requirement in Schedule XIV it was depreciating its oil and gas assets on

SLM basis. In the financial year 2014-15, when A applies Schedule II it decides to depreciate the said assets by following the UOP method.

How should change in method be accounted for?

Solution

In this case, in accordance with AS 6, A Limited should calculate depreciation on all such assets following the UOP method since the assets came into existence and recognise any deficiency/gain in the statement of profit and loss for the period ending on March 31, 2015.

Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately. It is commonly known as 'component accounting'. Companies will need to identify and depreciate significant components with different useful lives separately.

Under component accounting, companies will capitalise these costs as a separate component of the asset and decapitalise the carrying amount of previously recognised component. A company is required to apply component accounting (if appropriate) for all depreciable fixed assets (existing or newly acquired) as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset(s), company is not required to apply component accounting for such asset(s).

The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset.

It may be noted that Schedule II does not prescribe any such requirement to provide depreciation at the rate of hundred percent. Therefore, an issue may arise whether the earlier requirement of providing hundred percent depreciation on assets with value less than rupees five thousand can still be followed or not.

As the life of the asset is a matter of estimation, the materiality of impact of such charge should be considered with reference to the cost of asset. The size of the company will also be a factor to be considered for such policy. Accordingly, a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

The company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

The use of different methods for similar assets at different geographical locations is not justified.

29.5 Miscellaneous Illustrations

Illustration 1

HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2017, it has the following finished stocks in the factory warehouse:

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

(ii) Goods meant for exports ₹ 50 lakhs (cost ₹ 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.

Solution

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, ₹ 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.

Illustration 2

A factory went into commercial production on 1st April, 2017. It uses as its raw materials product X on which excise duty of ₹ 30 per kg. is paid and product Y on which excise duty of ₹ 20 per kg. is paid. On 31st March, 2017 it had stock of 20,000 kgs. of X and 15,000 kgs. of Y which it had purchased at an all inclusive price of ₹ 150 per kg. for X and ₹ 120 per kg. for Y. The suppliers of X and Y are to receive payment on 15th May, 2017.

During April 2017, the factory manufactured 40,000 units of the end product for which the consumption of material X was 60,000 kgs. and material Y was 45,000 kgs. The excise duty on the end product is ₹ 60 per unit. 30,000 units of the end product were dispatched, 8,000 units were kept in warehouse and balance 2,000 kgs. were kept in finished goods godown.

During the month the factory purchased 50,000 kgs. of X at ₹ 145 per kg. (inclusive of excise duty of ₹ 30 per kg.) on credit of 60 days and 50,000 kgs. of Y at ₹ 110 per kg. (inclusive of excise duty of ₹ 20 per kg.) on credit of 45 days.

The cost of "converting" the raw materials into finished product amounts to ₹ 150 per unit of end product of which ₹ 100 is "cash cost" paid immediately and ₹ 50 represents non-cash charge for depreciation. There is no work in process.

Sales are effected at ₹ 750 per unit in respect of credit transactions and at ₹ 700 per unit in respect of cash transactions. 20% of dispatches were in respect of cash transactions while the balance 80% were in respect of credit transactions (one month credit).

You are required to:

(a) (i) Calculate MODVAT credit available, MODVAT credit availed of and balance in MODVAT credit as on 30th April, 2017.

(ii) Show the necessary ledger accounts in respect of MODVAT.

(b) Value the inventory of:

(i) raw material

(ii) finished goods in warehouse

(iii) finished goods in finished goods godown on "first in first out" principle.

(c) Show the ledger accounts of customers, suppliers and bank, assuming that the necessary bank balance is available at the start of the month to meet "cash" expenses of that month.

(d) Calculate the working capital as on 30th April, 2017.

(e) State the impact of 'MODVAT' on working capital requirement of the factory as on 30th April, 2017.

Solution

(a) (i) Excise duty paid on raw materials:

	X			Y			Total
	kgs.	@	Amount ₹	kgs.	@	Amount ₹	Amount ₹
Stock on 31st March, 2017	20,000	30	6,00,000	15,000	20	3,00,000	9,00,000
Purchases	50,000	30	15,00,000	50,000	20	10,00,000	25,00,000
			21,00,000			13,00,000	34,00,000

MODVAT credit available:

₹ 21,00,000 + 13,00,000 = ₹ 34,00,000

MODVAT credit availed of:

Production = 40,000 units

Excise duty on the end product = ₹ 60 per unit

MODVAT credit availed of = 40,000 × 60 = ₹ 24,00,000

Balance in MODVAT credit 34,00,000 – 24,00,000 = ₹ 10,00,000

Note: Normally goods are removed from factory on payment of excise duty. However, in respect of certain goods, provision has been made to store the goods in warehouses without payment of duty (Rule 20 of Central Excise Rules, 2002). These provisions are also applicable to goods transferred to customs warehouse.

It is to be noted that as per para 33 of The Guidance Note on Accounting Treatment for Excise Duty, it is necessary that a provision for liability in respect of unpaid excise duty should be made in the accounts in respect of stocks lying in the factory or warehouse since the liability for excise duty arises when the manufacture of the goods is completed.

(ii) **MODVAT Credit Receivable Account**

2015			₹	*2015*		₹
April 1	To Balance b/d			April	By Excise Duty A/c	24,00,000
	X	6,00,000		1 to 30		
	Y	3,00,000				
			9,00,000	April 30	By Balance c/d	10,00,000
April 1	To Suppliers A/c					
to 30	X	15,00,000				
	Y	10,00,000				
			25,00,000			
			34,00,000			34,00,000

Purchases Account

2015		₹	*2015*		₹
April	To Suppliers A/c		April 30	By Balance c/d	1,02,50,000
1 to 30	X: [50,000 × (145 – 30)]	57,50,000			
	Y: [50,000 × (110 – 20)]	45,00,000			
		1,02,50,000			1,02,50,000

(b) Valuation of Inventory

(i) Raw material:

	X (Kgs.)	*Y (Kgs.)*
Opening stock	20,000	15,000
Purchases	50,000	50,000
	70,000	65,000
Consumption	60,000	45,000
Closing stock	10,000	20,000
Inventory:		₹
X : 10,000 × (145 – 30)		11,50,000
Y : 20,000 × (110 – 20)		18,00,000
		29,50,000

(ii) Finished goods in warehouse

		₹
Raw material cost of 8,000 units of output		
X : 12,000* × (145 – 30)	13,80,000	
Y : 9,000* × (110 – 20)	8,10,000	21,90,000
Conversion cost		
Cash cost : 8,000 × ₹ 100	8,00,000	
Non-cash : 8,000 × ₹ 50	4,00,000	12,00,000
Excise duty		
8,000 × ₹ 60		4,80,000
		38,70,000

* For 40,000 units of output,

Input of X = 60,000 Kgs.

Input of Y = 45,000 Kgs.

Therefore, for 8,000 units of finished goods in warehouse:

Input of X = $\frac{60,000}{40,000} \times 8,000 = 12,000$ Kgs.

Input of Y = $\frac{45,000}{40,000} \times 8,000 = 9,000$ Kgs.

(iii) Finished goods in finished goods godown

	₹
Cost of 8,000 units of finished goods in warehouse	38,70,000
Cost of 2,000 units of finished goods in finished goods godown $= \frac{38,70,000}{8,000} \times 2,000$	9,67,500

(c) **Customers Account**

	₹		₹
To Sales A/c $\left(\frac{80}{100} \times 30,000 \times 750\right)$	1,80,00,000	By Balance c/d	1,80,00,000
	1,80,00,000		1,80,00,000

Suppliers Account

	₹		₹
To Balance c/d	1,75,50,000	By Balance b/d	
		X : 20,000 × ₹ 150 = 30,00,000	
		Y : 15,000 × ₹ 120 = 18,00,000	48,00,000
		By Purchases A/c	1,02,50,000

		By Modvat Credit Receivable A/c X : 50,000 × 30 = 15,00,000 Y : 50,000 × 20 = 10,00,000	25,00,000
	1,75,50,000		1,75,50,000

Bank Account

	₹		₹
To Balance b/d	40,00,000	By Cash Expenses (40,000 × 100)	40,00,000
To Sales (cash sales) A/c $\left(\frac{20}{100} \times 30,000 \times ₹\ 700\right)$	42,00,000	By Balance c/d	42,00,000
	82,00,000		82,00,000

(d) Working Capital as on 30th April, 2017

Current Assets:

Inventory

(i)	Raw materials		
	X	11,50,000	
	Y	18,00,000	29,50,000
(ii)	Finished goods in warehouse	38,70,000	
	in finished goods godown	9,67,500	48,37,500
Customers			1,80,00,000
Bank balance			42,00,000
MODVAT credit receivable			10,00,000
			3,09,87,500
Less: Current Liabilities			
Sundry creditors			(1,75,50,000)
			1,34,37,500

(e) Impact of Modvat on Working Capital Requirement

Modvat has enabled

(i) dispatch on sale of 30,000 units of finished product,

(ii) removal of 10,000 units of finished product, without payment of a single rupee in cash. Cash outlay so saved at ₹ 60 per unit is ₹ 24,00,000.

It has also ensured creation of a current asset worth ₹ 10,00,000 in MODVAT Credit Receivable Account. Thus, MODVAT reduces the pressure on working capital.

Illustration 3

Vikas Ltd. purchased a plant for ₹ 50 lakhs from Yash Ltd. during 2015 - 2016 and installed immediately. The price includes excise duty of ₹ 5 lakhs. During 2015 - 2016, the company produced excisable goods on which the excise authority charged excise duty to the extent of ₹ 4.5 lakhs. Show *the necessary Journal Entries explaining the treatment of CENVAT credit. You are also required to indicate the value of plant at which it should be recorded in Fixed Asset register.*

Answer

(i) **Journal Entries**

			₹ *in lakhs*	
(a)	Plant and Machinery A/c	Dr.	45	
	CENVAT credit receivable on capital goods A/c	Dr.	5	
	To Bank A/c or Yash Ltd.			50
	(Being capitalization of plant and machinery)			
(b)	Excise duty A/c	Dr.	2.5	
	To CENVAT credit receivable on capital goods A/c			2.5
	(Being excise duty set off available to the extent of 50% in the first year of acquisition of capital asset)			

(ii) **Value of plant to be recorded in Fixed Asset Register:** As per Guidance Note on "Accounting Treatment for CENVAT", fixed assets have to be capitalised net of refundable amounts.

The plant and machinery will be recorded at ₹ 45 lakhs (₹ 50 lakhs - ₹ 5 lakhs) in the fixed asset register.

Illustration 4

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2016, it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 16th December, 2016 and 15th March, 2017. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

2016	*Particulars*		*Dr.* ₹	*Cr.* ₹
April 1	Employee Compensation Expense	Dr.	9,00,000	
	To Employee Stock Options Outstanding			9,00,000
	(Being grant of 10,000 stock options to employees at ₹ 40 when market price is ₹ 130)			
2017				
16th Dec.	Bank	Dr.	3,80,000	
to 15th	Employee stock options outstanding	Dr.	8,55,000	
March	To Equity share capital			95,000

	To Securities premium			11,40,000
	(Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)			
March 16	Employee stock options outstanding	Dr.	45,000	
	To Employee compensation expense			45,000
	(Being entry for lapse of stock options for 500 shares)			
March 31	Profit and Loss A/c	Dr.	8,55,000	
	To Employee compensation expense			8,55,000
	(Being transfer of employee compensation expense to profit and loss account)			

Illustration 5

Mr. Investor buys a stock option of ABC Co. Ltd. in July, 2017 with a strike price ₹ 250 to be expired on 30th August, 2017. The premium is ₹ 20 per unit and the market lot is 100. The margin to be paid is ₹ 120 per unit.

Show the accounting treatment in the books of Buyer when:

(i) the option is settled by delivery of the asset, and

(ii) the option is settled in cash and the Index price is ₹ 260 per unit.

Solution

Accounting entries in the books of buyer

			₹	₹
July, 2017	Equity stock option premium Account	Dr.	2,000	
	To Bank Account			2,000
	(Being premium paid to acquire stock option)			
	Equity Stock Option Margin Account	Dr.	12,000	
	To Bank Account			12,000
	(Being initial margin paid on option)			
	(i) Option is setted by delivery of assets			
August, 2017	Equity shares of ABC Ltd. Account	Dr.	25,000	
	To Equity Stock Option Margin Account			12,000
	To Bank Account			13,000
	(Being option exercised and shares acquired. Margin adjusted and the balance amount was paid)			
	Profit and loss Account	Dr.	2,000	
	To Equity Stock Option Premium Account			
	(Being the premium transferred to profit and loss account on exercise of option)			

	Bank Account	Dr.	12,000	
	To Equity Stock Option Margin Account			12,000
	(Being margin on equity stock option received back on exercise /expiry of option)			

Illustration 6

H Ltd. engaged in the business of manufacturing lotus wine. The process of manufacturing this wine takes around 18 months. Due to this reason H Ltd. has prepared its financial statements considering its operating cycle as 18 months and accordingly classified the raw material purchased and held in stock for less than 18 months as current asset. Comment on the accuracy of the decision and the treatment of the asset by H Ltd., as per the Schedule III.

Solution

As per Schedule III to the Companies Act, 2013, one of the criteria for classification of an asset as a current asset is that the asset is expected to be realised in the company's' operating cycle or is intended for sale or consumption in the company's normal operating cycle.

Further, Schedule III to the Companies Act, 2013 defines that an operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. However, when the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.

As per the facts given in the question, the process of manufacturing of lotus wine takes around 18 months; therefore, its realisation into cash and cash equivalents will be done only when it is ready for sale i.e. after 18 months. This means that normal operating cycle of the product is 18 months. Therefore, the contention of the company's management that the operating cycle of the product lotus wine is 18 months and not 12 months is correct.

Illustration 7

Combine Ltd. is a group engaged in manufacture and sale of industrial and consumer products. One of its division deals with the real estate. The real estate division is continuously engaged in leasing of real estate properties. The accountant showed the rent arising from leasing of real estate as 'other income' in the Statement of Profit and Loss. State, whether the classification of the rent income made by the accountant is correct or not in light of Schedule III to the companies Act, 2013?

Solution

As per para 4 of the 'General Instructions for preparation of Statement of Profit and Loss' given in the Schedule III to the Companies Act, 2013, 'other income' does not include operating income. However, rent income arising from leasing of real estate properties is an operating income as Real Estate is one of the divisions of Combine Ltd. There is a separate head for operating income i.e. 'Revenue from Operations'. Therefore, classification of rent income as 'Other income' in the Statement of Profit and Loss will not be correct. It would, infact, be shown under the heading 'Revenue from Operations' only.

Illustration 8

Presented below is an extract of the Schedule of Secured and Unsecured Loans of Annual Report 2016-2017 of Super Star Ltd.

Particulars	*Schedule No*	*As at 31st March, 2017 (₹)*
Loan Funds		
a) Secured Loans	*3*	*6,07,114*
b) Unsecured Loans - Short Term Banks		*36,112*
		6,43,226
Schedule 3: Secured Loans		
Term Loans from:		
- Banks		*2,95,002*
- Others		*3,12,112*
		6,07,114
Other Information:		
Current maturities of long-term loan from bank	*₹ 30,000*	
Current maturities of long-term loan from other parties	*₹ 15,376*	

There was no interest accrued/due as at end of the year.

Prepare appropriate note to accounts complying with the requirements of Schedule III to the Companies Act, 2013 on the basis of available information.

Solution

Balance Sheet of Super Star Ltd.
As on 31st March, 2017

Particulars	Note No	Amount
Non Current Liabilities		
Long term borrowings	4	5,61,738
Current Liabilities		
Short term borrowings	5	36,112
Other current liabilities	6	45,376
		6,43,226

Notes to Accounts

4. Long-Term Borrowings	
Term loans – Secured	
- from banks	2,95,002
- from other parties	3,12,112
	6,07,114

	Less : Shown in current maturities of long-term debt (Refer Note 6)	(45,376)
		5,61,738
5.	Short-Term Borrowings	
	(Unsecured – payable on demand)	
	- from bank	36,112
6.	Other Current Liabilities	
	Current maturities of long-term debt	
	From banks	30,000
	From other	15,376
		45,376

It is assumed the Note 1 is for 'Significant Accounting Policies', Note 2 for 'Share Capital', Note 3 for 'Reserves and Surplus'.

Illustration 9

Astha Ltd. has FCCBs worth ₹ 100 crore which are due to mature on 31st December 2016. While preparing the financial statements for the year ending 31st March 2016, it is expected that the FCCB holders will not exercise the option of converting the same to equity shares. How should the company classify the FCCBs on 31st March 2016? Will your answer be different if the company expects that FCCB holders will convert their holdings into equity shares of Astha Ltd.?

Solution

Schedule III to the companies Act, 2013 provides that:

"A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments and do not affect its classification."

In the present situation, Astha Ltd. does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. The position will be same even when the FCCB holders are expected to convert their holdings into equity shares of Astha Ltd. Expectations cannot be called as unconditional rights. Thus, in both the situations, Astha Ltd. should classify the FCCBs as current liabilities as on 31 March 2016.

Illustration 10

The Balance Sheet of Appropriate Ltd. as at 31st March, 2016 is as follows:

	Note No.	*31st March, 2016*	*31st March, 2015*
Equity & Liabilities			
Share Capital	1	XXX	XXX
Reserves and Surplus	2	0	0
Employee stock option outstanding	3	XXX	XXX
Share application money refundable	4	XXX	XXX
Non-Current Liabilities			
Deferred tax liability (Arising from Indian Income Tax)	5	XXX	XXX
Current Liabilities			
Trade Payables	6	XXX	XXX
Total		XXXX	XXXX
Assets			
Non-Current Assets			
Fixed Assets -Tangible	7	XXX	XXX
Capital Work in progress (including capital advances)	8	XXX	XXX
Current Assets			
Trade Receivables	9	XXX	XXX
Deferred Tax Asset (Arising from Indian Income Tax)	10	XXX	XXX
Profit and Loss (Debit balance)		XXX	XXX
Total		XXXX	XXXX

Comment on the presentation in terms of Schedule III to the Companies Act, 2013 and Accounting Standards notified by the Central Government.

Solution

(1) Share Capital' and 'Reserves and Surplus' are required to be shown under the heading "Shareholders' funds", which have not been shown in the given balance sheet. Although it is a part of 'Equity and Liabilities' yet it must be shown under the head "Shareholders' Funds". The heading "Shareholders' Funds" is missing in the balance sheet given in the question.

(2) Reserves & Surplus is showing zero balance, which is not correct since there is. Debit balance of Statement of Profit & Loss. This debit balance of Profit and Loss should be shown as a negative figure under the head 'Surplus'. The balance of 'Reserves and Surplus', after adjusting negative balance of surplus shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative. It should be noted that Profit and Loss Debit Balance is not a part of current assets rather debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus' as per requirement of Schedule III to the Companies Act, 2013.

(3) As per Schedule III to the Companies Act, 2013, Employee Stock Option Outstanding A/c is part of Reserves and Surplus and should not be shown separately. Classification of Reserves and Surplus should be reflected is 'Notes to Accounts' for the same.

(4) Share application money refundable shall be shown by way of note under the sub-heading "Other Current Liabilities". As this is refundable and not pending for allotment, hence it is not a part of equity.

(5) Deferred Tax Liabilities has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, can not be shown in balance sheet because only the net balance of Deferred Tax Liabilities or Asset is to be shown as per para 29 of AS 22, Appropriate Ltd. should offset Deferred Tax Asset & Deferred Tax Liabilities and the break up of Deferred Tax Asset & Deferred Tax Liabilities into major components of the respective balance should be disclosed in 'Notes to Account'. Deferred Tax Asset shall be shown under Non-current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

(6) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:

(i) Tangible assets

(ii) Intangible assets

(iii) Capital work in Progress

(iv) Intangible assets under development.

Keeping in view the above, the Capital Work-in Progress shall be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading "Long term loans and advances" under the heading Non-Current Assets.

<u>Reference:</u> The students are advised to refer the full text of relevant Guidance Notes.

FINAL COURSE STUDY MATERIAL

PAPER 1

FINANCIAL REPORTING

MODULE – 2

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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SIGNIFICANT ADDITIONS/AMENDMENTS IN THIS EDITION

Chapter/Unit No.	Name of the Chapter	Changes
Chapter 2	Indian Accounting Standards (Ind AS)	Para 3.2 modified
		Paras 4 and 5 newly added
		Para 6.2 newly added
		Para 8.1.3 amended
		Para 8.1.4 amended
		Para 8.2.1 amended
		Paras 8.2.4 and 8.2.5 added
		Para 8.2.9 modified
		Para 8.6 and all sub-paras therein on Ind AS 11 have been newly added
		Para 8.8.10 modified
		Para 8.10 and all sub-paras therein on Ind AS 18 have been newly added
		Para 8.11.8 modified
		Para 8.17.4.2 amended
		Para 8.17.4.4 amended
		Para 8.23.8 amended
		Para 8.24.9 amended
		Para 8.25.8 amended
		Para 8.25.10 amended
		Para 8.27.4 amended
		Para 8.27.8.2 amended
		Para 8.31.6 amended
		Para 8.33.4.3 amended
		Para 8.35.2 amended
		Para 8.36.2 amended
		Para 8.36.7 amended
		Para 8.37.2 amended
Chapter 3	Corporate Financial Reporting	Para 3 amended
Chapter 4	Accounting for Corporate Restructuring	Para 3 amended
		Para 6.4 amended

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2

Indian Accounting Standards (Ind AS)

1. Introduction to Ind AS

In the present era of globalisation and liberalisation, the world has become an economic village. The globalisation of the business world, the attendant structures and the regulations, which support it, as well as the development of e-commerce make it imperative to have a single globally accepted financial reporting system. A number of multi-national companies are establishing their businesses in various countries with emerging economies and vice versa. The entities in emerging economies are increasingly accessing the global markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside their country. Capital markets are, thus, becoming integrated consistent with this world-wide trend. More and more Indian companies are being listed on overseas stock exchanges. The use of different accounting frameworks in different countries, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore, increasing complexity of business transactions and globalisation of capital markets call for a single set of high quality accounting standards.

High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of national accounting standards with IFRS.

International Financial Reporting Standards (IFRS) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international financial reporting standards while preparing their financial statements.

2. Benefits of Convergence with IFRS

There are many beneficiaries of convergence with IFRS such as the economy, investors, industry etc.

The Economy: When the markets expand globally the need for convergence increases since the convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: A strong case for convergence can be made from the viewpoint of the investors who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors' confidence is strong when accounting standards used are globally accepted. Convergence with IFRS contributes to investors' understanding and confidence in high quality financial statements.

The Industry: A major force in the movement towards convergence has been the interest of the industry. The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

3. History of IFRS-converged Indian Accounting Standards (Ind AS)

3.1 First Step towards IFRS

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

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as, various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

3.2 Government of India - Commitment to IFRS Converged Ind AS

Consistent, comparable and understandable financial reporting is essential to develop a robust economy. With a view to achieve international benchmarks of financial reporting, the Institute of Chartered Accountants of India (ICAI), as a proactive role in accounting, set out to introduce Indian Accounting Standards (Ind AS) converged with the International Financial Reporting Standards (IFRS). This endeavour of the ICAI is supported by the Government of India.

Initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

In July 2014, the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies from the financial year 2015-16 voluntarily and from the financial year 2016-17 on a mandatory basis.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Indian Accounting Standards (Ind AS). Moving in this direction, the Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS). As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016.

Initially, India decided to adopt Ind AS 115 corresponding to IFRS 15 two years ahead of the world. However, after the same were notified by the MCA, many representations were being received from various organisations, industry associations etc. for deferring the applicability of Ind AS 115. Considering the difficulties being faced by various industries, it was decided to defer the applicability of Ind AS 115 and to bring Ind AS 11 and Ind AS 18 in its place. Further, there were certain amendments that were made in IFRS/IAS issued by the IASB. The Institute of Chartered Accountants of India (ICAI) to keep up the pace with the global developments, revised the notified Ind AS in line with the amendments made in IFRS/IAS issued by the IASB. MCA had notified the amendments to the Ind AS vide notification dated March 30, 2016, as Companies (Indian Accounting Standards) Amendment Rules, 2016.

4. What are Indian Accounting Standards (Ind AS)?

Indian Accounting Standards (Ind-AS) are the International Financial Reporting Standards (IFRS) converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with National Advisory Committee on Accounting Standards (NACAS).

ASB is a committee under Institute of Chartered Accountants of India (ICAI) which consists of representatives from government department, academicians, other professional bodies viz. icsi, icai, representatives from ASSOCHAM, CII, FICCI, etc. National Advisory Committee on Accounting Standards (NACAS) recommend these standards to the Ministry of Corporate Affairs (MCA). MCA has to spell out the accounting standards applicable for companies in India.

The Ind AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).

5. What are Carve outs/ins in Ind AS?

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

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

- Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'.
- Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will **not result into carve outs.**
- Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in application of accounting principles and practices and economic conditions prevailing in India. These diffferences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as **'Carve-outs'.**

Note: In Ind AS 103 "Business Combination", an additional guidance on "Accounting of Business Combinations of Entities under Common Control" is given which is over and above what is given in IFRS. This is termed as **'Carve-in'.**

6. Roadmap for Implementation of Indian Accounting Standards (Ind AS): A Snapshot

6.1 For Companies other than banks, NBFCs and Insurance Companies

Phase I	**1st April 2015 or thereafter: Voluntary Basis for all companies (with Comparatives)**	
	1st April 2016: Mandatory Basis	
	(a)	Companies listed/in process of listing on Stock Exchanges in India or Outside India having net worth $\geq$ INR 5 Billion
	(b)	Unlisted Companies having net worth $\geq$ INR 5 Billion
	(c)	Parent, Subsidiary, Associate and J.V. of above
Phase II	**1st April 2017: Mandatory Basis**	
	(a)	All companies which are listed/or in process of listing
		inside or outside India on Stock Exchanges not
		covered in Phase I (other than companies listed on
		SME Exchanges)
	(b)	Unlisted companies having net worth INR 5 Billion >
		INR 2.5 Billion
	(c)	Parent, Subsidiary, Associate and J.V. of Above

- Companies listed on SME exchange not required to apply Ind AS.
- Once Ind AS are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements.
- Companies not covered by the above roadmap shall continue to apply existing Accounting Standards notified in Companies (Accounting Standards) Rules, 2006.

6.2 For Scheduled Commercial Banks (Excluding RRBs), Insurers/Insurance Companies and Non-Banking Financial Companies (NBFC's)

Non-Banking Financial Companies (NBFC's)	
Phase I:	From 1st April, 2018 (with comparatives)
	• NBFCs (whether listed or unlisted) having net worth 500 crore or more
	• Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date

Phase II:	From 1st April, 2019 (with comparatives)
	• NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than 500 crore
	• NBFCs that are unlisted having net worth 250 crore or more but less 500 crore
	• Holding, Subsidiary, JV and Associate companies of above other than those already covered under corporate roadmap shall also apply from said date
➢ Applicable for both Consolidated and individual Financial Statements	
➢ NBFC having net worth below 250 crore shall not apply Ind AS.	
➢ Adoption of Ind AS is allowed only when required as per the roadmap.	
➢ Voluntary adoption of Ind AS is not allowed.	
Scheduled Commercial banks (excluding RRB's) and Insurers/Insurance companies	
➢ From 1st April, 2018 (with comparatives):	
• Holding, subsidiary, JV and Associates companies of scheduled commercial banks (excluding RRB's) shall also apply from the said date irrespective of it being covered under corporate roadmap.	
• Applicable for both Consolidated and individual Financial Statements	
➢ Urban Cooperative banks (UCBs) and Regional Rural banks (RRBs) are not required to apply Ind AS.	

7. List of Ind AS *vis-a-vis* IFRS and AS

Ind AS	IFRS	Title of Ind AS/IFRS	AS/GN	AS/GN Title
101	1	First Time Adoption of Indian Accounting Standards	-	-
102	2	Share Based Payment	GN 18	Guidance Note on Accounting for Employee Share-based Payments
103	3	Business Combinations	AS 14	Accounting for Amalgamations
104	4	Insurance Contracts	-	-
105	5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations
106	6	Exploration for and Evaluation of Mineral Resources	GN 15	Guidance Note on Accounting for Oil and Gas Producing Activities
107	7	Financial Instruments: Disclosures	AS 32	Financial Instruments: Disclosures
108	8	Operating Segments	AS 17	Segment Reporting

109	9	Financial Instruments	AS 30	Financial Instruments: Recognition and Measurement
110	10	Consolidated Financial Statements	AS 21	Consolidated Financial Statements
111	11	Joint Arrangements	AS 27	Financial Reporting of Interests in Joint Ventures
112	12	Disclosure of Interests in Other Entities	-	-
113	13	Fair Value Measurement	-	-
114	14	Regulatory Deferral Accounts	GN	Accounting for Rate Regulated Activities
1	1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies
2	2	Inventories	AS 2	Valuation of Inventories
7	7	Statement of Cash Flows	AS 3	Cash Flow Statements
8	8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior period Items and Changes in Accounting Policies
10	10	Events after the Reporting Period	AS 4	Contingencies and Events Occurring After the Balance Sheet
11	11	Construction Contracts	AS 7	Construction Contracts
12	12	Income Taxes	AS 22	Accounting for Taxes on Income
16	16	Property, Plant and Equipment	AS 10	Property, Plant and Equipment
17	17	Leases	AS 19	Leases
18	18	Revenue	AS 9	Revenue Recognition
19	19	Employee Benefits	AS 15	Employee Benefits
20	20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants
21	21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
23	23	Borrowing Costs	AS 16	Borrowing Costs
24	24	Related Party Disclosures	AS 18	Related Party Disclosures
27	27	Separate Financial Statements	-	-
28	28	Investment in Associates and Joint Ventures	AS 23	Accounting for Investment in Associates in Consolidated Financial Statements
29	29	Financial Reporting in Hyperinflationary Economies	-	-
32	32	Financial Instruments: Presentation	AS 31	Financial Instruments: Presentation

33	33	Earnings per Share	AS 20	Earnings per Share
34	34	Interim Financial Reporting	AS 25	Interim Financial Reporting
36	36	Impairment of Assets	AS 28	Impairment of Assets
37	37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets
38	38	Intangible Assets	AS 26	Intangible Assets
40	40	Investment Property	AS 13	Accounting for Investments
41	41	Agriculture	-	-

8. Summary of Indian Accounting Standards (Ind AS)

8.1 Ind AS 1 : Presentation of Financial Statements

8.1.1 Objective

This Standard prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out

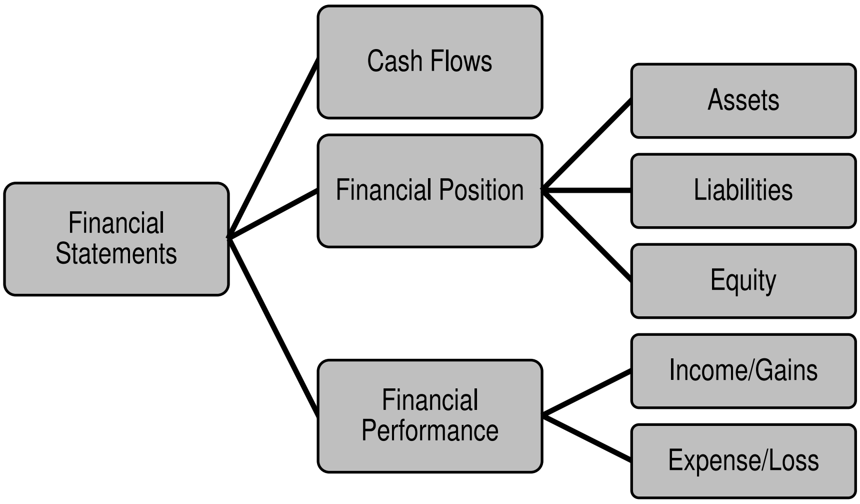
- Overall requirements for the presentation of financial statements,
- Guidelines for their structure and
- Minimum requirements for their content.

8.1.2 Financial Statements

Purpose of financial statements

Financial statements are a structured representation of the:

- financial position and
- financial performance of an entity.



A complete set of financial statements comprises:

- A balance sheet as at the end of the period
- Statement of changes in equity for the period
- A statement of profit and loss for the period
- A statement of cash flows for the period
- Notes, comprising significant accounting policies and other explanatory information
- Comparative information in respect of the preceeding period
- A balance sheet as at the beginning of the preceeding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements

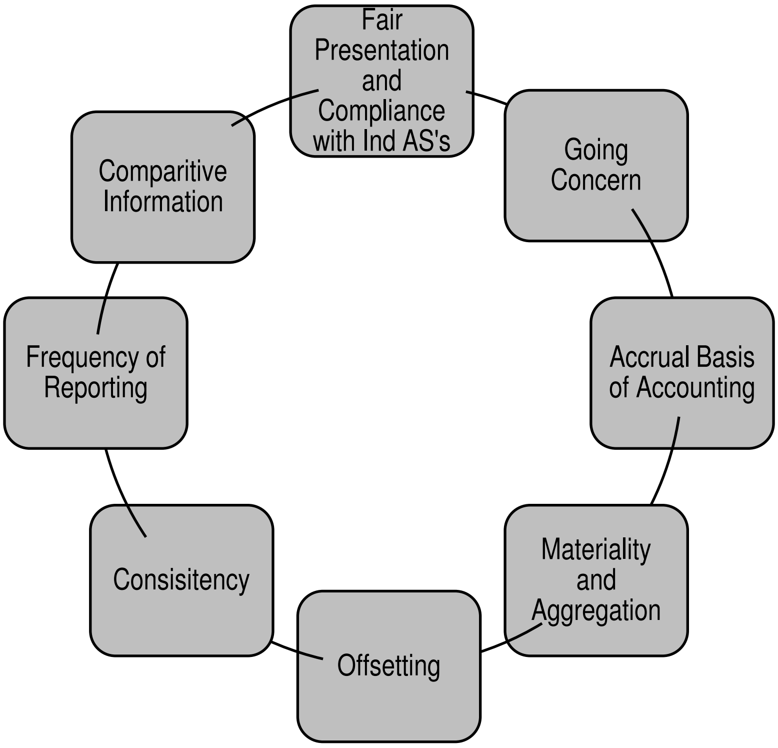
The Standard requires an entity to present, in a statement of changes in equity, all owner changes in equity. All non-owner changes in equity (ie comprehensive income) are required to be presented in single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.

The Standard requires that an entity whose financial statements comply with Ind AS must make an explicit and unreserved statement of such compliance in the notes. An entity must not describe financial statements as complying with Ind AS unless they comply with all the requirements of Ind AS. The application of Ind AS, with additional disclosure when necessary, is presumed to result in financial statements that achieve a presentation of true and fair view.

8.1.3 Presentation of True and Fair View

Presentation of true and fair view requires the faithful representation of

- The effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework.
- The application of Ind AS, with additional disclosure when necessary, is presumed to result in financial statements that present a true and fair view.



Structure and Content: The Standard requires that an entity shall clearly identify the financial statements and distinguish them from other information in the same published document. ***The Standard requires some line items to be presented in the balance sheet. An entity shall present additional line items, headings and sub-totals in the balance sheet when such presentation is relevant to an understanding of the entity's financial position.*** It also prescribes the information to be presented in statement of profit and loss, other comprehensive income section and statement of changes in equity. However, this Standard does not apply to the structure and content of condensed interim financial statements prepared in accordance with Ind AS 34 *'Interim Financial Reporting'*. However, this Standard does not apply to the structure and content of condensed interim financial statements prepared in accordance with

Ind AS 34 *'Interim Financial Reporting'*.

Other Comprehensive Income: Other comprehensive income comprises items of income and expenses (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Ind AS.

The Standard requires an entity to disclose reclassification adjustments and income tax relating to each component of other comprehensive income. Reclassification adjustments are the amounts reclassified to profit or loss in the current period that were previously recognised in other comprehensive income.

The other comprehensive income section shall present line items for amounts for the period of:

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other Ind AS:

(i) will not be reclassified subsequently to profit or loss; and

(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that in accordance with other Ind AS:

(i) will not be reclassified subsequently to profit or loss; and

(ii) will be reclassified subsequently to profit or loss when specific conditions are met.

Current/non-current distinction: The Standard requires that an entity shall present current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet except when a presentation based on liquidity provides information that is reliable and more relevant. When that exception applies, an entity shall present all assets and liabilities in order of liquidity.

The Standard also requires that whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:

(a) no more than twelve months after the reporting period, and

(b) more than twelve months after the reporting period.

8.1.4 Other Issues

The Standard also deals with certain issues like

(a) Going Concern

- When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern.

- An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.
- When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties.
- When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

(b) Accrual Basis of Accounting

- An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.
- When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Framework.

(c) Materiality and Aggregation

- An entity shall present separately each material class of similar items.
- An entity shall present separately items of a dissimilar nature or function unless they are immaterial except when required by law.
- ***An entity shall not reduce the understanding ability of financial statements by obscuring material information or by aggregating material items that have different natures or functions.***
- ***An entity shall consider whether to provide additional disclosures when compliance with the specific requirements in Ind AS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.***

(d) Offsetting

- An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an Ind AS.
- An entity reports separately both assets and liabilities, and income and expenses. Offsetting in the statements of profit and loss or balance sheet, except when offsetting reflects the substance of the transaction or other event, detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows. Measuring assets net of valuation allowances—for example, obsolescence allowances on inventories and doubtful debts allowances on receivables—is not offsetting.

(e) Frequency of Reporting

An entity shall present a complete set of financial statements (including comparative information) at least annually. When an entity changes the end of its reporting period and presents financial statements for a period longer or shorter than one year, an entity shall disclose, in addition to the period covered by the financial statements:

1. the reason for using a longer or shorter period, and
2. the fact that amounts presented in the financial statements are not entirely comparable.

(f) Comparative Information

Except when Ind AS permit or require otherwise, an entity shall present comparative information in respect of the preceding period for all amounts reported in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information if it is relevant to understanding the current period's financial statements.

An entity shall present, as a minimum:

- 2 Balance Sheets
- 2 Statement of Profit and Loss
- 2 Statement of Cash Flows
- 2 Statement of Changes in Equity and
- Related Notes

In some cases, narrative information provided in the financial statements for the preceding period(s) continues to be relevant for the current period.

(g) Change in Accounting Policy, Retrospective Restatement or Reclassification

An entity shall present a Third Balance Sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements if:

(a) It applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

(b) The retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.

In the above circumstances, an entity shall present 3 Balance sheets as at:

(a) The end of the current period;

(b) The end of the preceding period;

(c) The beginning of the preceding period.

When an entity is required to present an additional Balance sheet, it need not present the related notes to the opening Balance Sheet as at the beginning of the preceding period.

If an entity changes the presentation or classification of items in its financial statements, it shall reclassify comparative amounts unless reclassification is impracticable.

When an entity reclassifies comparative amounts, it shall disclose (including as at the beginning of the preceding period):

(a) the nature of the reclassification;

(b) the amount of each item or class of items that is reclassified; and

(c) the reason for the reclassification.

When it is impracticable to reclassify comparative amounts, an entity shall disclose:

(a) the reason for not reclassifying the amounts, and

(b) the nature of the adjustments that would have been made if the amounts had been reclassified.

(h) Consistency of Presentation

An entity shall retain the presentation and classification of items in the financial statements from one period to the next.

8.1.5 Disclosures

The Standard, among other things, requires that:

(a) An entity shall disclose, alongwith its significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

(b) An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

(c) An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. An entity shall also provide additional disclosures on puttable financial instruments classified as equity instruments.

8.1.6 Major Changes in Ind AS 1 *vis-à-vis* IAS* 1

8.1.6.1 Resulting in Carve outs: This carve-out is due to difference in application of accounting principles and practices and economic conditions prevailing in India.

IAS 1 requires that in case of a loan liability, if any condition of the loan agreement which was classified as non-current is breached on the reporting date, such loan liability should be classified as current. Where the breach is rectified after the balance sheet date IAS requires loans to be classified as current.

Carve Out: Ind AS 1 clarifies that where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

Reason: Under Indian banking system, a long-term loan agreement generally contains a large number of conditions. Some of these conditions are substantive, such as, recalling the loan in case interest is not paid, and some conditions are procedural and not substantive, such as, submission of insurance details where the entity has taken the insurance but not submitted the details to the lender at the end of the reporting period. Generally, customer-banker relationships are developed whereby in case of any procedural breach, a loan is generally not recalled. Also, in many cases, a breach is rectified after the balance sheet date and before the approval of financial statements. Carve out has been made as it is felt that if the breach is rectified after the balance sheet date and before the approval of the financial statements, it would be appropriate that the users are informed about the true nature of liabilities being non-current liabilities and not current liabilities.

8.1.6.2 Not Resulting in Carve outs

1. ***Statement of Profit or Loss:*** With regard to preparation of statement of profit and loss, IAS 1 provides an option either to follow the single statement approach or to follow the two statement approach. An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections or an entity may present the profit or loss section in a separate statement of profit or loss which shall immediately precede the statement presenting comprehensive income beginning with profit or loss.

   Ind AS 1 allows only the single statement approach with profit or loss and other comprehensive income presented in two sections.

2. ***Different Terminology:*** IAS 1 gives the option to individual entities to follow different terminology for the titles of financial statements. Ind AS 1 is changed to remove alternatives by giving one terminology to be used by all entities.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

3. ***Periodicity:*** IAS 1 permits the periodicity, for example, of 52 weeks for preparation of financial statements. Ind AS 1 does not permit it.

4. ***Analysis / Classification of Expenses:*** IAS 1 requires an entity to present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the equity. Ind AS 1 requires only nature-wise classification of expenses.

5. ***Materiality:*** Paragraphs 29 of IAS 1 requires that items of dissimilar nature or function shall be presented separately unless these are immaterial and paragraph 31 provides that specific disclosure required by IFRS need not be provided if the information is not material. In Ind AS 1, such paragraphs have been modified to include words 'except when required by law'.

6. ***Disclosures regarding Reconciliation:*** Paragraph 106(d)(iv) of Ind AS 1 dealing with disclosures regarding reconciliation between the carrying amount at the beginning and the end of the period for each component of equity, has been amended to include disclosure regarding recognition of bargain purchase gain arising on business combination in line with treatment prescribed in this regard in Ind AS 103.

8.1.7 Major Changes in Ind AS 1 *vis-a-vis* Notified AS 1

Ind AS 1 deals with presentation of financial statements, whereas existing AS 1 (issued 1979) deals only with the disclosure of accounting policies. The scope of Ind AS 1 is thus much wider and line by line comparison of the differences with the existing standard is not possible. However, the major requirements as laid down in Ind AS 1 are as follows:

(i) ***Explicit Statement of Compliance:*** An enterprise shall make an explicit statement in the financial statements of compliance with all the Indian Accounting Standards. Further, Ind AS 1 allows deviation from a requirement of an accounting standard in case the management concludes that compliance with Ind AS will be misleading and if the regulatory framework requires or does not prohibit such a departure.

(ii) ***Current and Non-current Classification:*** Ind AS 1 requires presentation and provides criteria for classification of Current / Non- Current assets / liabilities.

(iii) ***Extraordinary Items:*** Ind AS 1 prohibits presentation of any item as 'Extraordinary Item' in the statement of profit and loss or in the notes.

(iv) ***Disclosure of Judgements and Assumptions made:*** Ind AS 1 requires disclosure of judgments made by management while framing of accounting policies. Also, it requires disclosure of key assumptions about the future and other sources of measurement of uncertainty that have significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within next financial year.

(v) ***Classification of Expenses:*** Ind AS 1 requires classification of expenses to be presented based on nature of expenses.

(vi) ***Comparative Balance Sheets:*** Ind AS 1 requires presentation of balance sheet as at the beginning of the earliest period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in the financial statements, or when it reclassifies items in its financial statements.

(vii) ***Disclosure of Reclassified Items:*** In respect of reclassification of items, Ind AS 1 requires disclosure of nature, amount and reason for reclassification in the notes to financial statements.

(viii) ***Statement of Changes in Equity:*** Ind AS 1 requires the financial statements to include a Statement of Changes in Equity to be shown as a separate statement, which, inter alia, includes reconciliation between opening and closing balance for each component of equity.

(ix) ***Statement of Other Comprehensive Income:*** Ind AS 1 requires that an entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section.

(x) ***Inclusion of Comparative Information:*** As per Ind AS 1, an entity shall include certain comparative information for understanding the current period's financial statements.

(xi) ***Classification of Long-term Loan Arrangement:*** Ind AS 1 clarifies that long term loan arrangement need not be classified as current on account of breach of a material provision, for which the lender has agreed to waive before the approval of financial statements for issue. (Paragraph 74)

8.2 Ind AS 2: Valuation of Inventory

Inventories constitute a major portion of current assets of an entity. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised.

This Standard deals with the

- determination of cost and
- its subsequent recognition as an expense.
- Including any write-down to net realisable value.
- It also provides guidance on the cost formulas that are used to assign costs to inventories.

8.2.1 Scope

Ind AS 2 applies to all inventories, except ***work in progress arising under construction contracts, including directly related service contracts (Ind AS 11, 'Construction Contracts');*** financial instruments (Ind AS 32, *'Financial Instruments: Presentation'* and Ind AS 109, *'Financial Instruments')*; and biological assets (i.e., living animals or plants) related to agricultural activity and agricultural produce at the point of harvest ***(Ind AS 41, 'Agriculture').***

8.2.2 Definition of Inventory

Inventories are Assets:

(a) held for sale in the ordinary course of business (Finished Goods);

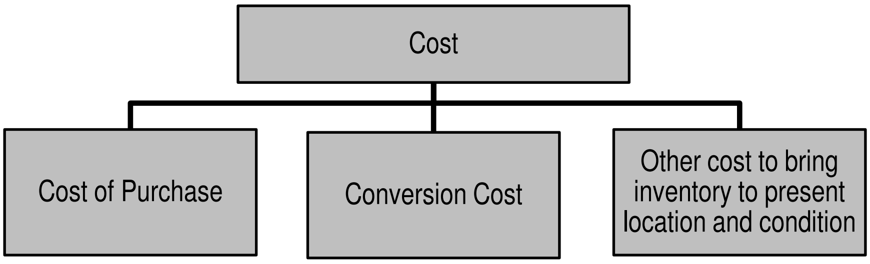
(b) in the process of production for such sale (WIP); or

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services (Raw Material).

8.2.3 Principles for Valuation of Inventory

Measurement of Inventories: Inventories shall be measured at the lower of cost and net realisable value.

Cost: Cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.



Cost of Purchase: The costs of purchase of inventories comprise the

- purchase price,
- import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities),
- transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services.
- trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

Conversion Cost: The costs of conversion of inventories include

- costs directly related to the units of production, such as direct labour
- systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

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

Excluded in Cost

(a) abnormal amounts of wasted materials, labour or other production costs; (Normal wastage will be considered)

(b) storage costs, unless those costs are necessary in the production process before a further stage; (For example: In case of wine, it has to be stored as a part of the production process)

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

(d) selling costs.

8.2.4 Cost of Inventories of a Service Provider

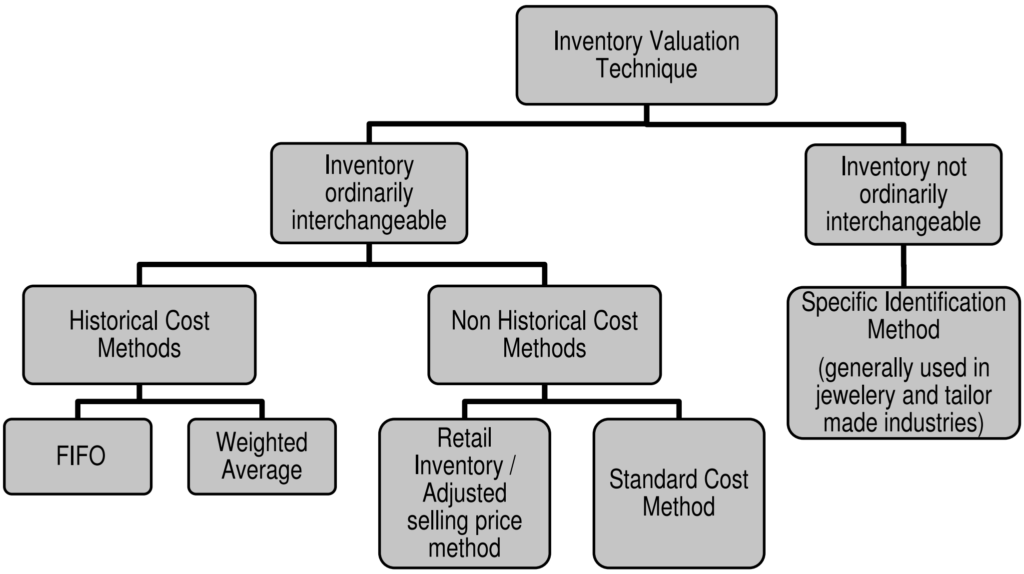
To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

8.2.5 Cost of Agricultural Produce Harvested from Biological Assets

In accordance with Ind AS 41, Agriculture, inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less costs to sell at the point of harvest. This is the cost of the inventories at that date for application of this Standard.

8.2.6 Inventory Valuation Techniques - Cost Formulae

The cost of inventories shall be assigned by using the first-in first-out (FIFO) or weighted average cost formula. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity.



8.2.7 Net Realisable Value

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made, of the amount the inventories are expected to realise.

NRV would be different for finished goods and WIP. It is fully applicable to WIP, but for fished goods it would be:

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs necessary to make the sale.

Recognition as an expense: When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised.

The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs.

The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

8.2.8 Major Change in Ind AS 2 *vis-à-vis* IAS* 2 Not Resulting in Carve Out

Classification of Expenses: Paragraph 38 of IAS 2 dealing with recognition of inventories as an expense based on function-wise classification, has been deleted keeping in view the fact that option provided in IAS 1 to present an analysis of expenses recognised in profit or loss using a classification based on their function within the entity has been removed and Ind AS 1 requires only nature-wise classification of expenses.

8.2.9 Major Changes in Ind AS 2 *vis-à-vis* Notified AS 2

(i) ***Subsequent Recognition:*** Ind AS 2 deals with the subsequent recognition of cost/carrying amount of inventories as an expense, whereas the existing AS 2 does not provide the same.

(ii) ***Inventory of Service Provider:*** Ind AS 2 provides explanation with regard to inventories of service providers whereas the existing AS 2 does not contain such an explanation.

(iii) ***Machinery Spares: The existing AS 2 explains that inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) 10, Property,***

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

Plant and Equipment. Ind AS 2 does not contain specific explanation in respect of such spares as this aspect is covered under Ind AS 16.

(iv) ***Inventory held by Commodity Broker-traders:*** Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell. However, this aspect is not there in the existing AS 2.

(v) ***Definition of Fair Value and Distinction Between NRV and Fair Value:*** Ind AS 2 defines fair value and provides an explanation in respect of distinction between 'net realisable value' and 'fair value'. The existing AS 2 does not contain the definition of fair value and such explanation.

(vi) ***Subsequent Assessment of NRV:*** Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and disclosure thereof in the financial statements. The existing AS 2 does not deal with such reversal.

(vii) ***Inventories Acquired on Deferred Settlement Terms:*** An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

(viii) ***Exclusion from its Scope but Guidance given:*** Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products though it provides guidance on measurement of such inventories. However, the existing AS 2 excludes from its scope such types of inventories.

(ix) ***Cost Formulae:*** The existing AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition whereas Ind AS 2 does not specifically state so and requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.

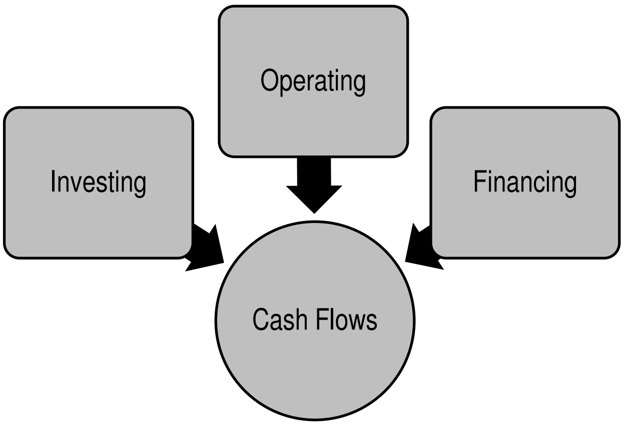
(x) ***Disclosures:*** Ind AS 2 requires more disclosures as compared to the existing AS 2.

8.3 Ind AS 7: Cash Flow Statement

Ind AS 7, Statement of Cash Flows, prescribes principles and guidance on preparation and presentation of cash flows of an entity from operating activities, investing activities and financing activities for a reporting period.

8.3.1 Objective

The objective of this Standard is to require the provide information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.



Cash comprises Cash on hand; and Demand deposits.

Cash flows are Inflows and Outflows of cash and cash equivalents.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Cash and cash equivalents include demand deposits, certain short-term investments and in some cases, bank overdrafts.

- For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.
- Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preference shares acquired within a short period of their maturity and with a specified redemption date.
- Bank borrowings are generally considered to be financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

8.3.2 Presentation of Cash Flow Statement

The statement of cash flows is required to report cash flows classified by operating, investing and financing activities along with the components of cash and cash equivalents at the beginning and end of the reporting period, except in limited circumstances where cash flows are offset and reported on net basis.

(a) Operating Activities: Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss.

The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing.

An entity shall report cash flows from operating activities using either the 'direct method' or the 'indirect method'. Under direct method, major classes of gross cash receipts and payments are presented. However, under indirect method, profit or loss is adjusted for the effects of transactions of a non-cash nature; deferrals or accruals of past or future operating cash receipts or payments; and items of income or expenses associated with investing or financing cash flows.

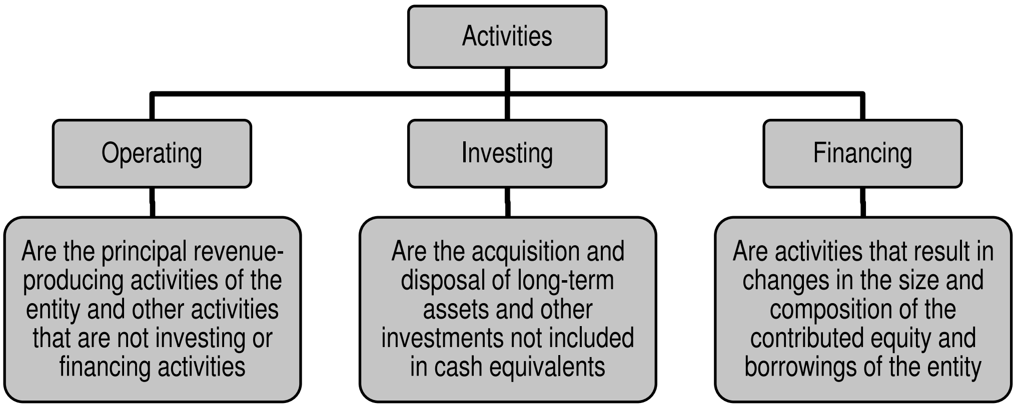
Cash flows arising from taxes on income shall be separately disclosed and classified as cash flow from operating activities unless they can be specifically identified with financing or investing activities.

(b) Investing Activities: Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

(c) Financing Activities: Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity.

An entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities



Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes.

Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other equity instruments;

(b) cash payments to owners to acquire or redeem the entity's shares;

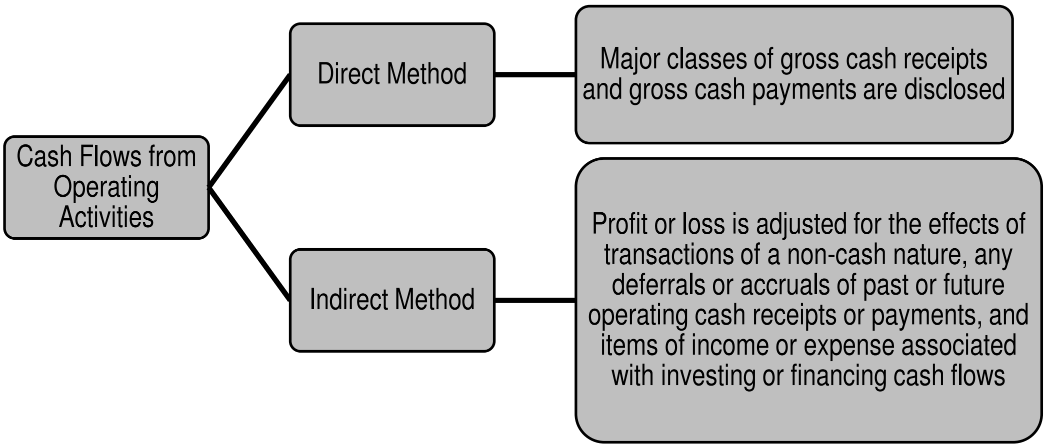
(c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

(d) cash repayments of amounts borrowed; and

(e) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

8.3.3 Reporting Cash Flows from Operating Activities

An entity shall report cash flows from operating activities using either:



8.3.4 Non-cash Transactions

Investing and financing transactions that do not require the use of cash or cash equivalents shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. The exclusion of non-cash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows as these items do not involve cash flows in the current period.

Examples of non-cash transactions are:

(a) the acquisition of assets either by assuming directly related liabilities or by means of a finance lease;

(b) the acquisition of an entity by means of an equity issue; and

(c) the conversion of debt to equity.

8.3.5 Foreign Currency Cash Flows

Cash flows arising from transactions in a foreign currency shall be recorded in an entity's functional currency by applying to the foreign currency amount the exchange rate between the functional currency and the foreign currency at the date of the cash flow. The cash flows of a foreign subsidiary shall be translated at the exchange rates between the functional currency and the foreign currency at the dates of the cash flows.

Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period.

8.3.6 Cash and Cash Equivalents

An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with equivalent items reported in the balance sheet.

An entity shall disclose, together with a commentary by management, the amount of significant cash and cash equivalents held by the entity that are restricted for specific purposes.

8.3.7 Major Changes in Ind AS 7 vis-à-vis IAS* 7 Not Resulting in Carve Outs

1. ***Interest:*** In case of other than financial entities, IAS 7 gives an option to classify the interest paid and interest and dividends received as item of operating cash flows. Ind AS 7 does not provide such an option and requires these items to be classified as items of financing activity and investing activity, respectively.
2. ***Dividend:*** IAS 7 gives an option to classify the dividend paid as an item of operating activity. However, Ind AS 7 requires it to be classified as a part of financing activity only.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

8.3.8 Major Changes in Ind AS 7 vis-à-vis Notified AS 3

(i) ***Bank Overdraft Repayable on Demand:*** Ind AS 7 specifically includes bank overdrafts which are repayable on demand as a part of cash and cash equivalents, whereas the existing AS 3 is silent on this aspect.

(ii) ***Treatment of Cash Payments in Specific Cases:*** Ind AS 7 provides the treatment of cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale in the ordinary course of business as cash flows from operating activities. Further, treatment of cash receipts from rent and subsequent sale of such assets as cash flow from operating activity is also provided. The existing AS 3 does not contain such requirements.

(iii) ***New Examples of Cash Flows arising from Financing Activities:*** Ind AS 7 includes the following new examples of cash flows arising from financing activities:

   (a) cash payments to owners to acquire or redeem the entity's shares

   (b) cash proceeds from mortgages

   (c) cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

(iv) ***Adjustment of the Profit or Loss for the Effects of Undistributed Profits of Associates and Non-controlling Interests:*** As compared to the existing AS 3, Ind AS 7 specifically requires adjustment of the profit or loss for the effects of 'undistributed profits of associates and non-controlling interests' while determining the net cash flow from operating activities using the indirect method.

(v) ***Cash Flows associated with Extraordinary Activities:*** The existing AS 3 requires cash flows associated with extraordinary activities to be separately classified as arising from operating, investing and financing activities, whereas Ind AS 7 does not contain this requirement.

(vi) ***Disclosure of the Amount of Cash and Cash Equivalents in Specific Situations:*** As compared to the existing AS 3, Ind AS 7 requires an entity (except an investment entity) to disclose the amount of cash and cash equivalents and other assets and liabilities in the subsidiaries or other businesses over which control is obtained or lost. Ind AS 7 also requires to report the aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries or other businesses in the statement of cash flows, net of cash and cash equivalents acquired or disposed of as a part of such transactions, events or changes in circumstances. The existing AS 3 does not contain such requirements.

(vii) ***Cash Flows arising from Changes in Ownership Interests in a Subsidiary:*** Ind AS 7 requires to classify cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control as cash flows from financing activities. The existing AS 3 does not contain such a requirement.

(viii) ***Investment in Subsidiaries, Associates and Joint Ventures (Investees):*** Ind AS 7 mentions the use of equity or cost method while accounting for an investment in an associate, joint venture or a subsidiary. It also specifically deals with the reporting of interest in an associate or a joint venture using equity method. The existing AS 3 does not contain such requirements.

(ix) ***Use of Different Terminology and Translation of Cash Flows of a Foreign Subsidiary:*** Ind AS 7 uses the term 'functional currency' instead of 'reporting currency' (as used in the existing AS 3). Ind AS 7 also deals with translation of cash flows of a foreign subsidiary *whereas in the existing AS 3, it is not dealt with.*

(x) ***Disclosures:*** Ind AS 7 requires more disclosures as compared to the existing AS 3.

8.4 Ind AS 8: Accounting Policies, Changes in Accounting Estimates and Errors

8.4.1 Objective

The objective of this Standard is to prescribe:

- The criteria for selecting and changing accounting policies,
- The accounting treatment of changes in accounting policies, changes in accounting estimates and corrections of errors and
- Disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors.

The Standard is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

Note: Disclosure requirements for accounting policies, except those for changes in accounting policies, are set out in Ind AS 1 Presentation of Financial Statements.

Note: The tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies are accounted for and disclosed in accordance with Ind AS 12 '*Income Taxes*'.

8.4.2 Accounting Policies

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

This Standard provides guidance in selection and application of the accounting policies. A two-step approach is advocated.

Step 1 requires that when an Ind AS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Ind AS.

Step 2 provides that in the absence of an Ind AS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy. This judgment should result in information that is:

- relevant to the economic decision-making needs of users; and
- reliable, so that the financial statements:
  - represent faithfully the financial position, financial performance and cash flows of the entity;
  - reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
  - are neutral, i.e. free from bias;
  - are prudent; and
  - are complete in all material respects.

Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows. Therefore, the same accounting policies are applied within each period and from one period to the next unless a change in accounting policy meets one of the criteria mentioned above.

An entity shall select and apply the accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. If an Ind AS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

8.4.3 Changes in Accounting Policies

An entity shall change an accounting policy only if the change:

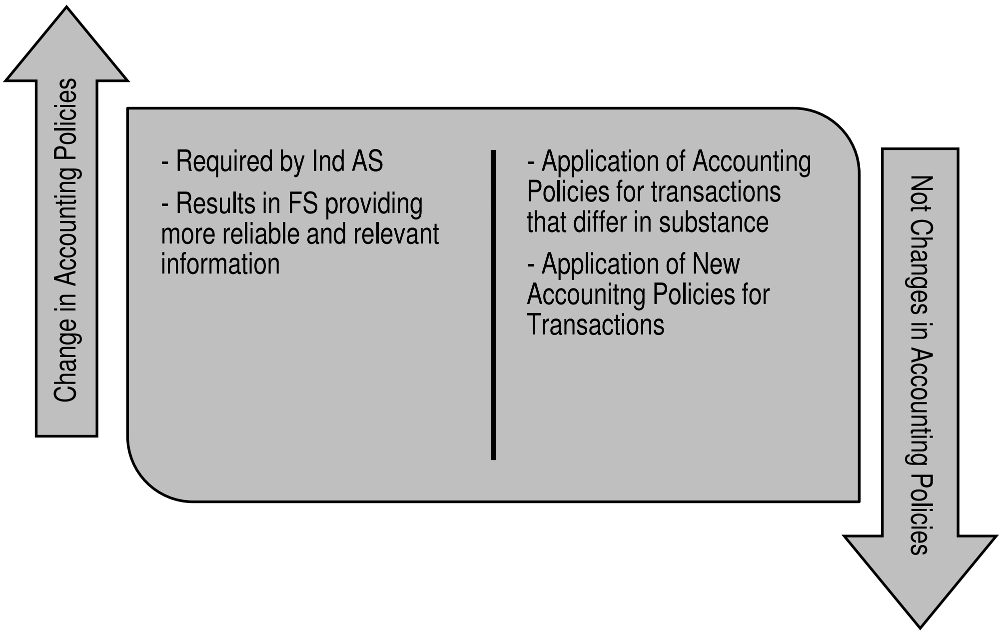
(a) is required by an Ind AS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

The following are not changes in accounting policies:

(a) the application of an accounting policy for transactions, other events or conditions that differ in substance from those previously occurring; and

(b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.



When it is impracticable for an entity to apply a new accounting policy retrospectively, because it cannot determine the cumulative effect of applying the policy to all prior periods, the entity will apply the new policy prospectively from the start of the earliest period practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period.

8.4.4 Accounting Estimates

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest available, reliable information.

For example, estimates may be required of:

(a) bad debts;

(b) inventory obsolescence;

(c) the fair value of financial assets or financial liabilities;

(d) the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and

(e) warranty obligations.

Note: The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

8.4.5 Changes in Accounting Estimates

An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.

By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

A change in accounting estimate is an:

- Adjustment of the carrying amount of an asset or a liability, or
- The amount of the periodic consumption of an asset,

That results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

The effect of change in an accounting estimate shall be recognised prospectively by including it in profit or loss in:

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

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

Example: A provision for Depreciation is initially recognised by reflecting this as a charge to Profit and Loss. A change in such an estimate that would occur in a subsequent period, would also be taken to Profit and Loss. The debit in P&L corresponds to the credit in Accumulated Provision for Depreciation.

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

Example: An estimate of a decommissioning liability or a liability for restoration of a site after removal of plant and machinery, the estimated amount of which would be initially recognised by increasing the carrying amount of related asset account and creating a liability account. Such estimates may undergo a change at a later date. Ind AS takes cognizance of these situations and provides that to the extent that where a change in accounting estimate affects assets and liabilities, or an item of equity, the change shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

Illustration

Cost of a machine acquired on 01.04.2013 was ₹ 5,00,000. The machine is expected to realize ₹ 50,000 at the end of its working life of 10 years. Straight-line depreciation of ₹ 45,000 per year has been charged upto 2015-2016. From 2016-17, the company switched over to 15% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 15 years. State how would you deal with the above in the annual accounts of the Company for the year ended 31st March, 2017 in light of Ind AS 8.

Solution

A change in the method of depreciation, as also a change in the useful life of an asset, are to be accounted for as a change in Accounting Estimates (Ind AS 16: Property, Plant and Equipment)

A change in an accounting estimate is to be given effect to on a prospective basis as per Ind AS 8 (Accounting Policies, Changes in Accounting Estimates and Errors)

In terms of Ind AS 8, the effect of change in an accounting estimate, shall be recognised prospectively by including it[1] in profit or loss in the following cases.

The period of the change, if the change affects that period only; or

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

A change in the method of depreciation, as also a change in the estimated useful life of a depreciable asset affects depreciation expense for the current period and in each future period during the asset's remaining revised useful life.

The effect of the change relating to the current period is included as expense in the current period. The effect, if any, on future periods is also to be similarly included in P&L as an item of expense in those future periods.

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[1] In this context, the word "It" means, the revision in the estimated amount

Thus, the following accounting treatment and disclosures will be appropriate:

Step 1 : Computation of carrying amount of asset at the time of change (in ₹)

Original Cost (A)	Annual depreciation for three years so far (B)	Carrying amount (A – B)
5,00,000	135,000 (being 45,000 x 3)	3,65,000

Book Value of the Asset at the end 2015-16: ₹ 3,65,000.

Step 2 : Change in the method of depreciation and useful life occurred from 2016-17.

There is also a consequential change in RV. The effect of these changes results in an increase in the estimated amount of depreciation. The revised estimated amount of depreciation for the year 2016-17 is ₹ 54,750 as shown below:

(in ₹)

Carrying amount at the time of change(A)	The effect of changes resulting in increased depreciation is (B)	Carrying amount A minus B
3,65,000	54,750	3,10,250
	(being 15% of 365,000)	

Step 3: The effect of change is an increased depreciation of ₹ 54,750. Therefore, the amount to be included in the Statement of Profit and Loss for the year ended 2016-17 is ₹ 54,750

Step 4: Disclosures prescribed in Ind AS 8 are:

An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.

Disclosures in the year of change would be.

1. Under Significant Accounting Policies:

Effective current reporting period, the entity has adopted WDV method of depreciation in place of straight line method followed earlier, and has also changed the estimated useful life of the asset to 15 years, thus increasing the revised remaining useful life to 12 years (PY 7 years). These changes, and the resultant change in RV, are based on technical evaluation.

2. As part of Notes to the Statement of Profit and Loss:

Consequent to the change in depreciation method from WDV to SLM, the amount of depreciation allocable to the current accounting period has been re-computed at ₹ 54,750 and this sum has been included in the Statement of Profit and Loss (Previous year 45,000).

8.4.6 Prior Period Errors

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were approved for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of:

- mathematical mistakes,
- mistakes in applying accounting policies,
- oversights or
- misinterpretations of facts, and
- fraud.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error, the Standard requires to correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

8.4.7 Major Change in Indian Accounting Standard (Ind AS) 8 vis-à-vis IAS* 8 Not Resulting in Carve Out

Guidance to the Standard: Paragraph 9 of IAS 8 provides that IFRS are accompanied by guidance to assist entities in applying their requirements. Guidance that is an integral part of IFRS is mandatory. Guidance that is not an integral part of IFRS does not contain requirements for financial statements. In Ind AS 8, paragraph 9 has been modified by not including the text given in the context of the guidance forming non-integral part of the Ind AS as such guidance

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

has not been given in the Ind AS.

8.4.8 Major Changes in Ind AS 8 vis-à-vis Notified AS 5

(i) ***Objective*****:** Objective of existing AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss for uniform preparation and presentation of financial statements. Objective of Ind AS 8 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Ind AS 8 intends to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

(ii) ***Extraordinary Items*****:** Keeping in view that Ind AS 1, '*Presentation of Financial Statements'*, prohibits the presentation of any items of income or expense as extraordinary items, Ind AS 8 does not deal with the same.

(iii) ***Definition of Accounting Policies*****:** Existing AS 5 restricts the definition of accounting policies to specific accounting principles and the methods of applying those principles while Ind AS 8 broadens the definition to include bases, conventions, rules and practices (in addition to principles) applied by an entity in the preparation and presentation of financial statements.

(iv) ***Change in Accounting Policies*****:** In addition to the situations allowed under Ind AS 8 for changing an accounting policy, existing AS 5 allows change in accounting policy if required by statute.

(v) ***Accounting for Changes in Accounting Policies:*** Ind AS 8 specifically states that an entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. Neither existing AS 5 nor any other existing Standard specifically requires accounting policies to be consistent for similar transactions, other events and conditions.

(vi) ***Exceptions in Retrospective Accounting of Changes in Accounting Policies:*** Ind AS 8 requires that changes in accounting policies should be accounted for with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy. On the other hand, existing AS 5 does not specify how change in accounting policy should be accounted for.

(vii) ***Prior Period Items*****:** Existing AS 5 defines prior period items as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods. Ind AS 8 uses the term 'errors' and relates it to errors or omissions arising from a failure to use or misuse of reliable information (in addition to mathematical mistakes, mistakes in application of accounting policies etc.) that was available when the financial statements of the prior periods were approved for issuance and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Ind AS 8 specifically states that errors include frauds, which is not covered in existing AS 5.

(viii) ***Rectification of Material Prior Period Errors:*** Ind AS 8 requires rectification of material prior period errors with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy. On the other hand, existing AS 5 requires the rectification of prior period items with prospective effect.

(ix) ***Disclosure Requirements*****:** Disclosure requirements given in Ind AS 8 are more detailed as compared to the disclosure requirements given in the existing AS 5.

8.5 Ind AS 10: Events after the Reporting Period

8.5.1 Objective

The objective of this Standard is to prescribe:

1. When an entity should adjust its financial statements for events after the reporting period; and
2. The disclosures that an entity should give about the date when the financial statements were approved for issue and about events after the reporting period.

Going Concern not appropriate

The Standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate.

8.5.2 Events after the Reporting Period

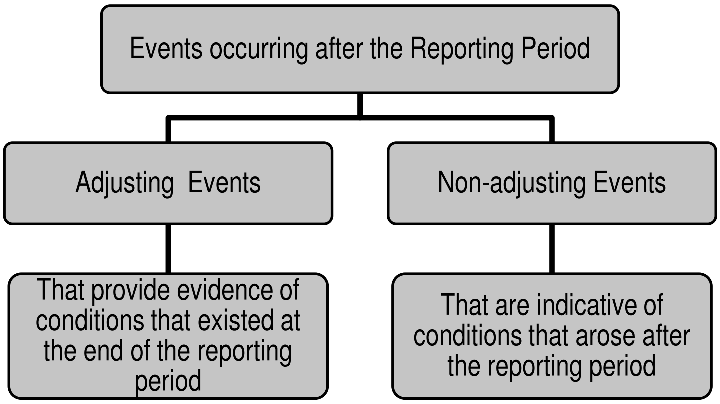
Events after the reporting period are those events:

- favourable and unfavourable,
- that occur between the end of the reporting period and the date when the financial statements are approved by the Board of Directors in case of a company, and, by the corresponding approving authority in case of any other entity for issue.

Two types of events can be identified:

(a) those that provide evidence **of conditions that existed** at the end of the reporting period (adjusting events after the reporting period); and

(b) those that are **indicative of conditions that arose after** the reporting period (non-adjusting events after the reporting period).



8.5.3 Recognition and Measurement

8.5.3.1 Adjusting Events after the Reporting Period: An entity shall adjust the amounts recognised in its financial statements to reflect adjusting events after the reporting period.

It requires an entity:

- To adjust the amounts recognised in its financial statements; OR
- To recognise items that were not previously recognised.

8.5.3.2 Non-adjusting Events after the Reporting Period: An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period.

If an entity declares dividends to holders of equity after the reporting period, the entity shall **not** recognise those dividends as a liability at the end of the reporting period.

If dividends are declared after the reporting period but before the financial statements are approved for issue, the dividends are not recognised as a liability at the end of the reporting period obligation existing at that time. Such dividends are disclosed in the notes in accordance with Ind AS 1 'Presentation of Financial Statements'.

Thus proposed dividend will not appear in the financial statements. Such dividends are disclosed in the notes in accordance with Ind AS 1.

8.5.4 Major Change in Ind AS 10 vis-à-vis IAS* 10 Resulting in Carve Out

As per IFRS: Rectification of any breach after the end of the reporting period is a non-adjusting event.

Carve Out: As a consequence to carve-out (resulted in carve out) stated in Ind AS 1 above, Ind AS 10 provides, in the definition of 'Events after the reporting period' that in case of breach of a

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.

8.5.5 Major Changes in Ind AS 10 vis-à-vis Notified AS 4

(i) ***Non Adjusting Events if Material*****:** In Ind AS 10, material non-adjusting events are required to be disclosed in the financial statements, whereas the existing AS 4 requires the same to be disclosed in the report of approving authority.

(ii) ***Accounting Treatment and Disclosure in case of Inappropriateness of Fundamental Accounting Assumption of Going Concern:*** If, after the reporting date, it is determined that the fundamental accounting assumption of going concern is no longer appropriate, Ind AS 10 requires a fundamental change in the basis of accounting. Whereas existing AS 4 requires assets and liabilities to be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern is not appropriate.

In this regard, Ind AS 10 refers to Ind AS 1, which requires an entity to make the following disclosures:

- disclose the fact that the financial statements are not prepared on a going concern basis together with the basis on which the financial statements are prepared
- state the reason why the entity is not regarded as a going concern.

Existing AS 4 does not require any such disclosure. However, existing AS 1 requires the disclosure of the fact in case going concern assumption is not followed.

(iii) ***In case of breach of a material provision of a long-term loan arrangement:*** Consequent to changes made in Ind AS 1, it has been provided in the definition of 'Events after the reporting period' that in case of breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, if the lender, before the approval of the financial statements for issue, agrees to waive the breach, it shall be considered as an adjusting event.

(iv) ***Distribution of non-cash assets to owners*****:** Ind AS 10 includes an Appendix *Distribution of Non-cash Assets to Owners* which deals, inter alia, with when to recognise dividends payable to its owners.

8.6 Ind AS 11: Construction Contracts

Ind AS 11 prescribes the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed.

8.6.1 Scope

The Standard shall be applied in accounting for construction contracts in the financial statements of contractors A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

Contract revenue shall comprise:

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

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

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

   (ii) they are capable of being reliably measured. Contract revenue is measured at the fair value of the consideration received or receivable.

Contract costs shall comprise:

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

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

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

8.6.2 Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

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

(a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and

(b) contract costs shall be recognised as an expense in the period in which they are incurred

8.6.3 Recognition of Expected Losses

When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.

An entity shall disclose the amount recognised as contract revenue in the period, the method used to determine the contract revenue recognised and stage of completion of contracts in progress.

For the contracts in progress at the end of the period, an entity shall disclose the aggregate costs incurred and recognised profits to date, the amounts of retentions and advances received.

Appendix A of Ind AS 11 gives guidance on accounting by operators for publicto- private service concession arrangements. It sets out principles for recognition and measurement of the obligations and related rights in service concession arrangements. The Appendix prescribes that an operator shall not recognise the public service infrastructure (within the scope of this appendix) as its Property, Plant and Equipment because the contractual service arrangement does not convey the right to control the use of the infrastructure. It only gives operator the access to operate the infrastructure to provide public service on behalf of the grantor.

The operator shall account for revenue and costs relating to construction or upgrade services in accordance with Ind AS 11 and those relating to operation services in accordance with Ind AS 18. The consideration received or receivable shall be recognised at its fair value. The consideration may be rights to a financial asset or an intangible asset.

The operator recognises a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services. The operator shall recognise an intangible asset to the extent that it receives a right (a license) to charge users of the public service.

8.6.4 Major Changes in Ind AS 11 vis-à-vis Notified AS 7

(i) ***Inclusion of Borrowing costs:*** Existing AS 7 includes borrowing costs as per AS 16, Borrowing Costs, in the costs that may be attributable to contract activity in general and can be allocated to specific contracts, whereas Ind AS 11 does not specifically make reference to Ind AS 23.

(ii) ***Fair Value:*** Existing AS 7 does not recognise fair value concept as contract revenue is measured at consideration received/receivable, whereas Ind AS 11 requires that contract revenue shall be measured at fair value of consideration received/receivable.

(iii) ***Accounting for Service Concession Arrangements:*** Existing AS 7 does not deal with accounting for Service Concession Arrangements, i.e., the arrangement where private sector entity (an operator) constructs or upgrades the infrastructure to be used to provide the public service and operates and maintains that infrastructure for a specified period of time, whereas Appendix A of Ind AS 11 deals with accounting aspects involved in such arrangements and Appendix B of Ind AS 11 deals with disclosures of such arrangements.

8.7 Ind AS 12: Income Taxes

8.7.1 Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes.

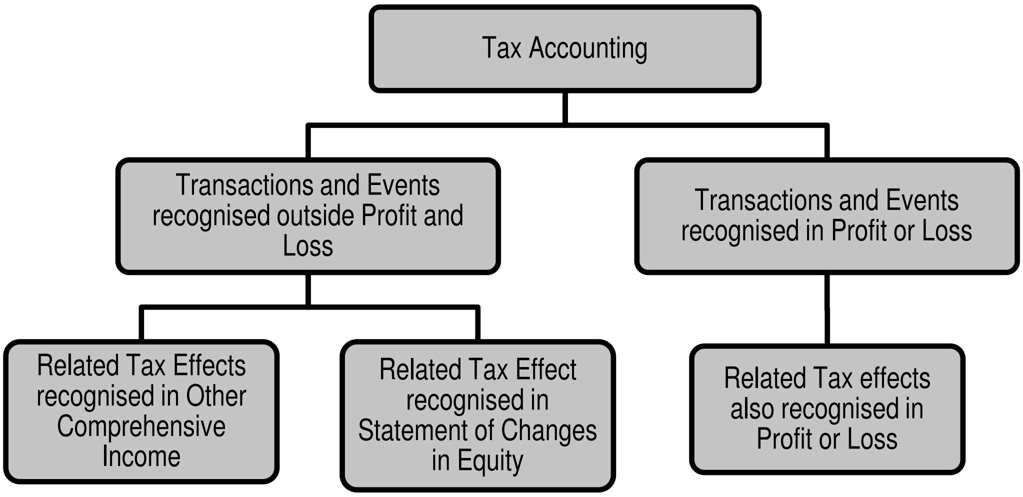
The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

(a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's balance sheet; and

(b) transactions and other events of the current period that are recognised in an entity's financial statements.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions.

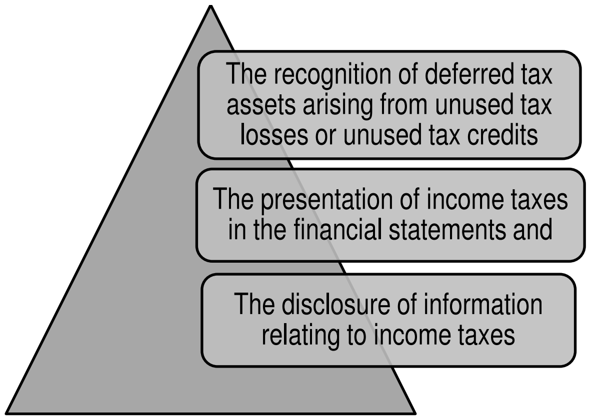
This Standard requires an entity to account for the tax consequences of transactions and other events in the same waythat it accounts for the transactions and other events themselves.



- Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss.
- For transactions and other events recognised outside profit or loss (either in other comprehensive income or directly in equity), any related tax effects are also recognised outside profit or loss (either in other comprehensive income or directly in equity, respectively.

Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill arising in that business combination or the amount of the bargain purchase gain recognised.

This Standard also deals with:



8.7.2 Scope

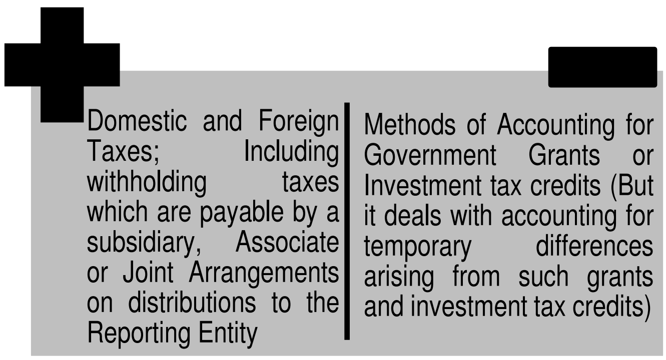
This Standard **shall be applied** in accounting for income taxes.

For the purposes of this Standard, income taxes include:

- All domestic and foreign taxes which are based on taxable profits.
- Taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.

This Standard **does not deal** with the methods of accounting for government grants (Ind AS 20, Accounting for Government Grants and Disclosure of Government Assistance) or investment tax credits.

However, this Standard does deal with the accounting for temporary differences that may arise from such grants or investment tax credits.



8.7.3 Concept of Current Tax, Deferred Tax Assets/Liabilities, Temporary Differences and Tax Base

Accounting Profit is profit or loss for a period before deducting **tax expense.**

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of **current tax and deferred tax.** In other words tax expense (tax income) comprises current tax expense (current tax income) and deferred tax expense (deferred tax income).

Taxable Profit is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

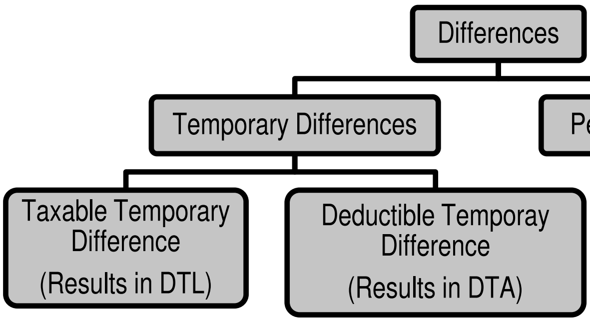
Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

(a) deductible temporary differences;

(b) the carry forward of unused tax losses; and

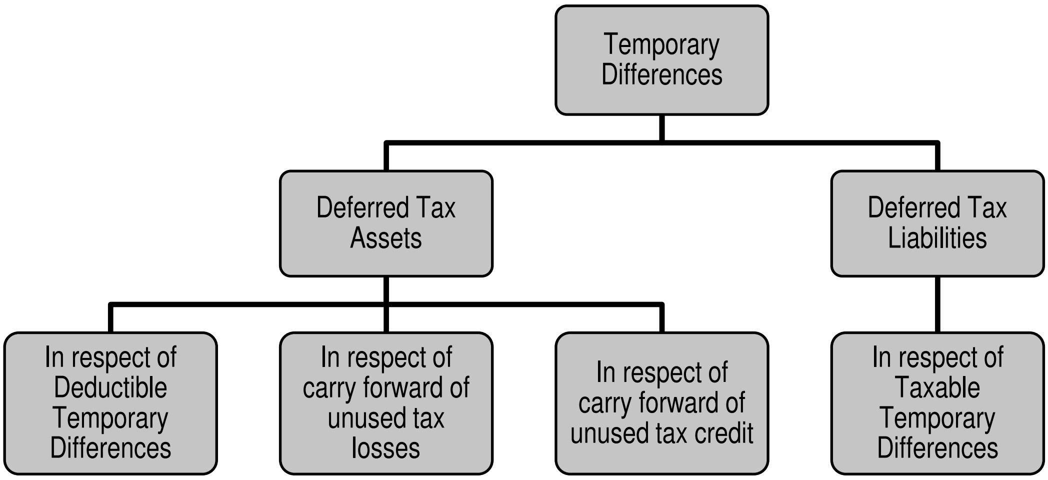
(c) the carry forward of unused tax credits.



Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Temporary differences may be either:

(a) taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.



8.7.4 Tax Base

The tax base of an **asset or liability** is the amount attributed to that asset or liability for tax purposes.

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.

Examples of Tax Base of an Asset:

S.No.	Particulars	Tax Base of an Asset
1.	A machine cost ₹ 100. For tax purposes, depreciation of ₹ 30 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal.	Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes. The tax base of the machine is ₹ 70.
2.	Interest receivable has a carrying amount of ₹ 100. The related interest revenue will be taxed on cash basis.	The tax base of the interest receivable is nil.
3.	Trade receivables have a carrying amount of ₹ 100. The related revenue has already been included in taxable profit (tax loss).	The tax base of trade receivable is ₹ 100.
4.	Dividends receivable from a subsidiary have a carrying amount of ₹ 100. The dividends are not taxable. In substance, the entire carrying amount of the asset is deductible against the economic benefits.	Consequently, the tax base of the dividends receivable is ₹ 100. {Under this analysis, there is no taxable temporary difference. An alternative analysis is that the accrued dividends

		receivable have a tax base of nil and that a tax rate of nil is applied to the resulting taxable temporary difference of ₹ 100. Under both analyses, there is no deferred tax liability.}
5.	A loan receivable has a carrying amount of ₹ 100. The repayment of the loan will have no tax consequences.	The tax base of the loan is ₹ 100.

The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Examples of Tax Base of a Liability:

S. No.	Particulars	Tax Base of Liability
1.	Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense will be deducted for tax purposes on a cash basis.	The tax base of the accrued expenses is nil.
2.	Current liabilities include interest revenue received in advance, with a carrying amount of ₹ 100. The related interest revenue was taxed on a cash basis.	The tax base of the interest received in advance is nil.
3.	Current liabilities include accrued expenses with a carrying amount of ₹ 100. The related expense has already been deducted for tax purposes.	The tax base of the accrued expenses is ₹ 100.
4.	Current liabilities include accrued fines and penalties with a carrying amount of ₹ 100. Fines and penalties are not deductible for tax purposes.	The tax base of the accrued fines and penalties is ₹ 100. {Under this analysis, there is no deductible temporary difference. An alternative analysis is that the accrued fines and penalties payable have a tax base of nil and that a tax rate of nil is applied to the resulting deductible temporary difference of ₹ 100. Under both analyses, there is no deferred tax asset.}
5.	A loan payable has a carrying amount of ₹ 100. The repayment of the loan will have no tax consequences.	The tax base of the loan is ₹ 100.

8.7.5 Recognition of Current Tax Liabilities and Current Tax Assets

- Current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability**.**
- If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset**.**
- The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset**.**
- When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

Example: A company had a loss of ₹ 1,00,000 in the current year. It had a profit of ₹ 60,000 and ₹ 50,000 in last 2 years.

The tax authorities allowed the company to offset the loss of current year against the profit of last 2 years and claim a tax refund for the tax paid in last 2 years.

Thus, if the company uses its tax loss of current year to recover current tax of the prior years, it can record the tax refund (which if probable) as an asset.

8.7.6 Recognition of Deferred Tax Liabilities and Deferred Tax Assets

Taxable Temporary Differences: A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or

(b) the initial recognition of an asset or liability in a transaction which:

 (i) is not a business combination; and

 (ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised.

It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.

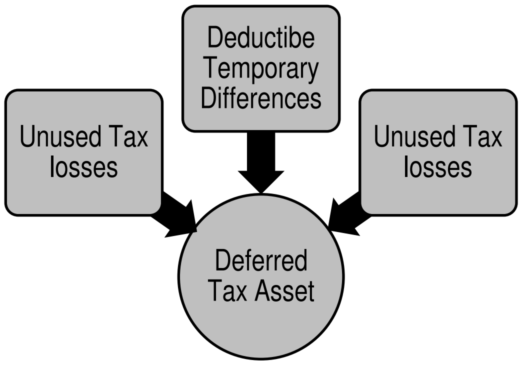
When the **carrying amount of the asset exceeds its tax base**, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a **taxable temporary difference** and the obligation to pay the resulting income taxes in future periods is a deferred tax liability.

As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39 of Ind AS 12.

Example: An asset which cost ₹ 150 has a carrying amount of ₹ 100. Cumulative depreciation for tax purposes is ₹ 90 and the tax rate is 25%.

The tax base of the asset is ₹ 60 (cost of ₹ 150 less cumulative tax depreciation of ₹ 90). To recover the carrying amount of ₹ 100, the entity must earn taxable income of ₹ 100, but will only be able to deduct tax depreciation of ₹ 60. Consequently, the entity will pay income taxes of ₹ 10 (₹ 40 at 25%) when it recovers the carrying amount of the asset. The difference between the carrying amount of ₹ 100 and the tax base of ₹ 60 is a taxable temporary difference of ₹ 40. Therefore, the entity recognises a deferred tax liability of ₹ 10 (₹ 40 at 25%) representing the income taxes that it will pay when it recovers the carrying amount of the asset.

Unused Tax Losses and Unused Tax Credits



A deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a **history of recent losses**, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

Reassessment of unrecognised deferred tax assets: At the end of each reporting period, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

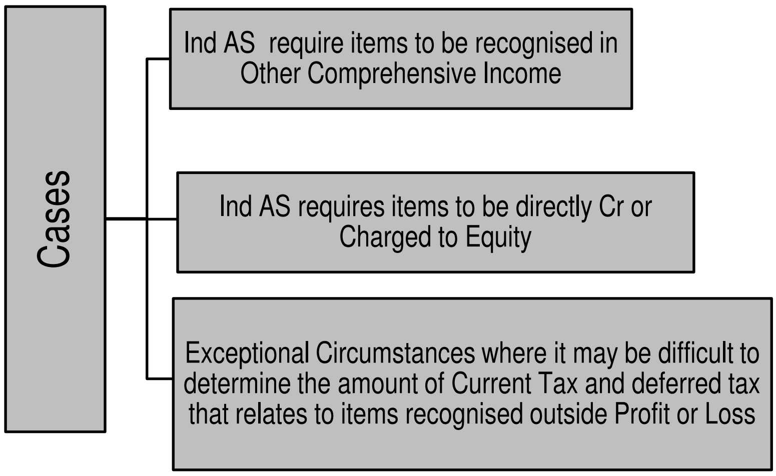
Measurement

- Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.
- Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Items recognised outside profit or loss: Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

(a) in other comprehensive income, shall be recognised in other comprehensive income.

(b) directly in equity, shall be recognised directly in equity.



CASE I: Indian Accounting Standards require or permit particular items to be recognised in other comprehensive income.

Examples of such items are:

(a) a change in carrying amount arising from the revaluation of property, plant and equipment (Ind AS 16); and

(b) exchange differences arising on the translation of the financial statements of a foreign operation (Ind AS 21).

CASE II: Indian Accounting Standards require or permit particular items to be credited or charged directly to equity.

Examples of such items are:

(a) an adjustment to the opening balance of retained earnings resulting from either a change in accounting policy that is applied retrospectively or the correction of an error (Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors); and

(b) amounts arising on initial recognition of the equity component of a compound financial instrument.

CASE III: In exceptional circumstances it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity).

This may be the case**, for example,** when:

(a) there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed;

(b) a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or

(c) an entity determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously recognised outside profit or loss.

8.7.7 Presentation - Offset

An entity shall offset **current tax assets and current tax liabilities** if, and only if, the entity:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

An entity shall offset **deferred tax assets and deferred tax liabilities** if, and only if:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:

    (i) the same taxable entity; or

    (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

8.7.8 Deferred Tax Assets and Liabilities shall not be Discounted

The carrying amount of a deferred tax asset shall be reviewed at the end of each reporting period. An entity shall reduce the carrying amount of a deferred tax asset to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. Any such reduction shall be reversed to the extent that it becomes probable that sufficient taxable profit will be available.

8.7.9 Major Changes in Ind AS 12 vis-à-vis IAS* 12 Not Resulting in Carve Outs

(i) ***Presentation of Tax Expense:*** IAS 12 requires presentation of tax expense (income) in the separate income statement, where separate income statement is presented. Ind AS 12 does not require such presentation since in Ind AS 1 option regarding the two statement approach has been removed.

(Ii) ***Fair Value Model:*** Since fair value model is not allowed in Ind AS 40, paragraph 20 of Ind AS 12 has been modified by not giving reference of Ind AS 40 and consequently paragraphs 51C-51D have been deleted.

(iii) ***Deferred Tax Benefits Related to Business Combinations:*** IAS 12 provides that acquired deferred tax benefits recognised within the measurement period that results from new information about facts and circumstances existed at the acquisition date shall be applied to reduce the carrying amount of goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in profit and loss. As a consequence of different accounting treatment of bargain purchase gain prescribed in Ind AS 103, in comparison to IFRS 3, Ind AS 12 provides that if the carrying amount of such goodwill is zero, any remaining deferred tax benefits shall be recognised in other comprehensive income and accumulated in equity as capital reserve or recognised directly in capital reserve.

(iv) ***Specified Grant Related to Asset (Para 33):***As against IAS 12, Ind AS 12 does not allow the option of deducting specified grant from the cost of the related asset as this option is not permitted in Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'.*

8.7.10 Major Changes in Ind AS 12 vis-à-vis Notified AS 22

(i) ***Approach for creating Deferred Tax:*** Ind AS 12 is based on balance sheet approach. It requires recognition of tax consequences of differences between the carrying amounts of assets and liabilities and their tax base. Existing AS 22 is based on income statement approach. It requires recognition of tax consequences of differences between taxable income and accounting income. For this purpose, differences between taxable income.

(ii) ***Limited Exceptions for Recognition of Deferred Tax Asset:*** As per Ind AS 12, subject to limited exceptions, deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. The criteria for recognising deferred tax assets arising from the carry forward of unused tax losses and tax credits are the same that for recognising deferred tax assets arising from deductible temporary differences.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity

(iii) ***Recognition of Current and Deferred Tax:*** As per the existing AS 22, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised. Where deferred tax asset is recognised against unabsorbed depreciation or carry forward of losses under tax laws, it is recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

As per Ind AS 12, current and deferred tax are recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from a transaction or event which is recognised outside profit or loss, either in other comprehensive income or directly in equity, in those cases tax is also recognised in other comprehensive income or in equity, as appropriate. Existing AS 22 does not specifically deal with this aspect.

(iv) ***Disclosure of DTA and DTL in Balance Sheet:*** Existing AS 22 deals with disclosure of deferred tax assets and deferred tax liabilities in the balance sheet. Ind AS 12 does not deal with this aspect except that it requires that income tax relating to each component of other comprehensive income shall be disclosed as current or non-current asset/liability in accordance with the requirements of Ind AS 1.

(v) ***Disclosure Requirements:*** Disclosure requirements given in the Ind AS 12 are more detailed as compared to existing AS 22.

(vi) ***DTA/DTL arising out of Revaluation of Assets:*** Ind AS 12 requires that deferred tax asset/liability arising from revaluation of non-depreciable assets shall be measured on the basis of tax consequences from the sale of asset rather than through use. Existing AS 22 does not deal with this aspect.

(vii) ***Changes in Entities Tax Status or that of its Shareholders:*** Ind AS 12 provides guidance as to how an entity should account for the tax consequences of a change in its tax status or that of its shareholders. Existing AS 22 does not deal with this aspect.

(viii) ***Virtual Certainty:*** Existing AS 22 explains virtual certainty supported by convincing evidence. Since the concept of virtual certainty does not exist in Ind AS 12, this explanation is not included.

(ix) ***Guidance for Recognition of Deferred Tax in a Tax Holiday Period:*** Existing AS 22 specifically provides guidance regarding recognition of deferred tax in the situations of Tax Holiday under Sections 80-IA and 80-IB and Tax Holiday under Sections 10A and 10B of the Income Tax Act, 1961. Similarly, existing AS 22 provides guidance regarding recognition of deferred tax asset in case of loss under the head 'capital gains'. Ind AS 12 does not specifically deal with these situations.

(x) ***Guidance on Certain Issues:*** Existing AS 22 specifically provides guidance regarding tax rates to be applied in measuring deferred tax assets/liabilities in a situation where a company pays tax under section 115JB. Ind AS 12 does not specifically deal with this aspect.

8.8 Ind AS 16 : Property, Plant and Equipment

8.8.1 Objective

The objective of this Standard is to prescribe the **accounting treatment** for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment.

The **principal issues** in accounting for property, plant and equipment are:

- The recognition of the assets
- The determination of their carrying amounts
- The depreciation charges
- Impairment losses to be recognised in relation to them

8.8.2 Scope

This Standard shall be applied in accounting for property, plant and equipment **except** when another Standard requires or permits a different accounting treatment.

This Standard does not apply to:

Property, plant and equipment classified as held for sale	
Ind AS 105	

Biological assets related to agricultural activity	
Ind AS 41	See Note below

Recognition and measurement of exploration and evaluation assets	
Ind AS 106	See Note below

Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources	
No Ind AS	See Note below

This Standard applies to property, plant and equipment used to **develop or maintain the assets** described above.

For example: Ind AS 17 'Leases' requires an entity to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

An entity accounting for investment property in accordance with Ind AS 40 'Investment Property' shall use the cost model in this Standard.

8.8.3 Property, Plant and Equipment

8.8.3.1 Definition: Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

8.8.3.2 Recognition: The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably.

An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include:

(a) **Initial Costs:** Costs incurred initially to acquire or construct an item of property, plant and equipment and

(b) **Subsequent Costs:** Costs incurred subsequently to add to, replace part of, or service it.

Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Ind AS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

8.8.4 Measurement at Recognition

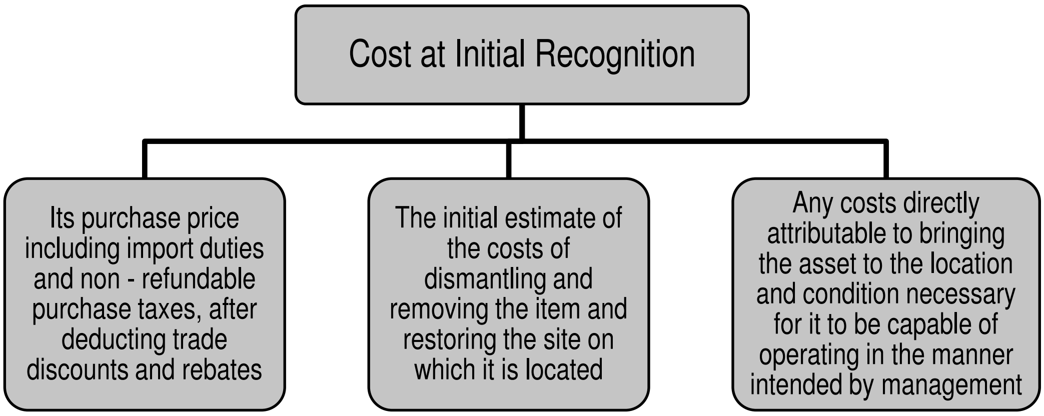
An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost**.**

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with Ind AS 23.

Cost is:

- The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset
- At the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Indian Accounting Standards, e.g. Ind AS 102 *'Share-based Payment'*.

8.8.4.1 Elements of Cost: The cost of an item of property, plant and equipment comprises:



8.8.4.2 Cost of Dismantling, Removal and Restoration: The obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

An entity applies Ind AS 2*'Inventories'* to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

8.8.4.3 Examples of Directly Attributable Costs: costs of employee benefits (as defined in Ind AS 19 *'Employee Benefits'*) arising directly from the construction or acquisition of the item of property, plant and equipment;

- costs of site preparation;
- initial delivery and handling costs;
- installation and assembly costs;
- costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- professional fees.

8.8.4.4 Examples of Costs that are not Costs of an Item of Property, Plant and Equipment

1. • Costs of opening a new facility
2. • Costs of introducing a new product or service (including costs of advertising and promotional activities)
3. • Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
4. • Administration and other general overhead costs

8.8.4.5 Costs not Included in the Carrying Amount of an Item of Property, Plant and Equipment

1. • Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity
2. • Initial operating losses, such as those incurred while demand for the item's output builds up
3. • Costs of relocating or reorganising part or all of an entity's operations

8.8.4.6 Self-constructed Asset: The cost of a self-constructed asset is determined using the same principles as for an acquired asset. Therefore, any internal profits are eliminated in arriving at such costs.

For Example: A transfer from one division of an organisation to another at a transfer price including profit margin. In such a case we will consider only the cost of transfer and not transfer price.

Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.

Ind AS 23 *'Borrowing Costs'* establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

8.8.4.7 Asset Exchange Transaction: One or more items of property, plant and equipment may be acquired in exchange for:

- A non-monetary asset or assets, or
- A combination of monetary and non-monetary assets.

The cost of such an item of property, plant and equipment is measured at fair value unless:

(a) the exchange transaction lacks commercial substance or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

8.8.5 Measurement after Recognition

An entity shall choose either:

- The cost model or
- The revaluation model

As its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

8.8.5.1 Cost Model: After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation less any accumulated impairment losses**.**

8.8.5.2 Revaluation Model: After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation less subsequent accumulated impairment losses.

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

If an asset's carrying amount is increased as a result of a revaluation, the increase should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

8.8.6 Depreciation

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset should be determined after deducting its residual value.

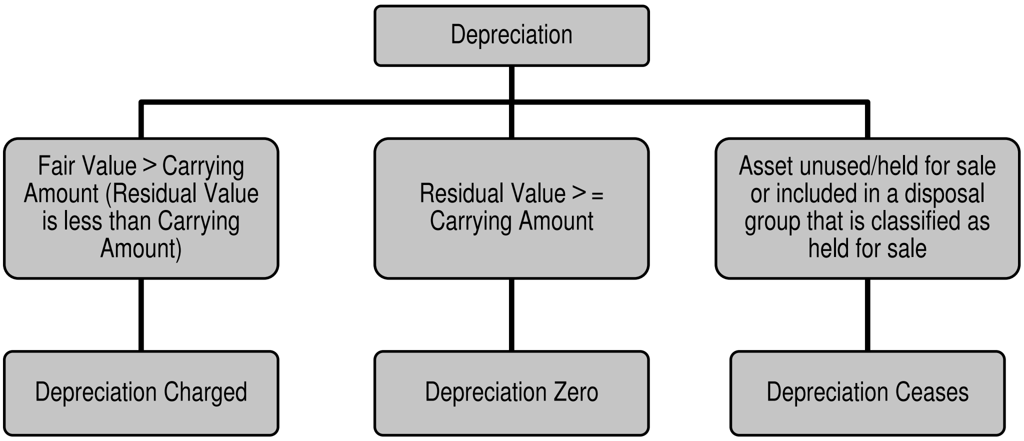
8.8.6.1 Component Cost Approach: Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part.

The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.

The depreciation charge for a period is usually recognised in profit or loss.

However, sometimes, the future economic benefits embodied in an asset are absorbed **in producing other assets.** In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount.



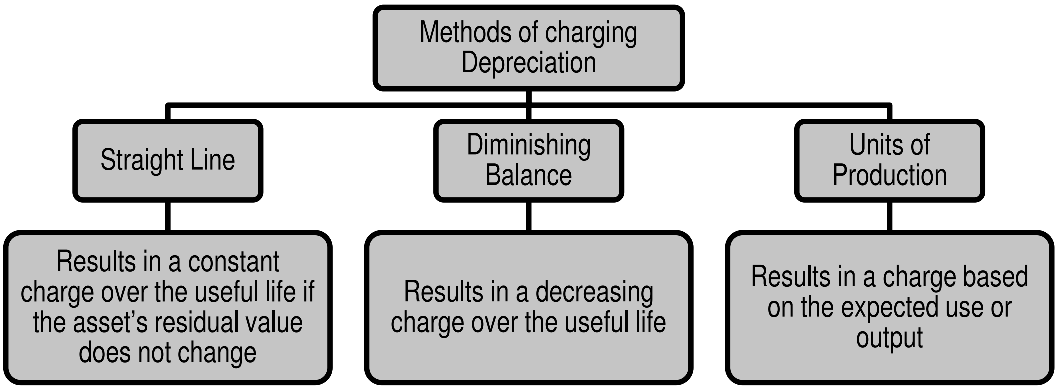
Depreciation Begins: Depreciation of an asset begins when it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation Ceases: Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105 and the date that the asset is derecognised.

Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

8.8.6.2 Depreciation Method

- The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
- The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with Ind AS 8.



8.8.7 Impairment

To determine whether an item of property, plant and equipment is impaired, an entity applies Ind AS 36 'Impairment of Assets'.

8.8.8 Derecognition

The carrying amount of an item of property, plant and equipment shall be derecognised:

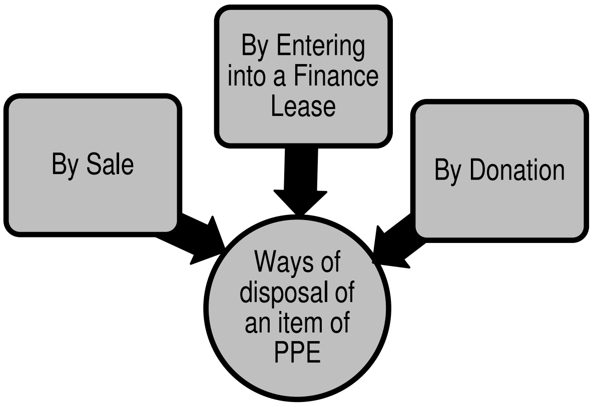
(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

The gain or loss arising from the de-recognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless Ind AS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

8.8.8.1 Ways of Disposal:



8.8.8.2 Gain or Loss: The gain or loss arising from the de-recognition of an item of property, plant and equipment shall be determined as the difference between

- The net disposal proceeds, if any, and
- The carrying amount of the item.

8.8.8.3 Consideration Receivable

- The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value.
- If payment for the item **is deferred,** the consideration received is recognised initially at the cash price equivalent.

8.8.9 Major Changes in Ind AS 16 vis-à-vis IAS* 16 Not Resulting in Carve Outs

1. ***Reduction in the Carrying Amount of PPE:*** Paragraph 28 has been shown as deleted since Ind AS 20 '*Accounting for Government Grants and Disclosure of Government Assistance'* does not permit the option of reducing the carrying amount of an item of property, plant and equipment by the amount of government grant received in respect of such an item, as permitted in IAS 20.
2. ***Fair Value Model:*** Paragraph 5 of Ind AS 16 has been modified, since Ind AS 40, '*Investment Property'*, prohibits the use of fair value model.
3. ***Guidance for Allocation Basis:*** Paragraph 12 of Appendix B has been modified by giving example of types of costs that would be included as directly attributable overhead costs of the stripping activity asset. Paragraph 13A has been added in Appendix B to provide guidance on allocation basis.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

8.8.10 Major Changes in Ind AS 16 vis-à-vis Notified AS 10

(i) ***Fixed Assets retired from Active Use and Held for Sale:*** Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Existing AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.

(ii) ***Stripping Costs in the Production Phase of a Surface Mine:*** Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'. Existing AS does not contain this guidance.

8.9 Ind AS 17: Leases

8.9.1 Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

8.9.2 Scope

This Standard shall be applied in accounting for all leases other than:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and
- Licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

However, this Standard shall not be applied as the basis of measurement for:

- Property held by lessees that is accounted for as investment property (Ind AS 40, 'Investment Property')
- Investment property provided by lessors under operating leases (Ind AS 40, 'Investment Property')
- Biological assets within the scope of Ind AS 41, 'Agriculture' held by lessees under finance leases
- Biological assets within the scope of Ind AS 41, provided by lessors under operating leases

8.9.3 Lease

A lease is an agreement whereby:

- The lessor conveys to the lessee

- In return for a payment or series of payments
- The right to use an asset
- For an agreed period of time

8.9.3.1 Finance Lease: A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.

Where, Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions.

Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

Title may or may not eventually be transferred.

8.9.3.2 Operating Lease: An operating lease is a lease other than a finance lease.

8.9.3.3 Non-cancellable Lease: A non-cancellable lease is a lease that is cancellable only:

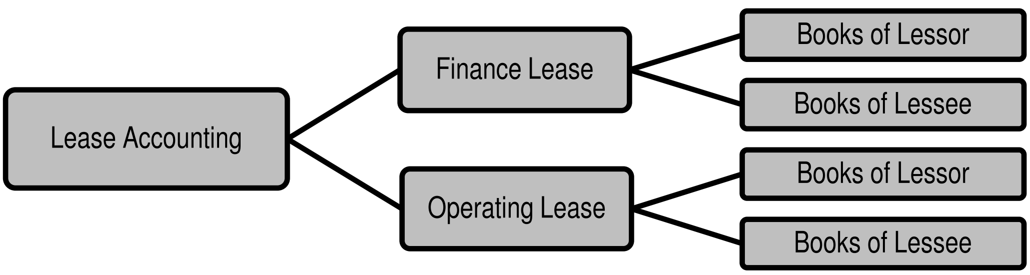
(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

8.9.4 Accounting Treatment of Lease



8.9.4.1 Leases in the Financial Statements of Lessees

(a) Finance Leases

Initial recognition: At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.

The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used.

Any initial direct costs of the lessee are added to the amount recognised as an asset.

Subsequent measurement

- Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability.
- The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.
- Contingent rents shall be charged as expenses in the periods in which they are incurred.
- A finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period.
- The depreciation policy for depreciable leased assets shall be consistent with that for depreciable assets that are owned, and the depreciation recognised shall be calculated in accordance with Ind AS 16, 'Property, Plant and Equipment' and Ind AS 38, 'Intangible Assets'.

(b) Operating Leases: Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless either:

(a) another systematic basis is more representative of the time pattern of the user's benefit even if the payments to the lessors are not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases.

8.9.4.2 Leases in the Financial Statements of Lessors

(a) Finance Leases

Initial recognition: Lessors shall recognise assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease.

Subsequent measurement: The recognition of finance income shall be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the finance lease.

(b) Operating Leases: Lessors shall present assets subject to operating leases in their balance sheet according to the nature of the asset.

Lease income from operating leases (excluding amounts for services such as insurance and maintenance) shall be recognised in income on a straight-line basis over the lease term, unless either:

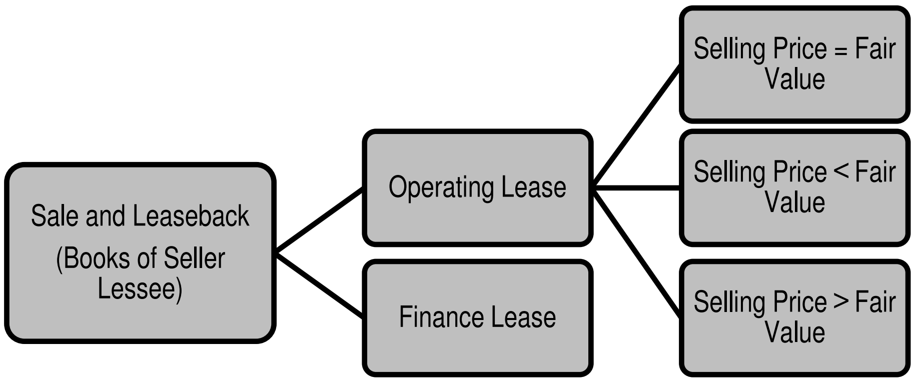
(a) another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished, even if the payments to the lessors are not on that basis; or

(b) the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary according to factors other than inflation, then this condition is not met

The depreciation policy for depreciable leased assets shall be consistent with the lessor's normal depreciation policy for similar assets, and depreciation shall be calculated in accordance with Ind AS 16 and Ind AS 38.

8.9.5 Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.



8.9.5.1 If a Sale and Leaseback Transaction Results in a Finance Lease: If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised over the lease term.

8.9.5.2 If a Sale and Leaseback Transaction Results in an Operating Lease

CASE I: When Sale Price = Fair Value: If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss shall be recognised immediately.

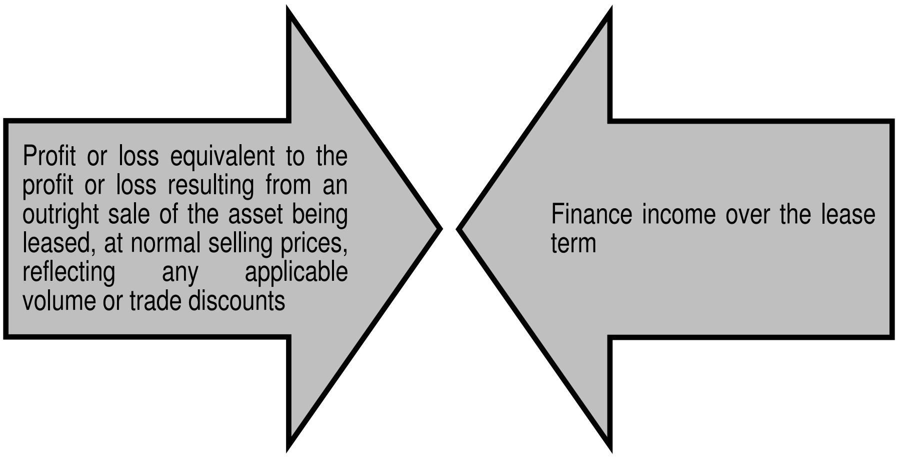
CASE II: When Sale Price < Fair Value: If the sale price is below fair value, any profit or loss shall be recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it shall be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

CASE III: When Sale Price > Fair Value: If the sale price is above fair value, the excess over fair value shall be deferred and amortised over the period for which the asset is expected to be used.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value shall be recognised immediately.

8.9.6 Accounting Treatment in the Books of Manufacturer or Dealer Lessors

- Manufacturer or dealer lessors shall recognise selling profit or loss in the period, in accordance with the policy followed by the entity for outright sales.
- If artificially low rates of interest are quoted, selling profit shall be restricted to that which would apply if a market rate of interest were charged.
- Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease shall be recognised as an expense when the selling profit is recognised.
- Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:



Appendix C of Ind AS 17 provides guidance (a) for determining whether the arrangement is, or contain, leases that should be accounted for in accordance with Ind AS 17; (b) when the assessment or a reassessment of whether an arrangement is, or contains, a lease should be made; and (c) if an arrangement is, or contains, a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Appendix A of Ind AS 17 provides guidance on recognition of incentives in an operating lease in the financial statements of lessor and lessee. The Appendix prescribes that the lessor shall recognise the aggregate cost of incentives as a reduction of rental income over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished. The lessee shall recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, on a straight-line basis unless another systematic basis is representative of the time pattern of the lessee's benefit from the use of the leased asset.

8.9.7 Major Changes in Ind AS 17 vis-à-vis IAS* 17

8.9.7.1 Resulting in Carve Out

As per IFRS: IAS 17 requires all leases rentals to be charged to statement of profit and loss on straight-line basis in case of operating leases unless another systematic basis is more representative of the time pattern of the user's benefit even if the payments to the lessor are not on that basis.

Carve out: A carve-out has been made to provide that lease rentals, in case of operating leases, shall be charged to the statement of profit and loss in accordance with the lease agreement unless the payments to the lessor are structured to increase in line with expected general inflation to compensate for the lessor's expected inflationary cost increases. If payments to the lessor vary because of factors other than general inflation, then this condition is not met.

Reason: Companies enter into various kinds of lease agreements to get the right to use an asset of the lessor. Considering the Indian inflationary situation, lease agreements contain periodic rent escalation. Accordingly, where there is periodic rent escalation in line with the expected inflation so as to compensate the lessor for expected inflationary cost increases, the rentals shall not be straight-lined.

8.9.7.2 Not Resulting in Carve Out

Investment Property: IAS 17 provides that separate measurement of land and buildings elements is not required when the lessee's interest in both land and buildings is classified as an investment property in accordance with Ind AS 40, '*Investment Property',* and fair value model is adopted. IAS 17 also permits property interest held under an operating lease as an investment property, if the definition of investment property is otherwise met and fair value model is applied. Since Ind AS 40 '*Investment Property'* prohibits the use of fair value model, these provisions of IAS 17 have not been included in Ind AS 17.

8.9.8 Major Changes in Ind AS 17 vis-à-vis Notified AS 19

(i) ***Land:*** The existing standard excludes leases of land from its scope. Ind AS 17 does not have such scope exclusion. It has specific provisions dealing with leases of land and building applicable. Further, Ind AS 17 is not applicable as the basis of measurement for

- property held by lessees/provided by lessors under operating leases but treated as investment property and
- biological assets held by lessees/provided by lessors under operating leases that are covered in the Standard on Agriculture.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

The existing standard does not contain such provisions.

(ii) ***Definition of Residual Value:*** The definition of residual value appearing in the existing standard has been deleted in Ind AS 17.

(iii) ***Initial Direct Costs:*** Consequent upon the difference between the existing standard and Ind AS 17 in respect of treatment of initial direct costs incurred by a non-manufacturer/non-dealer-lessor in respect of a finance lease (see point 5 below), the term 'initial direct costs' has been specifically defined in Ind AS 17 and definition of the term 'interest rate implicit in the lease' as per the existing standard has been modified in Ind AS 17.

(iv) ***Inception of Lease and Commencement of Lease:*** Ind AS 17 makes a distinction between inception of lease and commencement of lease. In the existing standard, though both the terms are used at some places, these terms have not been defined and distinguished. Further, Ind AS 17 deals with adjustment of lease payments during the period between inception of the lease and the commencement of the lease term. This aspect is not dealt with in the existing standard. Also, as per Ind AS 17, the lessee shall recognise finance leases as assets and liabilities in balance sheet at the commencement of the lease term whereas as per the existing standard such recognition is at the inception of the lease.

(v) ***Treatment of Initial Direct Costs:*** Treatment of initial direct costs under Ind AS 17 differs from the treatment prescribed under the existing standard. This is tabulated below:

Subject	*Existing standard*	*Ind AS 17*
Finance lease-lessee accounting	Added to the amount recognised as asset.	Same as per the existing standard.
Finance lease-lessor accounting		
Non- manufacturer/ Non-dealer	Either recognised as expense immediately or allocated against the finance income over the lease term.	Interest rate implicit in the lease is defined in such a way that the initial direct costs included automatically in the finance lease receivable; there is no need to add them separately.
Manufacturer/dealer:	Recognised as expense at the commencement of the lease term.	Same as per the existing standard.
Operating lease-Lessee accounting	No discussion	No discussion
Operating lease-Lessor accounting	Either deferred and allocated to income over the lease term in proportion to the recognition of rent	Added to the carrying amount of the leased asset and recognized as expense over the lease term on the same basis as lease income

	income, or recognized as expense in the period in which incurred.	

(vi) ***Current/Non-current Classification of Lease Liabilities:*** Ind AS 17 requires current/non-current classification of lease Liabilities if such classification is made for other liabilities. Also, it makes reference to Ind AS 105, '*Non-current Assets Held for Sale and Discontinued Operations'*. These matters are not addressed in the existing standard.

(vii) ***Sale and Leaseback Transaction:*** As per the existing standard, if a sale and leaseback transaction results in a finance lease, excess, if any, of the sale proceeds over the carrying amount shall be deferred and amortised by the seller-lessee over the lease term in proportion to depreciation of the leased asset. While Ind AS 17 retains the deferral and amortisation principle, it does not specify any method of amortisation.

(viii) ***Accounting for Incentives in the Case of Operating Leases:*** Ind AS 17 provides guidance on accounting for incentives in the case of operating leases, evaluating the substance of transactions involving the legal form of a lease and determining whether an arrangement contains a lease. The existing standard does not contain such guidance.

(ix) ***Recognition of Lease Payments:*** Ind AS 17 requires that in case of operating lease, where escalation of lease rentals is in line with the expected general inflation so as to compensate the lessor for expected inflationary cost increases shall not be straight lined. AS 19 does not provide for the same.

(x) ***Disclosure Requirements****:* There are some differences in disclosure requirements as per the existing standard and disclosure requirements as per Ind AS 17.

8.10 Ind AS 18 : Revenue

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

The Standard shall be applied in accounting for revenue arising from the following transactions and events: (a) the sale of goods; (b) the rendering of services; and (c) the use by others of entity assets yielding interest and royalties The Standard deals with recognition of interest. However, measurement of interest and recognition and measurement of dividend are dealt in accordance with Ind AS 109, *Financial Instruments*.

The impairment of any contractual right to receive cash or another financial asset arising from this Standard shall be dealt in accordance with Ind AS 109, *Financial Instruments.*

8.10.1 Identification of the transaction

The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

8.10.2 Measurement of revenue

Revenue shall be measured at the fair value of the consideration received or receivable. *Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

8.10.3 Sale of goods

Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied: (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods; (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; (c) the amount of revenue can be measured reliably; (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

8.10.4 Rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied: (a) the amount of revenue can be measured reliably; (b) it is probable that the economic benefits associated with the transaction will flow to the entity; (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period.

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

8.10.5 Interest and Royalties

Revenue arising from the use by others of entity assets yielding interest and royalties shall be recognised when: (a) it is probable that the economic benefits associated with the transaction will flow to the entity; and (b) the amount of the revenue can be measured reliably.

Revenue shall be recognised on the following bases: (a) interest shall be recognised using the effective interest method as set out in Ind AS 109; (b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement.

8.10.6 Major Changes in Ind AS 18 vis-à-vis IAS* 18

8.10.6.1 Resulting in Carve Out

As per IFRS: On the basis of principles of the IAS 18, IFRIC 15, Agreement for Construction of Real Estate, prescribes that construction of real estate should be treated as sale of goods and revenue should be recognised when the entity has transferred significant risks and rewards of ownership and retained neither continuing managerial involvement nor effective control.

Carve out: IFRIC 15 has not been included in Ind AS 18 to scope out such agreements from Ind AS 18. A separate guidance note on accounting for real estate developers (for Ind AS compliant entities) has been issued by the ICAI to address the matter.

Reason: It was observed that requirement will lead to recognition of revenue in the financial statements by real estate developers based on the completion method, i.e., only in the last year of the completion of project. It was felt that in case the revenue for the whole project is recognised in the last year of completion of project, it will not reflect the true performance of the business of the real estate developer. Further, it was felt that since Ind AS 11 requires recognition of revenue of all construction contracts by reference to stage of completion, it may lead to inappropriate accounting in case of certain real estate development projects in case this Ind AS is applied for all real estate development projects. Therefore, it was considered appropriate that rather than making changes in Ind AS 11 or Ind AS 18, a separate Guidance note (for Ind AS-compliant entities) should be issued in line with the Guidance note on Accounting for Real Estate Transactions issued by the Institute of Chartered Accountants of India (for entities on which AS are applicable).

8.10.6.2 Not Resulting in Carve Out

1. ***Recognition and Measurement of Interest:*** Paragraph 1A is inserted in Ind AS 18 which states that recognition of interest is dealt in this standard whereas measurement of interest is dealt in accordance with Ind AS 109, *Financial Instruments.*

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

2. ***Impairment of Contractual Right***: Paragraph 1B is inserted in Ind AS 18, which prescribes the impairment of any contractual right to receive cash or another financial asset arising from this standard, shall be dealt in accordance with Ind AS 109, *Financial Instruments*.

8.10.7 Major Changes in Ind AS 18 vis-à-vis Notified AS 9

(i) ***Definition of 'Revenue':*** Definition of 'revenue' given in Ind AS 18 is broad compared to the definition of 'revenue' given in existing AS 9 because it covers all economic benefits that arise in the ordinary course of activities of an entity which result in increases in equity, other than increases relating to contributions from equity participants. On the other hand, as per the existing AS 9, revenue is gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

(ii) ***Measurement of Revenue:*** Measurement of revenue is briefly covered in the definition of revenue in the existing AS 9, while Ind AS 18 deals separately in detail with measurement of revenue. As per existing AS 9, revenue is recognised at the nominal amount of consideration receivable. Ind AS 18 requires the revenue to be measured at fair value of the consideration received or receivable.

(iii) ***Barter Transactions***: Ind AS 18 specifically deals with the exchange of goods and services with goods and services of similar and dissimilar nature. In this regard specific guidance is given regarding barter transactions involving advertising services. This aspect is not dealt with in the existing AS 9.

(iv) ***Recognition of Separately Identifiable Components:*** Ind AS 18 provides guidance on application of recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. Existing AS 9 does not specifically deal with the same.

(v) ***Recognition of Interest:*** Existing AS 9 requires the recognition of revenue from interest on time proportion basis. Ind AS 18 requires interest to be recognised using effective interest rate method as set out in Ind AS 109, Financial Instruments.

(vi) ***Guidance Regarding Revenue Recognition in Specific Cases:*** Ind AS 18 specifically provides guidance regarding revenue recognition in case the entity is under any obligation to provide free or discounted goods or services or award credits to its customers due to any customer loyalty programme. Existing AS 9 does not deal with this aspect.

(vii) ***Disclosure of Excise Duty***: Existing AS 9 specifically deals with disclosure of excise duty as a deduction from revenue from sales transactions. Ind AS 18 does not specifically deal with the same.

(viii) ***Disclosure Requirements:*** Disclosure requirements given in the Ind AS 18 are more detailed as compared to existing AS 9.

8.11 Ind AS 19 : Employee Benefits

8.11.1 Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

- A liability - When an employee has provided service in exchange for employee benefits to be paid in the future
- An expense - When the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits

8.11.2 Scope

This Standard shall be applied by an employer in accounting for all employee benefits, except those to which Ind AS 102, *'Share-based Payment'*, applies.

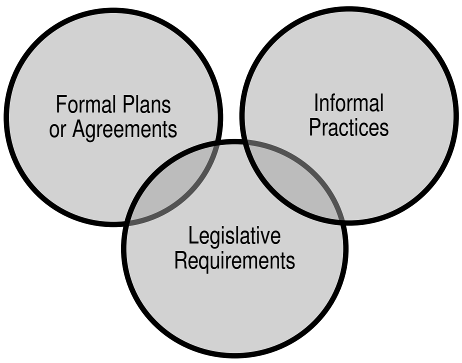
This Standard does not deal with reporting by employee benefit plans.

The employee benefits to which this Standard applies include those provided:

(a) under formal plans or other formal agreements between an entity and individual employees, groups of employees or their representatives;

(b) under legislative requirements, or through industry arrangements, whereby entities are required to contribute to national, state, industry or other multi-employer plans; or

(c) by those informal practices that give rise to a constructive obligation. Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits.



8.11.3 Employee Benefits

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

8.11.3.1 Types of Employee Benefits: Employee benefits include:

(a) **Short-term Employee Benefits:** Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services. It includes:

   (i) wages, salaries and social security contributions;

   (ii) paid annual leave and paid sick leave;

   (iii) profit-sharing and bonuses; and

   (iv) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) **Post-employment Benefits:** Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees, such as the following:

   (i) retirement benefits (e.g. pensions and lump sum payments on retirement); and

   (ii) other post-employment benefits, such as post-employment life insurance and post-employment medical care;

(c) **Other Long-term Employee Benefits:** Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits, such as the following:

   (i) long-term paid absences such as long-service leave or sabbatical leave;

   (ii) jubilee or other long-service benefits; and

   (iii) long-term disability benefits; and

(d) **Termination Benefits:** Termination benefits are employee benefits provided in exchange for the termination of an employee's employment.

8.11.3.2 Settlement of Employee Benefits: Employee benefits include benefits provided:

- To employees or

- To their dependants or beneficiaries

And may be settled by payments (or the provision of goods or services) made either directly:

- To the employees; or
- To their spouses; or
- Children; or
- Other dependants; or
- To others, such as insurance companies.

An employee may provide services to an entity on:

- A full-time
- Part-time
- Permanent
- Casual or
- Temporary basis

For the purpose of this Standard, employees include directors and other management personnel.

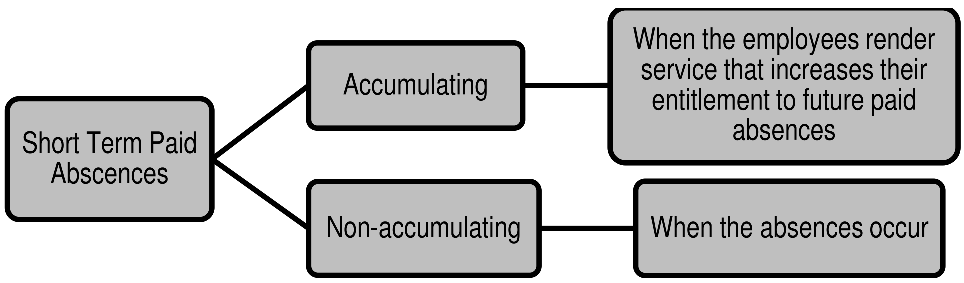
8.11.4 Short-term Employee Benefits

When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

(a) **as a liability** (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an entity shall recognise that excess as an **asset** (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

(b) **as an expense**, unless another Ind AS requires or permits the inclusion of the benefits in the cost of an asset (For example, Ind AS 2, *'Inventories'*, and Ind AS 16*, 'Property, Plant and Equipment'*).

Short-term paid absences: An entity shall recognise the expected cost of short-term employee benefits in the form of paid absences as follows:



Profit-sharing and bonus plans: An entity shall recognise the expected cost of profit-sharing and bonus payments, only when:

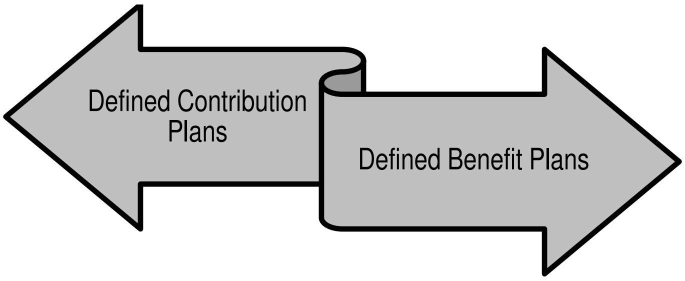
(i) the entity has a present legal or constructive obligation to make such payments as a result of past events; and

(ii) a reliable estimate of the obligation can be made.

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments.

8.11.5 Post-Employment Benefits

Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions.



8.11.5.1 Defined Contribution Plans: The entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions.

In consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall, in substance, on the employee.

Recognition and measurement: When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

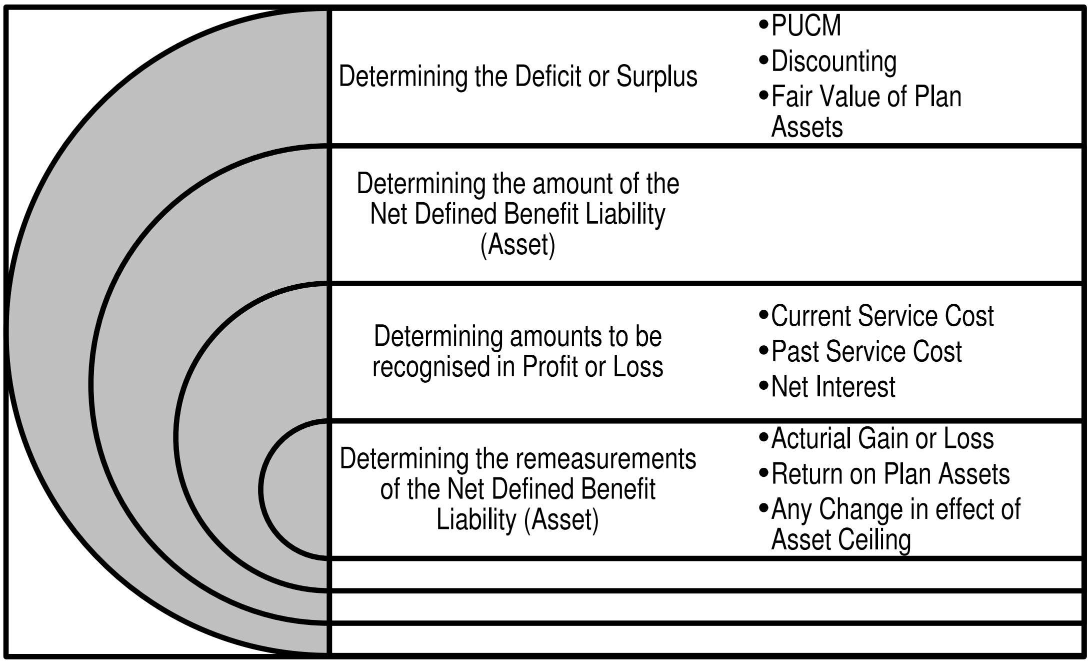
(b) as an expense, unless another Ind AS requires or permits the inclusion of the contribution in the cost of an asset (For example, Ind AS 2 and Ind AS 16).

> **Note:** When contributions to a defined contribution plan are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service, they shall be discounted using discount rate.

8.11.5.2 Defined Benefit Plans

- The entity's obligation is to provide the agreed benefits to current and former employees; and
- Actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

Recognition and Measurement:



Accounting by an entity for defined benefit plans involves the following steps:

(A) Determining the deficit or surplus. This involves:

(i) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods.

(ii) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost.

(iii) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

(B) Determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (A), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

(C) Determining amounts to be recognised in profit or loss:

   (i) current service cost.

   (ii) any past service cost and gain or loss on settlement.

   (iii) net interest on the net defined benefit liability (asset).

(D) Determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

   (i) actuarial gains and losses;

   (ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

   (iii) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

8.11.6 Other Long-term Employee Benefits

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Recognition and Measurement

The Standard does not require the measurement of other long-term employee benefits to the same degree of uncertainty as the measurement of post-employment benefits. The Standard requires a simplified method of accounting for other long-term employee benefits. Unlike the accounting required for post-employment benefits, this method does not recognise re-measurements in other comprehensive income.

For other long-term employee benefits, an entity shall recognise the net total of the following amounts in profit or loss, except to the extent that another Ind AS requires or permits their inclusion in the cost of an asset:

- Service cost;
- Net interest on the net defined benefit liability (asset); and
- Remeasurements of the net defined benefit liability (asset).

8.11.7 Termination Benefits

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

(a) an entity's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Recognition and Measurement

An entity shall recognise a liability and expense for termination benefits at the earlier of the following dates:

(a) when the entity can no longer withdraw the offer of those benefits; and

(b) when the entity recognises costs for a restructuring that is within the scope of Ind AS 37 and involves the payment of termination benefits.

An entity shall measure termination benefits on initial recognition, and shall measure and recognise subsequent changes, in accordance with the nature of the employee benefit, provided that if the termination benefits are an enhancement to post-employment benefits, the entity shall apply the requirements for post-employment benefits. Otherwise:

(i) if the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognised, the entity shall apply the requirements for short-term employee benefits.

(ii) if the termination benefits are not expected to be settled wholly before twelve months after the end of the annual reporting period, the entity shall apply the requirements for other long-term employee benefits.

8.11.8 Major Changes in Ind AS 19 vis-à-vis IAS* 19 Not Resulting in Carve Outs

1. ***Discount Rate*: ** According to Ind AS 19, the rate to be used to discount postemployment benefit obligations (both funded and unfunded) shall be determined by reference to the market yields on government bonds whereas under IAS 19, the government bonds can be used only where there is no deep market of high quality corporate bonds. However, requirements given in IAS 19 in this regard have been retained with appropriate modifications for currencies other than Indian rupee.
2. ***Example on Gratuity:*** To illustrate treatment of gratuity subject to ceiling under Indian Gratuity Rules, an example has been added in Ind AS 19.
3. ***Appendix B of Ind AS 19:*** In Appendix B of Ind AS 19, paragraph of IFRIC 14 dealing with reason for amending IFRIC 14 has not been included.

8.11.9 Major Changes in Ind AS 19 vis-à-vis Notified AS 15

(i) Constructive Obligations: In Ind AS 19, employee benefits arising from constructive obligations are also covered whereas the existing AS 15 does not deal with the same.

(ii) Definition of Employee: As per the existing standard, the term 'employee' includes whole-time directors whereas under Ind AS 19 the term includes directors.

(iii) Other Definitions: Definitions of short-term employee benefits, other long-term employee benefits, and past service cost as per the existing AS 15 have been changed in Ind AS 19.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

(iv) ***Contractual Agreement between a Multi-employer Plan and its Participants:*** Ind AS 19 deals with situations where there is a contractual agreement between a multi-employer plan and its participants that determines how the surplus in the plan will be distributed to the participants (or the deficit funded). The existing AS 15 does not deal with it.

(v) ***Participation in a Defined Benefit Plan Sharing Risks Between Various Entities under Common Control:*** As per Ind AS 19, participation in a defined benefit plan sharing risks between various entities under common control is a related party transaction for each group entity and some disclosures are required in the separate or individual financial statements of an entity whereas the existing AS 15 does not contain similar provisions.

(vi) ***Qualified Actuary:*** Ind AS 19 encourages, but does not require, an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations whereas the existing standard, though does not require involvement of a qualified actuary, does not specifically encourage the same.

(vii) ***Recognition of Actuarial Gains and Losses:*** Actuarial valuation is based on certain assumptions. Changes in these assumptions give rise to actuarial gains and losses, for example, changes in estimates of salary or medical cost. Existing AS 15 requires recognition of actuarial gains and losses immediately in the profit and loss but Ind AS 19 requires that the same shall be recognised in other comprehensive income and should not be recognised in profit or loss.

(viii) ***Financial Assumptions:*** Ind AS 19 makes it clear that financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled whereas the existing standard does not clarify the same.

(ix) ***Discounting of Post-employment Benefit Obligations:*** As per Ind AS 19, subsidiaries, associates, joint ventures and branches domiciled outside India shall discount post-employment benefit obligations arising on account of post-employment benefit plans using the rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In case, such subsidiaries, associates, joint ventures and branches are domiciled in countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds of that country shall be used.

As per existing AS 15, the rate used to discount post-employment benefit obligations should always be determined by reference to market yields at the balance sheet date on government bond.

(x) ***Timing of Recognition of Termination Benefits:*** Under Ind AS 19, more guidance has been given for timing of recognition of termination benefits. Recognition criteria for termination benefits under the revised standard differ from the criteria prescribed in the existing standard.

(xi) ***Guidance on Interaction of Ceiling of Asset Recognition and Minimum Funding Requirement:*** Ind AS 19 gives guidance on the interaction of ceiling of asset recognition and minimum funding requirement in the case of defined benefit obligations, whereas this guidance is not available in the existing standard.

8.12 Ind AS 20: Accounting for Government Grants and Disclosure of Government Assistance

8.12.1 Scope

This Standard shall be applied in:

- Accounting for and the disclosure of government grants and
- In the disclosure of other forms of government assistance.

This Standard does not deal with:

Ind AS 20 does not deal with

- The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature
- Government assistance that is provided for an entity in the form of benefits that are available in determining taxable profit or tax loss, or are determined or limited on the basis of income tax liability.
- Government participation in the ownership of the entity
- Government grants covered by Ind AS 41 on Agriculture

8.12.2 Government Grants

Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

Government grants are

- assistance by **government**
- in the form of transfers of resources to an entity in return for past or future compliance with certain conditions
- relating to the operating activities of the entity.

They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

8.12.2.1 Forgivable Loan: Forgivable loans are loans which the lender undertakes to waive repayment under certain prescribed conditions.

A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

8.12.2.2 Government Loan at a below Market Rate of Interest: The benefit of a government loan at a below-market rate of interest is treated as a government grant.

The loan shall be recognised and measured in accordance with Ind AS 109 Financial Instruments: Recognition and Measurement. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with Ind AS 109 and the proceeds received.

The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

8.12.3 Government Assistance

- is action by government
- designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

In this Standard, government assistance does not include the provision of infrastructure by improvement to the general transport and communication network and the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community.

8.12.4 Recognition and Presentation of Government Grants

Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances, the fair value of the non-monetary asset is assessed and both grant and asset are accounted for at that fair value.

Government grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

8.12.4.1 Grants Related to Assets: Grants related to assets are Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Government grants related to assets, including non-monetary grants at fair value, shall be presented in the balance sheet by setting up the grant as deferred income.

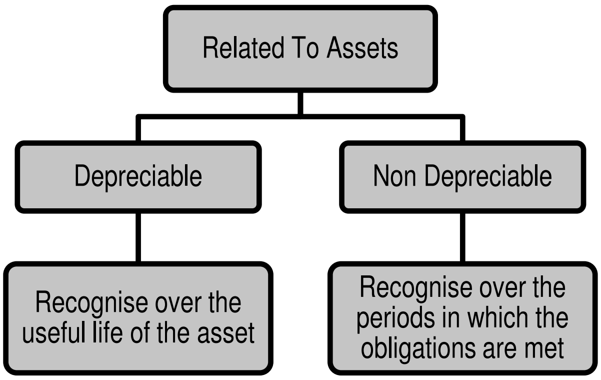
1. **Grants Related to Depreciable Assets:** Grants related to depreciable assets are usually recognised in profit or loss over the periods and in the proportions in which depreciation expense on those assets is recognised.

2. **Grants Related to Non-depreciable Assets:** Grants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations.

For example: A grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.

Presentation of Grants Related to Assets: Government grants related to assets, including non-monetary grants at fair value, shall be

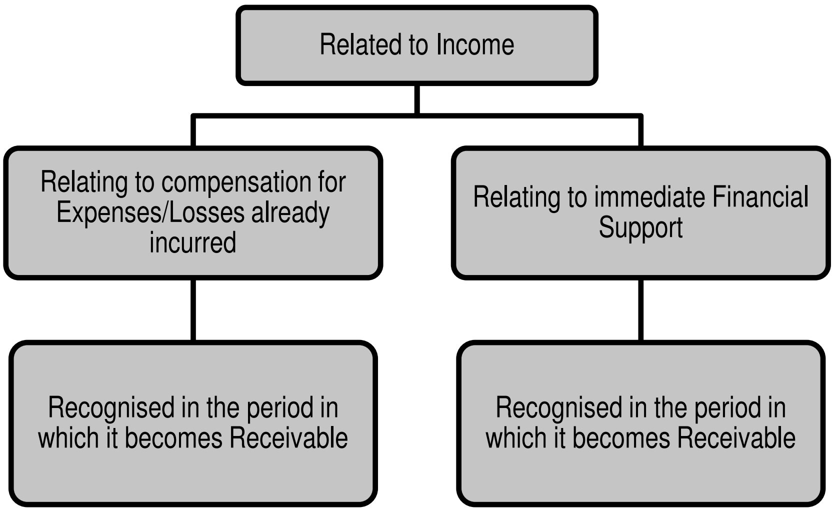
- Presented in the balance sheet by setting up the grant as deferred income.
- The grant set up as deferred income is recognised in profit or loss on a systematic basis over the useful life of the asset.
- The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are disclosed as separate items in the statement of cash flows (as a Financing Activity).



8.12.4.2 Grants related to Income: Grants related to income are Government grants other than those related to assets. Grants related to income are presented as part of profit or loss, either separately or under a general heading such as 'Other income'; alternatively, they are deducted in reporting the related expenses.

Presentation of Grants related to Income: Grants related to income are presented as a

- As a part of profit and loss, either separately or under a general heading such as 'Other income';
- Alternatively, they are deducted in reporting the related expense.



8.12.4.3 Grants Receivable as Compensation for Expenses or Losses with no Future Related Costs: A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised in profit or loss of the period in which it becomes receivable.

8.12.4.4 Grants Received as a Package: Grants are sometimes received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another.

8.12.5 Repayment of Government Grants

A government grant that becomes repayable shall be accounted for as a change in accounting estimate as per Ind AS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

8.12.5.1 Repayment of a Grant Related to Income: Repayment of a grant related to income shall be applied first against any unamortised deferred credit recognised in respect of the grant.

To the extent that the repayment exceeds any such deferred credit, or when no deferred credit exists, the repayment shall be recognised immediately in profit or loss.

8.12.5.2 Repayment of a Grant Related to an Asset: Repayment of a grant related to an asset shall be recognised by reducing the deferred income balance by the amount repayable.

8.12.6 Government Assistance

Excluded from the definition of government grants are certain forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Examples of assistance that cannot reasonably have a value placed upon them are:

- Free technical or marketing advice and
- The provision of guarantees.

Appendix A of Ind AS 20 address the issue that whether government assistance is a government grant within the scope of Ind AS 20 and, therefore, should be accounted for in accordance within the Standard. The Appendix prescribes that government assistance to entities meets the definition of government grants in Ind AS 20, even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors. The Appendix provides that such grants shall not be credited directly to shareholders' interests.

8.12.7 Disclosures

The following matters shall be disclosed:

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

(b) the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and

(c) unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

8.12.8 Major Changes in Ind AS 20 vis-à-vis IAS* 20 Not Resulting in Carve Outs

1. ***Non-Monetary Grant:*** IAS 20 gives an option to measure non-monetary government grants either at their fair value or at nominal value. Ind AS 20 requires measurement of such grants only at their fair value. Thus, the option to measure these grants at nominal value is not available under Ind AS 20.
2. ***Grant related to Assets:*** IAS 20 gives an option to present the grants related to assets, including non-monetary grants at fair value in the balance sheet either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset. Ind AS 20 requires presentation of such grants in balance sheet only by setting up the grant as deferred income. Thus, the option to present such grants by deduction of the grant in arriving at the carrying amount of the asset is not available under Ind AS 20.
3. ***Presentation of Grants Related to Income:*** IAS 20 requires presentation of grants related to income in the separate income statement. This requirement is not provided in Ind AS 20 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

8.12.9 Major Changes in Ind AS 20 vis-à-vis Notified AS 12

(i) ***Government Assistance which does not fall within the Definition of Government Grants:*** Ind AS 20 deals with the other forms of government assistance which do not fall within the definition of government grants. It requires that an indication of other forms of government assistance from which the entity has directly benefited should be disclosed in the financial statements. However, AS 12 does not deal with such government assistance.

(ii) ***Grant in respect of Non Depreciable Assets:*** AS 12 requires that in case the grant is in respect of non-depreciable assets, the amount of the grant should be shown as capital reserve which is a part of shareholders' funds. It further requires that if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. AS 12 also gives an alternative to treat such grants as a deduction from the cost of such asset.

As compared to the above, Ind AS 20, is based on the principle that all government grants would normally have certain obligations attached to them and these grants should be recognised as income over the periods which bear the cost of meeting the obligation. It, therefore, specifically prohibits recognition of grants directly in the shareholders' funds.

(iii) ***Government Grants in the Nature of Promoters Contribution:*** AS 12 recognises that some government grants have the characteristics similar to those of promoters' contribution. It requires that such grants should be credited directly to capital reserve and treated as a part of shareholders' funds. Ind AS 20 does not recognise government grants of the nature of promoters' contribution. As stated at (ii) above, Ind AS 20 is based on the principle that all government grants would normally have certain obligations attached to them and it, accordingly, requires all grants to be recognised as income over the periods which bear the cost of meeting the obligation.

(iv) ***Valuation of Non-monetary Grants given Free or at a Concessional Rate:*** AS 12 requires that government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Ind AS 20 requires to value non-monetary grants at their fair value, since it results into presentation of more relevant information and is conceptually superior as compared to valuation at a nominal amount.

(v) ***Accounting for Grant Related to Assets including Non-monetary Grant:*** Existing AS 12 gives an option to present the grants related to assets, including non-monetary grants at fair value in the balance sheet either by setting up the grant as deferred income or by deducting the grant from the gross value of asset concerned in arriving at its book value. Ind AS 20 requires presentation of such grants in balance sheet only by setting up the grant as deferred income. Thus, the option to present such grants by deduction of the grant in arriving at its book value is not available under Ind AS 20.

(vi) ***Government Assistance:*** Ind AS 20 includes Appendix A which deals with Government Assistance—No Specific Relation to Operating Activities.

(vii) ***Loans at Concessional Rate:*** Ind AS 20 requires that loans received from a government that have a below-market rate of interest should be recognised and measured in accordance with Ind AS 109 (which requires all loans to be recognised at fair value, thus requiring interest to be imputed to loans with a below-market rate of interest) whereas AS 12 does not require so.

8.13 Ind AS 21: The Effects of Changes in Foreign Exchange Rates

8.13.1 Objective

An entity may carry on foreign activities in two ways:

1. It may have transactions in foreign currencies or
2. It may have foreign operations.

In addition, an entity may present its financial statements in a foreign currency.

The objective of this Standard is to prescribe how to:

- Include foreign currency transactions and foreign operations in the financial statements of an entity
- How to translate financial statements into a presentation currency

The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

8.13.2 Scope

This Standard shall be applied:

(a) in accounting for transactions and balances in foreign currencies

(b) in translating the results and financial position of foreign operations that are included in the financial statements of the entity by consolidation or the equity method; and

(c) in translating an entity's results and financial position into a presentation currency.

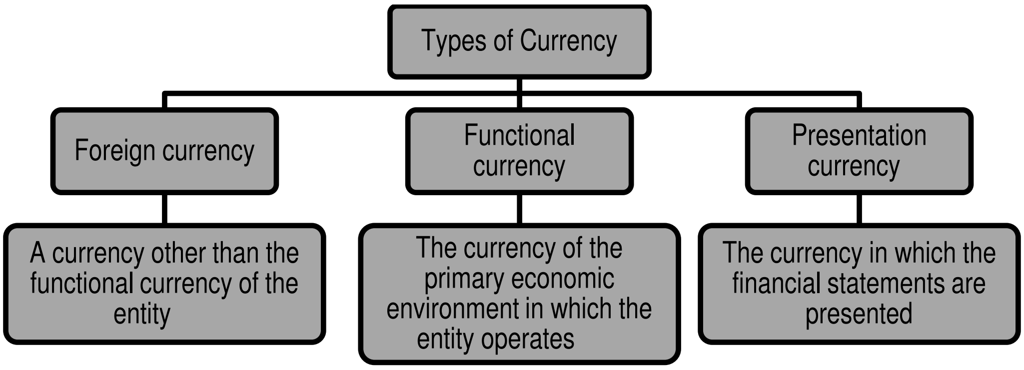
This Standard does not apply to

(a) hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. Ind AS 109 applies to hedge accounting.

(b) the presentation in a statement of cash flows of the cash flows arising from transactions in a foreign currency, or to the translation of cash flows of a foreign operation

(c) long-term foreign currency monetary items for which an entity has opted for the exemption.

8.13.3 Types of Currency



8.13.4 Functional Currency

Functional currency is the currency of the primary economic environment in which the entity operates. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity considers the following factors in determining its functional currency:

(a) the currency:

   (i) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

   (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services.

(b) the currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

The following factors may also provide evidence of an entity's functional currency:

(a) the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

(b) the currency in which receipts from operating activities are usually retained.

Change in Functional Currency: When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency **prospectively** from the date of the change.

8.13.5 Reporting Foreign Currency Transactions in the Functional Currency

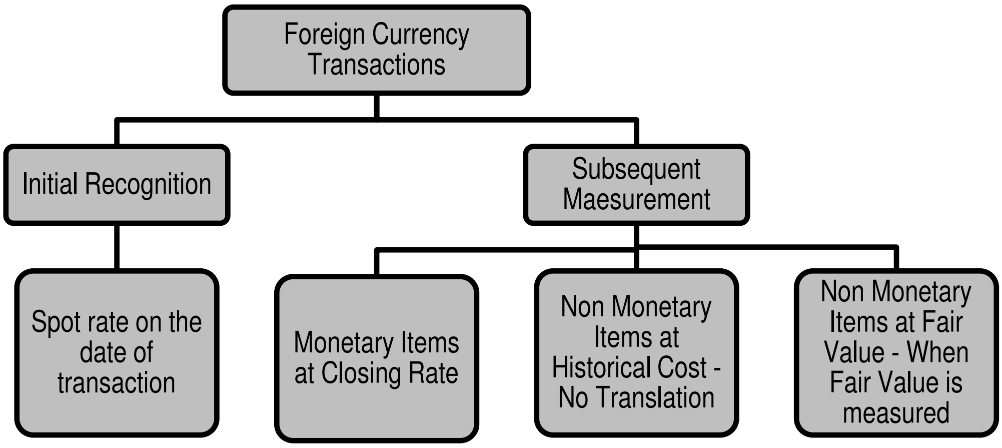
8.13.5.1 Initial Recognition: A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

8.13.5.2 Reporting at the End of Subsequent Reporting Periods: At the end of each reporting period:

(a) foreign currency monetary items shall be translated using the closing rate;

(b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and

(c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.



8.13.5.3 Recognition of Exchange Differences: Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange component of that gain or loss shall be recognised in other comprehensive income. Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

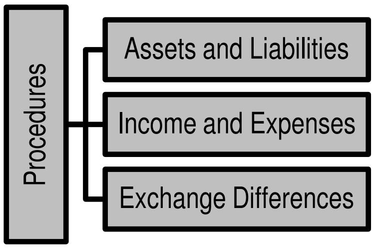
Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. In the financial statements that include the foreign operation and the reporting entity (e.g. consolidated financial statements when the foreign operation is a subsidiary), such exchange differences shall be recognised initially in other comprehensive income and reclassified from equity to profit or loss on disposal of the net investment.

8.13.6 Translation to the Presentation Currency from/other than the Functional Currency

An entity may present its financial statements in any currency (or currencies).If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency.

For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be presented.

8.13.6.1 The Results and Financial Position of an Entity whose Functional Currency is NOT the Currency of a Hyperinflationary Economy : The results and financial position of an entity whose functional currency is **NOT** the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:



1. ***Assets and liabilities for each balance sheet presented (i.e. including comparatives):*** Translated at the closing rate at the date of that balance sheet
2. ***Income and expenses for each statement of profit and loss presented (i.e. including comparatives):*** Translated at exchange rates at the dates of the transactions.
3. ***All resulting exchange differences:*** Recognised in other comprehensive income

8.13.6.2 The Results and Financial Position of an Entity whose Functional Currency is the Currency of a Hyperinflationary Economy: The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:

(a) all amounts (i.e. assets, liabilities, equity items, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent balance sheet, except that

(b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements (i.e. not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).

8.13.7 Foreign Operation

Foreign operation is an entity that is a Subsidiary, Associate, Joint arrangement or Branch of a reporting entity the activities of which are based or conducted in a country or currency other than those of the reporting entity.

8.13.7.1 Approach required by this Standard

- In preparing financial statements, each entity—whether a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch)—determines its functional currency.
- Many reporting entities comprise a number of individual entities (e.g. A group is made up of a parent and one or more subsidiaries). It is necessary for the results and financial position of each individual entity included in the reporting entity to be translated into the currency in which the reporting entity presents its financial statements. This Standard permits the presentation currency of a reporting entity to be any currency (or currencies). The results and financial position of any individual entity within the reporting entity whose functional currency differs from the presentation currency are translated in accordance with this AS.
- This Standard also permits a stand-alone entity preparing financial statements or an entity preparing separate financial statements in accordance with Ind AS 27, 'Separate Financial Statements', to present its financial statements in any currency (or currencies). If the entity's presentation currency differs from its functional currency, its results and financial position are also translated into the presentation currency.

8.13.7.2 Translation of a Foreign Operation: Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation shall be treated as assets and liabilities of the foreign operation. Thus they shall be expressed in the functional currency of the foreign operation and shall be translated at the closing rate.

8.13.7.3 Disposal or Partial Disposal of a Foreign Operation: On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (Ind AS 1, Presentation of Financial Statements).

On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

8.13.8 Major Change in Ind AS 21 vis-à-vis IAS* 21 Not Resulting in Carve Out

In case of Change in Functional Currency: When there is a change in functional currency, IAS 21 requires disclosure of that fact and the reason for the change in functional currency. Ind AS 21 requires an additional disclosure of the date of change in functional currency.

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

8.13.9 Major Changes in Ind AS 21 vis-à-vis Notified AS 11

(i) ***Forward Exchange Contracts and other similar Financial Instruments:*** Ind AS 21 excludes from its scope forward exchange contracts and other similar financial instruments, which are treated in accordance with Ind AS 109. The existing AS 11 does not such exclude accounting for such contracts.

(ii) ***Exchange Differences arising on Translation of Certain Long-term Monetary Items from Foreign Currency to Functional Currency:*** Existing AS 11, gives an option to recognise exchange differences arising on translation of certain long-term monetary items from foreign currency to functional currency directly in equity, to be transferred to profit or loss over the life of the relevant liability/asset if such items are not related to acquisition of fixed assets. Where such items are related to acquisition of fixed assets, the foreign exchange differences can be recognised as part of the cost of the asset.

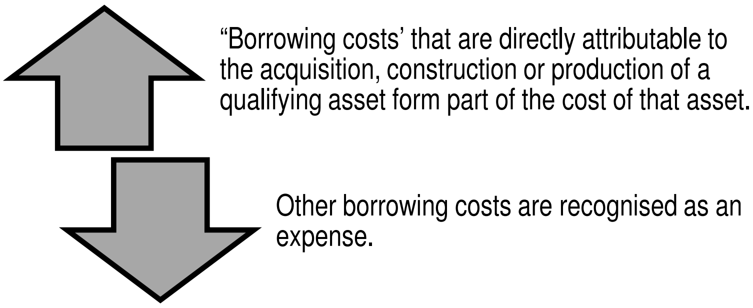
Ind AS 21 does not give the above option. However, Ind AS 21 does not apply to long-term foreign currency monetary items recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e. AS 11. However, as provided in Ind AS 101, such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items as per the previous GAAP.

(iii) ***Approach for Translation:*** The existing AS 11 is based on integral foreign operations and non-integral foreign operations approach for accounting for a foreign operation, whereas Ind AS 21 is based on the functional currency approach. However, in Ind AS 21 the factors to be considered in determining an entity's functional currency are similar to the indicators in existing AS 11 to determine the foreign operations as non-integral foreign operations. As a result, despite the difference in the term, there are no substantive differences in respect of accounting of a foreign operation.

(iv) ***Presentation Currency:*** As per Ind AS 21, presentation currency can be different from local currency and it gives detailed guidance in this regard, whereas the existing AS 11 does not explicitly state so.

8.14 Ind AS 23: Borrowing Costs

8.14.1 Core Principle



8.14.2 Scope

- An entity shall apply this Standard in accounting for borrowing costs.
- The Standard does not deal with the actual or imputed cost of equity, including preferred capital **not classified as a liability (Irredeemable Preferred Capital).**

An entity is **not required** to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

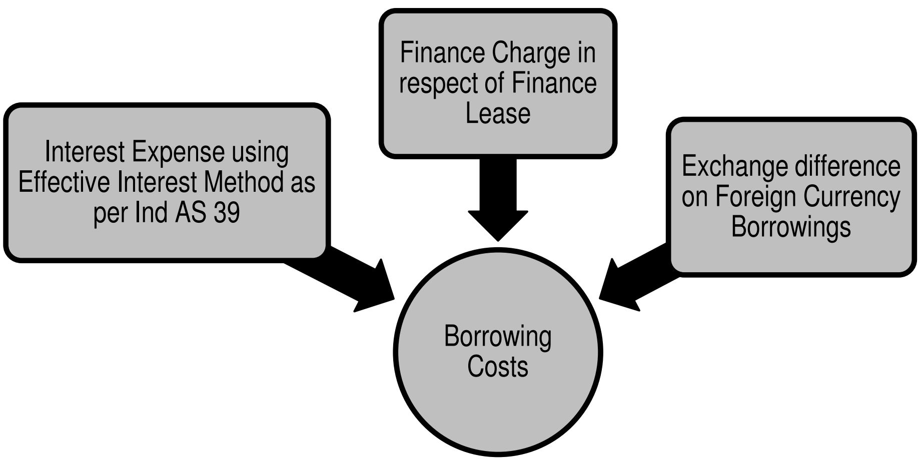
- A qualifying asset measured at fair value {For example: A biological asset}
- Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis

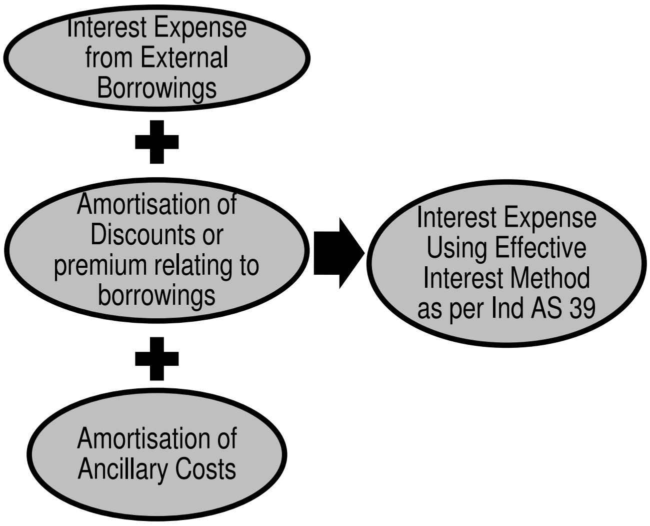
8.14.3 Borrowing Costs

Borrowing costs **are interest and other costs** that an entity incurs in connection with the borrowing of funds.

Borrowing costs may include:

1. interest expense calculated using the effective interest method as described in Ind AS 39 *'Financial Instruments: Recognition and Measurement'*;
2. finance charges in respect of finance leases recognised in accordance with Ind AS 17 *'Leases'*; and
3. exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.





8.14.4 Exchange Difference

With regard to exchange difference required to be treated as borrowing cost, the manner of arriving at the adjustments stated therein shall be as follows:

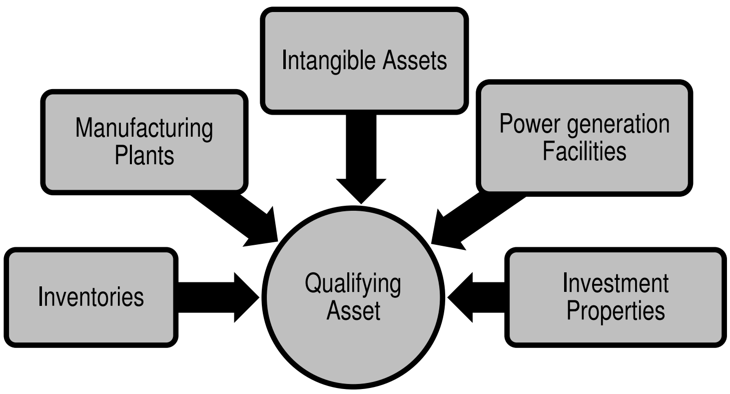
(i) the adjustment should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in a foreign currency.

(j) where there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognised as an adjustment should also be recognised as an adjustment to interest.

8.14.5 Qualifying Asset

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Depending on the circumstances, any of the following may be qualifying assets:

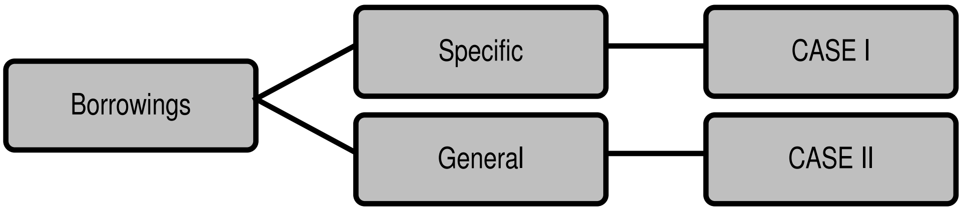


Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

8.14.6 Recognition

Principle 1: An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.

Principle 2: An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.



CASE I: To the extent that an entity borrows funds **specifically** for the purpose of obtaining a qualifying asset, the entity shall determine:

The amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period **less** any investment income on the temporary investment of those borrowings

CASE II: To the extent that an entity borrows funds **generally** and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.

The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

8.14.6.1 Commencement of Capitalisation: An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date.

The commencement date for capitalisation is the date when the entity first meets **ALL** of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

8.14.6.2 Suspension of Capitalisation: An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation.

Exception:

1. An entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work.
2. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

For example: Capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

8.14.6.3 Cessation of Capitalisation: An entity shall cease capitalising borrowing costs when **substantially all the activities** necessary to prepare the qualifying asset for its intended use or sale are complete.

8.14.7 Disclosures

An entity shall disclose

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

8.14.8 Major Change in Ind AS 23 vis-à-vis IAS* 23 Not Resulting in Carve Out

Exchange Difference: IAS 23 provides no guidance as to how the adjustment for exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (as prescribed in paragraph 6(e)) is to be determined. Ind AS 23 provides guidance in this regard.

8.14.9 Major Changes in Ind AS 23 vis-à-vis Notified AS 16

(i) ***Qualifying Asset measured at Fair Value:*** Ind AS 23 does not require an entity to apply this standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value, for example, a biological asset whereas the existing AS 16 does not provide for such scope relaxation.

(ii) ***Applicability to Inventories:*** Ind AS 23 excludes the application of this Standard to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis whereas existing AS 16 does not provide for such scope relaxation and is applicable

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

to borrowing costs related to all inventories that require substantial period of time to bring them in saleable condition.

(iii) ***Inclusion as Borrowing Costs:*** As per existing AS 16, *Borrowing Costs*, inter alia, include the following:

- interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- amortisation of discounts or premiums relating to borrowings;
- amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

Ind AS 23 requires to calculate the interest expense using the effective interest rate method as described in Ind AS 109. Certain items therein have been deleted, as some of those components of borrowing costs are considered as the components of interest expense calculated using the effective interest rate method.

(iv) ***Explanation of Substantial Period of Time:*** Existing AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term 'qualifying asset'. This explanation is not included in Ind AS 23.

(v) ***Reporting in Hyperinflationary Economies:*** Ind AS 23 provides that when Ind AS 29, '*Financial Reporting in Hyperinflationary Economies',* is applied, part of the borrowing costs that compensates for inflation should be expensed as required by that Standard (and not capitalized in respect of qualifying assets). The existing AS 16 does not contain a similar clarification because at present, in India, there is no Standard on '*Financial Reporting in Hyperinflationary Economies'.*

(vi) ***Borrowings of the Parent and its Subsidiaries for Computing Weighted Average:*** Ind AS 23 specifically provides that in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs while in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. This specific provision is not there in the existing AS 16.

(vii) ***Disclosure of Capitalisation Rate:*** Ind AS 23 requires disclosure of capitalization rate used to determine the amount of borrowing costs eligible for capitalization. The existing AS 16 does not have this disclosure requirement.

8.15 Ind AS 24: Related Party Disclosures

8.15.1 Objective

The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

8.15.2 Scope

This Standard shall be applied in:

- Identifying related party relationships and transactions
- Identifying outstanding balances, including commitments, between an entity and its related parties
- Identifying the circumstances in which disclosure of the items above are required
- Determining the disclosures to be made about those items

This Standard requires disclosure of:

- related party relationships,
- transactions and
- outstanding balances, including commitments,

In the consolidated and separate financial statements of:

- a parent,
- or investors with joint control of, or significant influence over, an investee

Presented in accordance with Indian Accounting Standard (Ind AS) 110 or 27 'Consolidated' and 'Separate Financial Statements'. This Standard also applies to individual financial statements.

This Standard shall not be applied:

- in circumstances where providing such disclosures would conflict with the reporting entity's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.
- In case a statute or a regulator or a similar competent authority governing an entity prohibits the entity to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

8.15.3 Definition of Related Party and Related Party Transactions

8.15.3.1 A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

   (i) has control or joint control of the reporting entity;

   (ii) has significant influence over the reporting entity; or

   (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

   Where,

   Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity including:

   (a) that person's children, spouse or domestic partner, brother, sister, father and mother;

   (b) children of that person's spouse or domestic partner; and

   (c) dependants of that person or that person's spouse or domestic partner.

   The terms **'Control'** and **'Investment entity'**, **'Joint Control'** and **'Significant Influence'** are defined in Ind AS 110, Ind AS 111 and Ind AS 28 respectively and are used in this standard with the meanings specified in those Ind AS's.

   Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

   (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

   (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

   (iii) Both entities are joint ventures of the same third party.

   (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

   (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

   (vi) The entity is controlled or jointly controlled by a person identified in (a).

   (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

   (viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

The following are not related parties:

(a) two entities simply because they have a director or other member of key management personnel in common or because a member of key management personnel of one entity has significant influence over the other entity.

(b) Two joint venturers simply because they share joint control of a joint venture.

(c) (i) providers of finance,

(ii) trade unions,

(iii) public utilities, and

(iv) departments and agencies of a **government** that does not control, jointly control or significantly influence the reporting entity, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process).

(c) a customer, supplier, franchisor, distributor or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

8.15.3.2 A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

8.15.4 Disclosures

Relationships between a parent and its subsidiaries shall be disclosed irrespective of whether there have been transactions between them. An entity shall disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces consolidated financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

An entity shall disclose key management personnel compensation in total and for each of the following categories:

(a) short-term employee benefits;

(b) post-employment benefits;

(c) other long-term benefits;

(d) termination benefits; and

(e) share-based payment.

If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements. These disclosure requirements are in addition to those in paragraph 17 of the Standard. At a minimum, disclosures shall include:

(a) the amount of the transactions;

(b) the amount of outstanding balances, including commitments, and:

   (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and

   (ii) details of any guarantees given or received;

(c) provisions for doubtful debts related to the amount of outstanding balances; and

(d) the expense recognised during the period in respect of bad or doubtful debts due from related parties. (paragraph 18 of the Standard)

The Standard requires that the disclosures, as per paragraph 18 of the Standard, shall be made separately for each of the following categories:

(a) the parent;

(b) entities with joint control of, or significant influence over, the entity;

(c) subsidiaries;

(d) associates;

(e) joint ventures in which the entity is a joint venturer;

(f) key management personnel of the entity or its parent; and

(g) other related parties.

Items of a similar nature may be disclosed in aggregate except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions. Hence, purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

A reporting entity is exempt from the disclosure requirements of paragraph 18 of the Standard in relation to related party transactions and outstanding balances, including commitments, with:

(a) a government that has control or joint control of, or significant influence over, the reporting entity; and

(b) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity. (paragraph 25 of the Standard)

If a reporting entity applies the exemption in paragraph 25 of the Standard, it shall disclose the following about the transactions and related outstanding balances referred to in paragraph 25 of the Standard:

(a) the name of the government and the nature of its relationship with the reporting entity (ie control, joint control or significant influence);

(b) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:

   (i) the nature and amount of each individually significant transaction; and

   (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent. Types of transactions include those listed in paragraph 21 of the Standard.

8.15.5 Major Changes in Ind AS 24 vis-à-vis IAS* 24 Not Resulting in Carve Outs

1. ***Confidentially:*** In Ind AS 24, disclosures which conflict with confidentiality requirements of statute/regulations are not required to be made since Accounting Standards cannot override legal/regulatory requirements.

2. ***Additional Clarificatory Guidance Regarding Aggregation of Transactions:*** Paragraph 24A (reproduced below) has been included in the Ind AS 24. It provides additional clarificatory guidance regarding aggregation of transactions for disclosure.

   "24A Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions. Hence, purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure."

3. ***Modification of Paragraph 14:*** Paragraph 14 of Ind AS 24 has been modified to explain the rationale for disclosing related party relationship when control exists.

4. ***Management Contracts Including for Deputation or Employees:*** In Ind AS 24, '(k) management contracts including for deputation or employees' has been added in the example of transactions that are disclosed if they are with related party.

5. ***Definition of Close Members of the Family of a Person:*** 'Definition of close members of the family of a person' has been amended to include brother, sister, father and mother in the category of family members who may be expected to influence, or be influenced.

8.15.6 Major Changes in Ind AS 24 vis-à-vis Notified AS 18

(i) ***Definition of Relative:*** Existing AS 18 uses the term "relatives of an individual", whereas Ind AS 24 uses the term "a close member of the family of a person".

Existing AS 18 covers the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

However, definition of close members of family as per Ind AS 24 includes those family members, who may be expected to influence, or be influenced by, that person in their dealings with the entity, including:

(a) that person's children, spouse or domestic partner, brother, sister, father and mother;

(b) children of that person's spouse or domestic partner; and

(c) dependants of that person or that person's spouse or domestic partner.

Hence, the definition as per Ind AS 24 is much wider.

(ii) ***State Controlled Enterprise:*** Existing AS 18 defines state-controlled enterprise as *"an enterprise which is under the control of the Central Government and/or any State Government(s)"*. However, in Ind AS 24, there is extended coverage of Government Enterprises, as it defines a government-related entity as "an entity that is controlled, jointly controlled or significantly influenced by a government." Further, "Government refers to government, government agencies and similar bodies whether local, national or international."

(iii) ***Key Management Personnel:*** Existing AS 18 covers key management personnel (KMP) of the entity only, whereas, Ind AS 24 covers KMP of the parent as well. Ind AS 24 also covers the entity, or any member of a group of which it is a part, providing key management personnel services to the reporting entity or to the parent of the reporting entity

(iv) ***Related Parties in case of Joint Venture:*** Under Ind AS 24 there is extended coverage in case of joint ventures. Two entities are related to each other in both their financial statements, if they are either co-venturers or one is a venturer and the other is an associate. Whereas as per existing AS 18, co-venturers or co-associates are not related to each other.

(v) ***Effect of influences which do not lead to transactions:*** Existing AS 18 mentions that where there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required whereas Ind AS 24 does not specifically mention this.

(vi) ***Post-employment Benefits:*** Existing AS 18 does not specifically cover entities that are post-employment benefit plans, as related parties. However, Ind AS 24 specifically includes post-employment benefit plans for the benefit of employees of an entity or its related entity as related parties.

(vii) ***Next Most Senior Parent:*** Ind AS 24 requires an additional disclosure as to the name of the next most senior parent which produces consolidated financial statements for public use, whereas the existing AS 18 has no such requirement.

(viii) ***Disclosure for Compensation:*** Ind AS 24 requires extended disclosures for compensation of KMP under different categories, whereas the existing AS 18 does not specifically require.

(ix) ***Disclosure of 'Amount of the Transactions' vs 'Volume of the Transactions:*** Ind AS 24 requires "the amount of the transactions" need to be disclosed, whereas existing

AS 18 gives an option to disclose the "Volume of the transactions either as an amount or as an appropriate proportion".

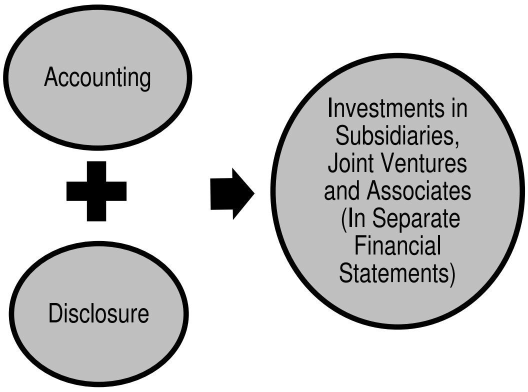
(x) ***Government Related Entities:*** Ind AS 24 requires disclosures of certain information by the government related entities, whereas the existing AS 18 presently exempts the disclosure of such information.

(xi) ***Clarification of Control, Substantial Interest and Significant Influence:*** Existing AS 18 includes definition and clarificatory text, primarily with regard to control, substantial interest (including 20% threshold), significant influence (including 20% threshold). However, Ind AS 24 neither defines these terms nor it includes such clarificatory text and allows respective standards to deal with the same.

8.16 Ind AS 27: Separate Financial Statements

8.16.1 Objective

The objective of this Standard is to prescribe the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.



8.16.2 Scope

- This Standard shall be applied in accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by law, to present separate financial statements.
- This Standard does not mandate which entities produce separate financial statements. It applies when an entity prepares separate financial statements shall comply with Indian Accounting Standards.

8.16.3 Separate and Consolidated Financial Statements

Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with Ind AS 109, *'Financial Instruments'*.

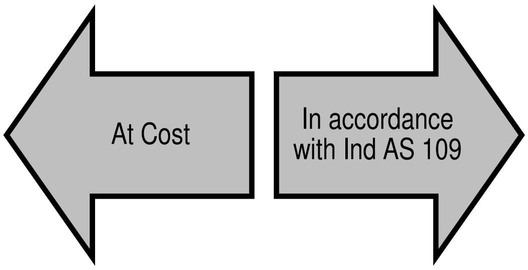
8.16.4 Preparation of Separate Financial Statements

Separate financial statements shall be prepared in accordance with all applicable Ind AS.

When an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures and associates either:

(a) at cost, or

(b) in accordance with Ind AS 109, *Financial Instruments*.

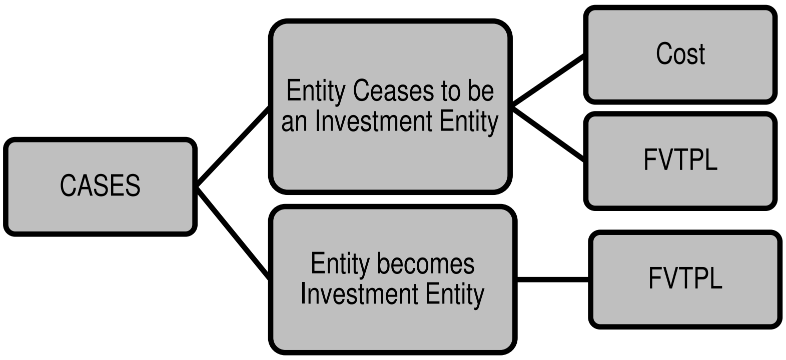


The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with Ind AS 105, {Non-current Assets Held for Sale and Discontinued Operations}, when they are classified as held for sale (or included in a disposal group that is classified as held for sale). The measurement of investments accounted for in accordance with Ind AS 109 is not changed in such circumstances.

If an entity elects, in accordance with Ind AS 28, to measure its investments in associates or joint ventures at fair value through profit or loss in accordance with Ind AS 109, it shall also account for those investments in the same way in its separate financial statements.

If a parent is required, in accordance with Ind AS 110, to measure its investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109, it shall also account for its investment in a subsidiary in the same way in its separate financial statements.

8.16.5 When a Parent Ceases to be an Investment Entity, or Becomes an Investment Entity



When a parent ceases to be an investment entity, or becomes an investment entity, it shall account for the change from the date when the change in status occurred, as follows:

(a) when an entity ceases to be an investment entity, the entity shall, either:

(i) Account for an investment in a subsidiary at cost.

The fair value of the subsidiary at the date of the change of status shall be used as the deemed cost at that date; or

(ii) Continue to account for an investment in a subsidiary in accordance with Ind AS 109.

(b) when an entity becomes an investment entity, it shall account for an investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109.

The difference between the previous carrying amount of the subsidiary and its fair value at the date of the change of status of the investor shall be recognised as a gain or loss in profit or loss. The cumulative amount of any fair value adjustment previously recognised in other comprehensive income in respect of those subsidiaries shall be treated as if the investment entity had disposed of those subsidiaries at the date of change in status.

8.16.6 Dividend

An entity shall recognise a dividend from a subsidiary, a joint venture or an associate in profit or loss in its separate financial statements when its right to receive the dividend is established.

8.16.7 Major Changes in Ind AS 27 vis-à-vis IAS* 27 Not Resulting in Carve Outs

1. ***Separate Financial Statements:*** IAS 27 requires to disclose the reason for preparing separate financial statements if not required by law. In India, since the Companies Act

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

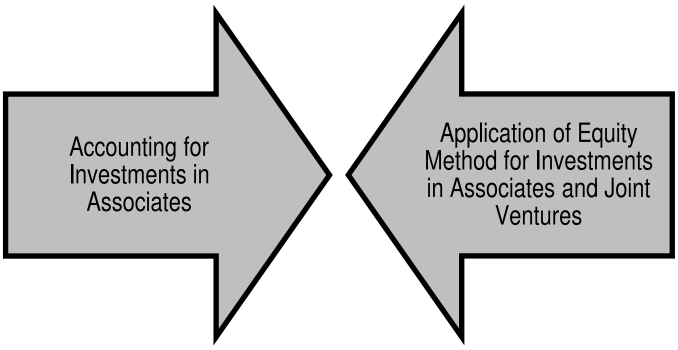
mandates preparation of separate financial statements, such requirement has been removed in Ind AS 27.

2. ***Option to use Equity Method:*** IAS 27 allows the entities to use the equity method to account for investment in subsidiaries, joint ventures and associates in their Separate Financial Statements (SFS). This option is not given in Ind AS 27, as the equity method is not a measurement basis like cost and fair value but is a manner of consolidation and therefore would lead to inconsistent accounting conceptually.

8.17 Ind AS 28: Investments in Associates and Joint Ventures

8.17.1 Objective

The objective of this Standard is to prescribe the accounting for investments in associates and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.



8.17.2 Scope

This Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee.

8.17.3 Definitions

An associate is an entity over which the investor has ***significant influence***.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

Significant Influence

- If an entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case.
- A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

- Representation on the board of directors or equivalent governing body of the investee
- Participation in policy-making processes, including participation in decisions about dividends or other distributions
- Material transactions between the entity and its investee
- Interchange of managerial personnel
- Provision of essential technical information

A **joint venture** is a ***joint arrangement*** whereby the parties that have ***joint control*** of the arrangement have rights to the net assets of the arrangement.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint arrangement is an arrangement of which two or more parties have joint control.

Ind AS 111, *Joint Arrangements,* establishes principles for the financial reporting of parties to joint arrangements. As per the Standard, an entity shall determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement. The Standard requires that a joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with Ind AS 28 unless the entity is exempted from applying the equity method as specified in the standard.

8.17.4 Equity Method

The equity method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets.

8.17.4.1 Application of the Equity Method: An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture.

The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee are other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in the investor's other comprehensive income (Ind AS 1, *Presentation of Financial Statements*).

If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not re-measure the retained interest.

8.17.4.2 Equity Method Procedures: Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in Ind AS 110.

A group's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate or a joint venture has subsidiaries , associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the profit or loss, other comprehensive income and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies.

Goodwill/Capital Reserve

On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:

(i) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment.

Amortisation of that goodwill is not permitted.

(ii) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is recognised directly in equity as capital reserve in the period in which the investment is acquired.

8.17.4.3 Changes in Ownership Interest: If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities.

8.17.4.4 Exemptions from Applying the Equity Method: An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception of Ind AS 110 or if all the following apply:

(a) The entity is a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not applying the equity method.

(b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation, for the purpose of issuing any class of instruments in a public market.

(d) ***The ultimate or any intermediate parent of the entity produces financial statements available for public use that comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with Ind AS 110.***

The Standard also provides exemptions from applying the equity method when the investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds. Those investments may be measured at fair value through profit or loss in accordance with Ind AS 109,

8.17.4.5 Discontinuing the use of the Equity Method: An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:

(a) If the investment becomes a subsidiary, the entity shall account for its investment in accordance with Ind AS 103, Business Combinations, and Ind AS 110.

(b) If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with Ind AS 109. The entity shall recognise in profit or loss any difference between:

    (i) the fair value of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and

    (ii) the carrying amount of the investment at the date the equity method was discontinued.

When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognised in other comprehensive income in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.

8.17.5 Financial Statements

- The most recent available financial statements of the associate or joint venture are used by the entity in applying the equity method.
- When the end of the reporting period of the entity is different from that of the associate or joint venture, the associate or joint venture prepares, for the use of the entity, financial

statements as of the same date as the financial statements of the entity unless it is impracticable to do so.

- When, the financial statements of an associate or a joint venture used in applying the equity method are prepared as of a date different from that used by the entity, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the entity's financial statements. In any case, the difference between the end of the reporting period of the associate or joint venture and that of the entity shall be no more than three months.
- The entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances unless, in case of an associate, it is impracticable to do so.

Separate Financial Statements

An investment in an associate or a joint venture shall be accounted for in the entity's separate financial statements in accordance with Ind AS 27.

8.17.6 Impairment Losses

The entity applies the impairment requirements in Ind AS 109 to its other interests in the associate or joint venture that are in the scope of Ind AS 109 and that do not constitute a part of the net investment.

Because goodwill that forms part of the carrying amount of the net investment in an associate or a joint venture is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in Ind AS 36, 'Impairment of Assets'.

Instead, the entire carrying amount of the investment is tested for impairment in accordance with Ind AS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever there is an indication that the net investment may be impaired.

8.17.7 Major Change in Ind AS 28 vis-à-vis IAS* 28 Resulting in Carve Out

As per IFRS: IAS 28 requires that for the purpose of applying equity method of accounting in the preparation of investor's financial statements, uniform accounting policies should be used. In other words, if the associate's accounting policies are different from those of the investor, the investor should change the financial statements of the associate by using same accounting policies.

Carve out 1: In Ind AS 28, the phrase, 'unless impracticable to do so' has been added in the relevant requirements, i.e., paragraph 35.

Reasons: Certain associates, e.g., regional rural banks (RRBs), being associates of nationalized banks, are not in a position to use the Ind AS as these may be too advanced for

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

the RRBs. Accordingly, the above-stated words have been included to exempt such associates.

Carve out 2: Further, in IAS 28, Capital Reserve when Investors share in Net Assets exceeds Cost of Investment is recognised in profit or loss while in Ind AS 28, Paragraph 32 (b) has been modified on the lines of Ind AS 103, *'Business Combinations'*, to transfer excess of the investor's share of the net fair value of the investee's identifiable assets and liabilities over the cost of investment in capital reserve.

8.17.8 Major Changes in Ind AS 28 vis-à-vis Notified AS 23

(i) ***Definition of Significant Influence:*** In the existing AS 23, 'Significant Influence' has been defined as 'power to participate in the financial and/or operating policy decisions of the investee but is not control over those policies'. In Ind AS 28, the same has been defined as 'power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies'. Ind AS 28 defines joint control also.

(ii) ***Potential Equity Shares:*** For considering share ownership for the purpose of significant influence, potential equity shares of the investee held by investor are not taken into account as per the existing AS 23. As per Ind AS 28, existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether an entity has significant influence or not.

(iii) ***Equity Method:*** Existing AS 23 requires application of the equity method only when the entity has subsidiaries and prepares Consolidated Financial Statements. Ind AS 28 requires application of equity method in financial statements other than separate financial statements even if the investor does not have any subsidiary.

(iv) ***Exemption:*** One of the exemptions from applying equity method in the existing AS 23 is where the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investee. No such exemption is provided in Ind AS 28.

(v) ***Explanation regarding the term 'Near Future':*** An explanation has been given in existing AS 23 regarding the term 'near future' used in another exemption from applying equity method, i.e., where the investment is acquired and held exclusively with a view to its subsequent disposal in the near future. This explanation has not been given in the Ind AS 28 as such situations are covered by Ind AS 105, '*Non-current Assets Held for Sale and Discontinued Operations'*.

(vi) ***Measurement of Investment:*** Ind AS 28 now permits an entity that has an investment in an associate, a portion of which is held indirectly through venture capital organisations, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, to elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with Ind AS 109 regardless of whether these entities have significant influence over that portion of the investment.

(vii) ***Investment Classified as Held for Sale:*** Ind AS 28 requires a portion of an investment in an associate or a joint venture to be classified as held for sale if the disposal of that portion of the interest would fulfill the criteria to be classified as held for sale in accordance with Ind AS 105. AS 23 does not specifically deal with this aspect.

(vii) ***Application of Equity Method in Separate Financial Statements:*** As per the existing AS 23, in separate financial statements, investment in an associate is not accounted for as per the equity method, the same is accounted for in accordance with existing AS 13, *'Accounting for Investments'*. As per Ind AS 28, the same is to be accounted for at cost or in accordance with Ind AS 109, '*Financial Instruments'*.

(viii) ***Difference in Reporting Dates:*** The existing AS 23 permits the use of financial statements of the associate drawn upto a date different from the date of financial statements of the investor when it is impracticable to draw the financial statements of the associate upto the date of the financial statements of the investor. There is no limit on the length of difference in the reporting dates of the investor and the associate. As per Ind AS 28, length of difference in the reporting dates of the associate or joint venture should not be more than three months unless.

(ix) ***Accounting Policies:*** Both the existing AS 23 and Ind AS 28 require that similar accounting policies should be used for preparation of investor's financial statements and in case an associate uses different accounting policies for like transactions, appropriate adjustments shall be made to the accounting policies of the associate. The existing AS 23 provides exemption to this that if it is not possible to make adjustments to the accounting policies of the associate, the fact shall be disclosed along with a brief description of the differences between the accounting policies. Ind AS 28 provides that the entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances unless, in case of an associate, it is impracticable to do so.

(x) ***Share in Losses:*** As per existing AS 23, investor's share of losses in the associate is recognised to the extent of carrying amount of investment in the associate. As per Ind AS 28, carrying amount of investment in the associate or joint venture determined using the equity method together with any long term interests that, in substance form part of the entity's net investment in the associate or joint venture shall be considered for recognising entity's share of losses in the associate or joint venture.

(xi) ***Impairment Loss:*** With regard to impairment, the existing AS 23 requires that the carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment. Ind AS 28 requires that after application of equity method, including recognising the associate's or joint venture's losses, the requirements of Ind AS 109 shall be applied to determine whether it is necessary to recognise any additional impairment loss.

8.18 Ind AS 29 : Financial Reporting in Hyperinflationary Economies

8.18.1 Scope

This Standard shall be applied to the financial statements, including the consolidated financial statements, of any entity whose functional currency is the currency of a hyperinflationary economy.

The Standard does not establish an absolute rate at which hyperinflation is deemed to arise. It is a matter of judgement when restatement of financial statements in accordance with this Standard becomes necessary. Hyperinflation is indicated by characteristics of the economic environment of a country which include, but are not limited to, the following:

- The general population prefers to keep its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts of local currency held are immediately invested to maintain purchasing power.
- The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency.
- Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short.
- Interest rates, wages and prices are linked to a price index.
- The cumulative inflation rate over three years is approaching, or exceeds, 100%.

1. It is preferable that all entities that report in the currency of the same hyperinflationary economy apply this Standard from the same date.
2. This Standard applies to the financial statements of any entity from the beginning of the reporting period in which it identifies the existence of hyperinflation in the country in whose currency it reports.

8.18.2 Restatement of Financial Statements

Entities that prepare financial statements on the historical cost basis of accounting do so without regard either to:

- Changes in the general level of prices or
- Increases in specific prices of recognised assets or liabilities.

The Exceptions to this are those assets and liabilities that the entity is required, or chooses, to measure at fair value.

For example, property, plant and equipment may be revalued to fair value and biological assets are generally required to be measured at fair value.

Some entities, however, present financial statements that are based on a current cost approach that reflects the effects of changes in the specific prices of assets held.

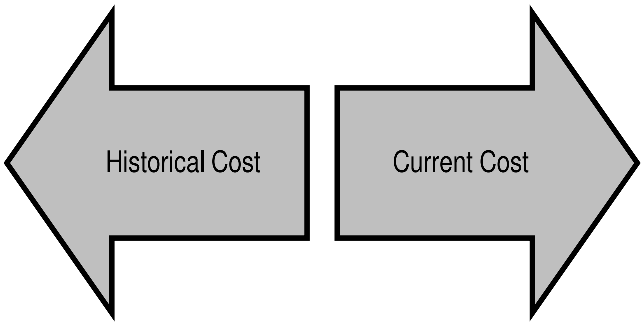
The financial statements of an entity whose functional currency is the currency of a hyperinflationary economy, whether they are based on a historical cost approach or a current cost approach, shall be stated in terms of the measuring unit current at the end of the reporting period.

The corresponding figures for the previous period required by Ind AS 1, Presentation of Financial Statements, and any information in respect of earlier periods shall also be stated in terms of the measuring unit current at the end of the reporting period.

The gain or loss on the net monetary position shall be included in profit or loss and separately disclosed.

The restatement of financial statements in accordance with this Standard requires the application of certain procedures as well as judgement. The consistent application of these procedures and judgements from period to period is more important than the precise accuracy of the resulting amounts included in the restated financial statements.

8.18.3 Approaches for Preparation of Financial Statements



8.18.3.1 Historical Cost Financial Statements

Balance Sheet

- Balance sheet amounts not already expressed in terms of the measuring unit current at the end of the reporting period are restated by applying a general price index.
- Monetary items are not restated because they are already expressed in terms of the monetary unit current at the end of the reporting period. Monetary items are money held and items to be received or paid in money.
- Assets and liabilities linked by agreement to changes in prices, such as index linked bonds and loans, are adjusted in accordance with the agreement in order to ascertain the amount outstanding at the end of the reporting period. These items are carried at this adjusted amount in the restated balance sheet.
- All other assets and liabilities are non-monetary. Some non-monetary items are carried at amounts current at the end of the reporting period, such as net realisable value and fair value, so they are not restated. All other non-monetary assets and liabilities are restated.

- The restated amount of a non-monetary item is reduced, in accordance with appropriate Ind AS, when it exceeds its recoverable amount. For example, restated amounts of property, plant and equipment, goodwill, patents and trademarks are reduced to recoverable amount and restated amounts of inventories are reduced to net realisable value.

Statement of Profit and Loss

- This Standard requires that all items in the statement of profit and loss are expressed in terms of the measuring unit current at the end of the reporting period.
- Therefore, all amounts need to be restated by applying the change in the general price index from the dates when the items of income and expenses were initially recorded in the financial statements.

Gain or Loss on Net Monetary Position

In a period of inflation, an entity holding an excess of monetary assets over monetary liabilities loses purchasing power and an entity with an excess of monetary liabilities over monetary assets gains purchasing power to the extent the assets and liabilities are not linked to a price level.

- This gain or loss on the net monetary position may be derived as the difference resulting from the restatement of non-monetary assets, owners' equity and items in the statement of profit and loss and the adjustment of index linked assets and liabilities.
- The gain or loss may be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities.
- The gain or loss on the net monetary position is included in profit or loss.
- The adjustment to those assets and liabilities linked by agreement to changes in prices is offset against the gain or loss on net monetary position.
- Other income and expense items, such as interest income and expense, and foreign exchange differences related to invested or borrowed funds, are also associated with the net monetary position. Although such items are separately disclosed, it may be helpful if they are presented together with the gain or loss on net monetary position in the statement of profit and loss.

8.18.3.2 Current Cost Financial Statements

Balance Sheet

- Items stated at current cost are not restated because they are already expressed in terms of the measuring unit current at the end of the reporting period.
- Other items in the balance sheet are restated in accordance with same principles as Historical Cost Financial Statements.

Statement of Profit and Loss

- The current cost statement of profit and loss, before restatement, generally reports costs current at the time at which the underlying transactions or events occurred.
- Cost of sales and depreciation are recorded at current costs at the time of consumption.
- Sales and other expenses are recorded at their money amounts when they occurred.
- Therefore, all amounts need to be restated into the measuring unit current at the end of the reporting period by applying a general price index.

Gain or Loss on Net Monetary Position

The gain or loss on the net monetary position is accounted for in accordance with same principles as Historical Cost Financial Statements.

8.18.4 Taxes

The restatement of financial statements in accordance with this Standard may give rise to differences between the carrying amount of individual assets and liabilities in the balance sheet and their tax bases. These differences are accounted for in accordance with Ind AS 12, Income Taxes.

8.18.5 Statement of Cash Flows

This Standard requires that all items in the statement of cash flows are expressed in terms of the measuring unit current at the end of the reporting period.

8.18.6 Corresponding Figures

Corresponding figures for the previous reporting period, whether they were based on a historical cost approach or a current cost approach, are restated by applying a general price index so that the comparative financial statements are presented in terms of the measuring unit current at the end of the reporting period. Information that is disclosed in respect of earlier periods is also expressed in terms of the measuring unit current at the end of the reporting period.

8.18.7 Consolidated Financial Statements

- A parent that reports in the currency of a hyperinflationary economy may have subsidiaries that also report in the currencies of hyperinflationary economies. The financial statements of any such subsidiary need to be restated by applying a general price index of the country in whose currency it reports before they are included in the consolidated financial statements issued by its parent. Where such a subsidiary is a foreign subsidiary, its restated financial statements are translated at closing rates.
- The financial statements of subsidiaries that do not report in the currencies of hyperinflationary economies are dealt with in accordance with Ind AS 21.
- If financial statements with different ends of the reporting periods are consolidated, all items, whether non-monetary or monetary, need to be restated into the measuring unit current at the date of the consolidated financial statements.

8.18.8 Selection and Use of the General Price Index

The restatement of financial statements in accordance with this Standard requires the use of a general price index that reflects changes in general purchasing power. It is preferable that all entities that report in the currency of the same economy use the same index.

8.18.9 Economies Ceasing to be Hyperinflationary

When an economy ceases to be hyperinflationary and an entity discontinues the preparation and presentation of financial statements prepared in accordance with this Standard, it shall treat the amounts expressed in the measuring unit current at the end of the previous reporting period as the basis for the carrying amounts in its subsequent financial statements.

Appendix A of Ind AS 29 provides guidance on how to apply the requirements of Ind AS 29 in a reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, when that economy was not hyperinflationary in the prior period, and the entity therefore restates its financial statements in accordance with Ind AS 29. The Appendix prescribes that in the reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, not having been hyperinflationary in the prior period, the entity shall apply the requirements of Ind AS 29 as if the economy had always been hyperinflationary. At the end of the reporting period, deferred tax items are recognised and measured in accordance with Ind AS 12.

8.18.10 Major Change in Ind AS 29 vis-à-vis IAS 29 Not Resulting in Carve Out

Disclosure: Ind AS 29 requires an additional disclosure regarding the duration of the hyperinflationary situation existing in the economy as compared to IAS 29.

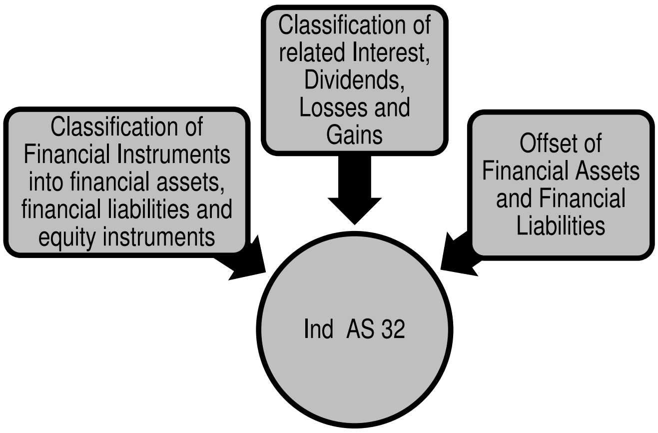
8.19 Ind AS 32 : Financial Instruments: Presentation

8.19.1 Objective

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.

It applies to

1. The classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments;
2. The classification of related interest, dividends, losses and gains; and
3. The circumstances in which financial assets and financial liabilities should be offset.



8.19.2 Scope

This Standard shall be applied by all entities to all types of financial instruments except:

(a) interests in subsidiaries, associates or joint ventures that are accounted for in accordance with:

- Ind AS 110 *"Consolidated Financial Statements"*
- Ind AS 27 *"Separate Financial Statements"* or
- Ind AS 28 *"Investments in Associates and Joint Ventures"*.

Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

(b) employers' rights and obligations under employee benefit plans, to which Ind AS 19, *'Employee Benefits'*, applies.

(c) insurance contracts as defined in Ind AS 104, *'Insurance Contracts'*.

However, this Standard applies to derivatives that are embedded in insurance contracts if Ind AS 109 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies Ind AS 109 in recognising and measuring the contracts.

(d) financial instruments that are within the scope of Ind AS 104 because they contain a discretionary participation feature. Furthermore, this Standard applies to derivatives that are embedded in these instruments (Ind AS 109).

(e) financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102*, 'Share-based Payment'*, applies, except for:

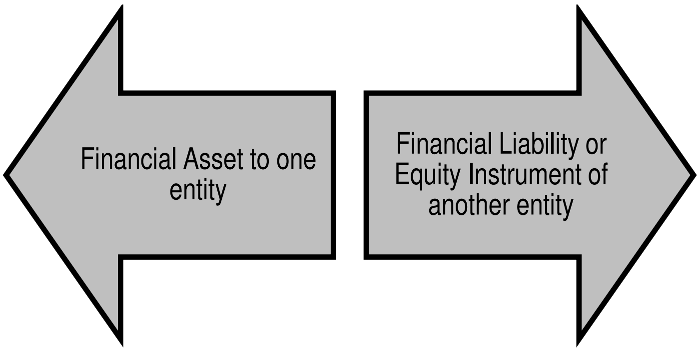
(i) contracts within the scope of this Standard, to which this Standard applies,

(ii) to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements.

This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with Ind AS 109, *'Financial Instruments'*.

8.19.3 Financial Instrument

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.



8.19.3.1 Financial Asset: A financial asset is any asset that is:

(a) cash;

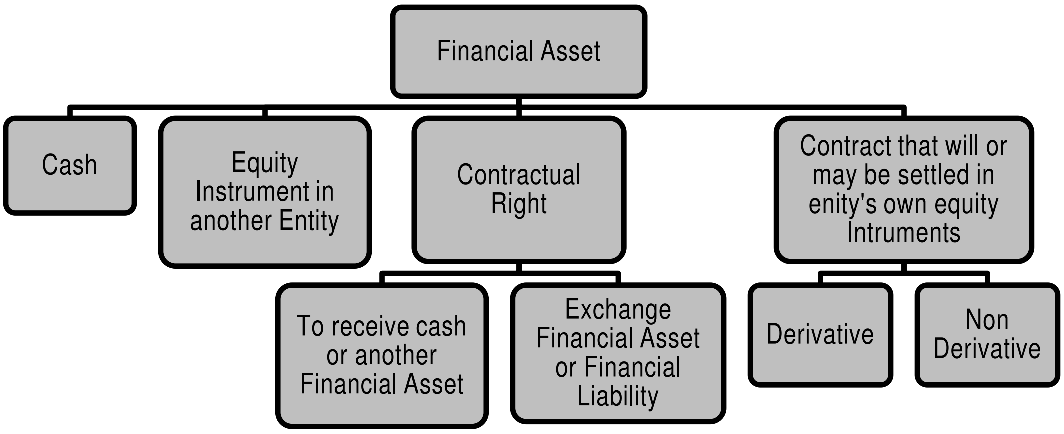
(b) an equity instrument of another entity;

(c) a contractual right:

- (i) to receive cash or another financial asset from another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

- (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.



8.19.3.2 Financial Liability: A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

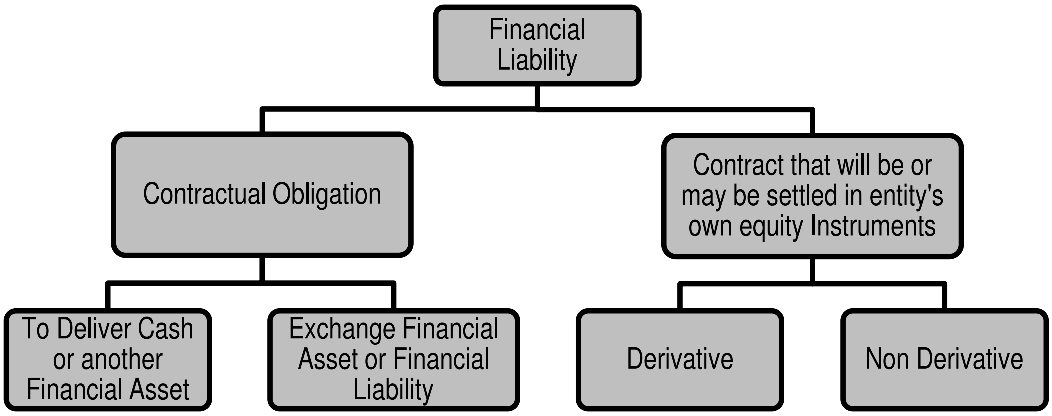
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

The equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.



8.19.3.3 Equity Instrument: An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

8.19.3.4 Puttable Financial Instruments: As an exception, puttable instruments are classified as an equity instrument even if they meet the definition of financial liability. A puttable instrument is a financial instrument that gives the holder of the instrument the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

8.19.4 Presentation

Liabilities and equity: The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

The instrument is an equity instrument if, and only if, **both conditions (a) and (b) below are met.**

(a) The instrument includes no contractual obligation:

  (i) to deliver cash or another financial asset to another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) In case of settlement by the issuer's own equity instruments, it should be fixed to fixed contracts (no. of equity instruments and the price per unit of equity instruments is fixed).

Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

8.19.5 Specific Situations

8.19.5.1 Contingent settlement provisions A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio.

The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(i) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;

(ii) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

(iii) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.

8.19.5.2 Settlement options In case a derivative financial instruments provides an option to one party to choose between various modes of settlement (settlement net in cash or by exchanging shares for cash), such derivative instrument should be a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

8.19.5.3 Compound Financial Instruments: It may be possible that a non-derivative financial instrument may contain both component of liability and component of equity as well. Such components shall be classified separately as financial liabilities or equity instruments. Example, bonds with a option to convert into equity.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole.

No gain or loss arises from initially recognising the components of the instrument separately.

8.19.5.4 Treasury Shares: If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.

8.19.5.5 Interest, Dividends, Losses and Gains: Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.

Transaction costs of an equity transaction shall be accounted for as a deduction from equity. Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12, *'Income Taxes'*.

Changes in the fair value of an equity instrument are not recognised in the financial statements.

8.19.5.6 Offsetting a Financial Asset and a Financial Liability: A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

(i) currently has a legally enforceable right to set off the recognised amounts; and

(ii) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability.

An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract.

8.19.5.7 Consolidated Financial Statements: An entity in its consolidated financial statements, when classifying a financial instrument (or a component of it) should consider all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

8.19.6 Major Changes in Ind AS 32 vis-à-vis IAS* 32

8.19.6.1 Resulting in Carve out/carve in

As per IFRS: As per accounting treatment prescribed under IAS 32, equity conversion option in case of foreign currency denominated convertible bonds is considered a derivative liability which is embedded in the bond. Gains or losses arising on account of change in fair value of the derivative need to be recognised in the statement of profit and loss as per IAS 32.

Carve out: In Ind AS 32, an exception has been included to the definition of 'financial liability' in paragraph 11 (b) (ii), whereby conversion option in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments is classified as an equity instrument if the exercise price is fixed in any currency.

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

Reasons: This treatment as per IAS 32 is not appropriate in instruments, such as, FCCBs since the number of shares convertible on the exercise of the option remains fixed and the amount at which the option is to be exercised in terms of foreign currency is also fixed; merely the difference in the currency should not affect the nature of derivative, i.e., the option. Further, the fair value of the option is based on the fair value of the share prices of the company. If there is decrease in the share price, the fair value of derivative liability would also decrease which would result in recognition of gain in the statement of profit and loss. This would bring unintended volatility in the statement of profit and loss due to volatility in share prices. This will also not give a true and fair view of the liability as in this situation, when the share prices fall, the option will not be exercised. However, it has been considered that if such option is classified as equity, fair value changes would not be required to be recognised. Accordingly, the exception has been made in definition of financial liability in Ind AS 32.

8.19.6.2 Not Resulting in Carve out

Presentation of Dividends: IAS 32 requires presentation of dividends classified as an expense in the separate income statement, where separate income statement is presented. This requirement is not provided in Ind AS 32 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

8.20 Ind AS 33 : Earnings Per Share

8.20.1 Objective

The objective of this Standard is to prescribe principles for the determination and presentation of Earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity.

Even though earnings per share data have limitations because of different accounting policies that may be used for determining 'earnings', a consistently determined denominator enhances financial reporting.

The focus of this Standard is on the denominator of the earnings per share calculation.

8.20.2 Scope

This Indian Accounting Standard shall apply to companies that have issued ordinary shares to which Indian Accounting Standards (Ind AS) notified under the Companies Act apply.

An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with Ind AS 110, *'Consolidated Financial Statements'*, and Ind AS 27, *'Separate Financial Statements'*, respectively, the disclosures required by this Standard shall be presented both in the consolidated financial statements and separate financial statements.

1. In consolidated financial statements such disclosures shall be based on consolidated information and in separate financial statements such disclosures shall be based on information given in separate financial statements.
2. An entity shall not present in consolidated financial statements, earnings per share based on the information given in separate financial statements and shall not present in separate financial statements, earnings per share based on the information given in consolidated financial statements.

8.20.3 Measurement

8.20.3.1 Basic Earnings Per Share: An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

Examples of potential ordinary shares are:

(a) financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;

(b) options and warrants;

(c) shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

An entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

Basic earnings per share shall be calculated by:

$$\frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:

(a) profit or loss from continuing operations attributable to the parent entity; and

(b) profit or loss attributable to the parent entity

adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

Where any item of income or expense which is otherwise required to be recognised in profit or loss in accordance with Indian Accounting Standards is debited or credited to securities premium account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share.

For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares that have changed the number of ordinary shares outstanding without a corresponding change in resources.

Ordinary shares may be issued, or the number of ordinary shares outstanding may be reduced, without a corresponding change in resources. Examples include:

- Capitalisation or bonus issue (sometimes referred to as a stock dividend)
- Bonus element in any other issue (For example a bonus element in a rights issue to existing shareholders)
- A share split
- A reverse share split (consolidation of shares)

8.20.3.2 Diluted Earnings Per Share: An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

For the purpose of calculating diluted earnings per share, an entity shall **ADJUST** profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

Diluted EPS shall be calculated by:

$$\frac{\text{Adjusted Profit/loss attributable to ordinary Equity holders of the parent entity}}{\text{Adjusted Weighted average number of ordinary shares outstanding during the period}}$$

For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, as calculated in accordance with Basic EPS, by the after-tax effect of:

(a) any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity;

(b) any interest recognised in the period related to dilutive potential ordinary shares; and

(c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares.

Potential ordinary shares shall be treated as dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

8.20.4 Presentation

An entity shall present in the statement of profit and loss basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period.

An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.

An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of profit and loss or in the notes.

(a) An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the statement of profit and loss or in the notes.

(b) An entity shall present basic and diluted earnings per share, even if the amounts are negative (i.e. a loss per share).

8.20.5 Retrospective Adjustments

If the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the calculation of basic and diluted earnings per share for all periods presented shall be adjusted retrospectively. If these changes occur after the reporting period but before the financial statements are approved for issue, the per share calculations for those and any prior period financial statements presented shall be based on the new number of shares.

8.20.6 Major Changes in Ind AS 33 vis-à-vis IAS* 33 Not Resulting in Carve Outs

1. ***Consolidated Financial Statements and Separate Financial Statements:*** IAS 33 provides that when an entity presents both consolidated financial statements and separate financial statements, it may give EPS related information in consolidated financial statements only, whereas, Ind AS 33 requires EPS related information to be disclosed both in consolidated financial statements and separate financial statements.

2. ***Applicability of the Standard:*** Paragraph 2 of IAS 33 requires that the entire standard applies to:

   (a) the separate or individual financial statements of an entity:

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a Securities Regulator or other regulatory organisation for the purpose of issuing ordinary shares in a public market; and

(b) the consolidated financial statements of a group with a parent:

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a Securities Regulator or other regulatory organisation for the purpose of issuing ordinary shares in a public market.

It also requires that an entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

The above requirements have been deleted in the Ind AS as the applicability or exemptions to the Ind AS are governed by the Companies Act and the Rules made there under.

3. ***Usage of Information:*** Paragraph 4 has been modified in Ind AS 33 to clarify that an entity shall not present in separate financial statements, earnings per share based on the information given in consolidated financial statements, besides requiring as in IAS 33, that earnings per share based on the information given in separate financial statements shall not be presented in the consolidated financial statements.

4. ***Adjustment of Securities Premium:*** In Ind AS 33, a paragraph has been added after paragraph 12 on the following lines -

   "Where any item of income or expense which is otherwise required to be recognized in profit or loss in accordance with Indian Accounting Standards is debited or credited to securities premium account/other reserves, the amount in respect thereof shall be deducted from profit or loss from continuing operations for the purpose of calculating basic earnings per share."

5. ***Amortisation of Discount or Premium:*** In Ind AS 33 paragraph 15 has been amended by adding the phrase, 'irrespective of whether such discount or premium is debited or credited to securities premium account' to further clarify that such discount or premium shall also be amortised to retained earnings.

6. ***Disclosure of Amounts of per Share using a Reported Component:*** IAS 33 requires disclosure of amounts of per share using a reported component, basic and diluted earnings per share and basic and diluted earnings per share for discontinued operations in the separate income statement, where separate income statement is presented. This requirement is not provided in Ind AS 33 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or

loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

8.20.7 Major Changes in Ind AS 33 vis a vis Notified AS 20

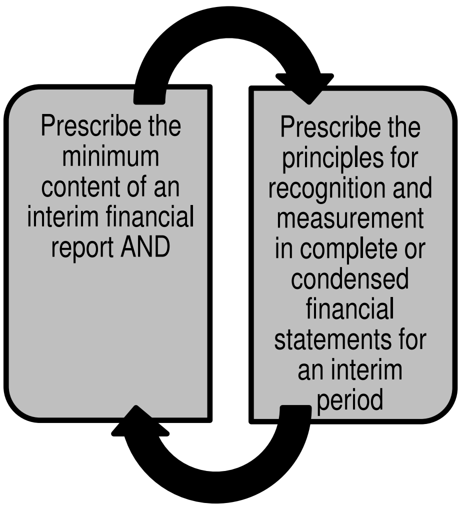
(i) ***Options held by the Entity on its Shares:*** Existing AS 20 does not specifically deal with options held by the entity on its shares, e.g., purchased options, written put option etc. Ind AS 33 deals with the same.

(ii) ***Presentation of Basic and Diluted EPS from Continuing and Discontinued Operations:*** Ind AS 33 requires presentation of basic and diluted EPS from continuing and discontinued operations separately. However, existing AS 20 does not require any such disclosure.

(iii) ***Disclosure of EPS with and without Extraordinary Items:*** Existing AS 20 requires the disclosure of EPS with and without extraordinary items. Since as per Ind AS 1, '*Presentation of Financial Statements*', no item can be presented as extraordinary item, Ind AS 33 does not require the aforesaid disclosure.

8.21 Ind AS 34 : Interim Financial Reporting

8.21.1 Objective



Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

8.21.2 Scope

This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period. However, governments, securities regulators, stock exchanges, and accountancy bodies often require entities whose debt or equity securities are publicly traded to publish interim financial reports.

This Standard applies if an entity is required or elects to publish an interim financial report in accordance with Indian Accounting Standards.

8.21.3 Interim Financial Report

Interim financial report means a financial report containing either a complete set of financial statements (as described in Ind AS 1, *'Presentation of Financial Statements'*), or a set of condensed financial statements (as described in this Standard) for an interim period.

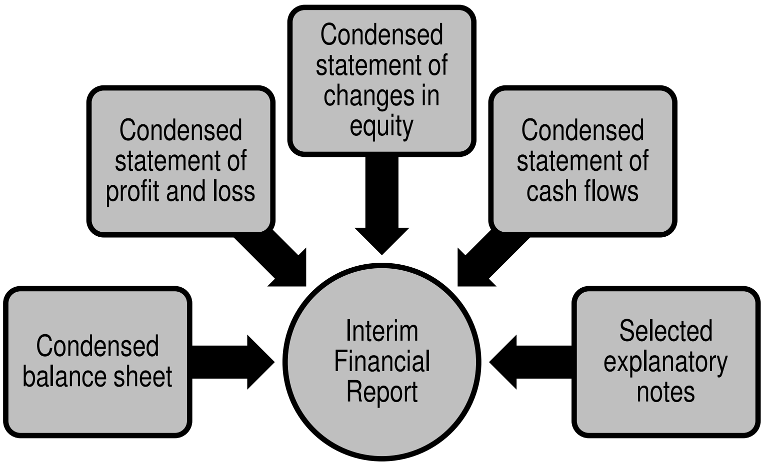
Interim period is a financial reporting period shorter than a full financial year.

8.21.4 Minimum Components of an Interim Financial Report

In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements. This Standard defines the minimum content of an interim financial report as including condensed financial statements and selected explanatory notes. The interim financial report is intended to provide an update on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.

Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in Ind AS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements shall conform to the requirements of Ind AS 1 for a complete set of financial statements.

An interim financial report shall include, at a minimum, the following components:



Form and Content of Interim Financial Statements

$\boxed{\textbf{Situation I}}$: if an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements shall conform to the requirements of Ind AS 1 for a complete set of financial statements.

Situation II: If an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements shall include, at a minimum:

- Each of the headings and subtotals that were included in its most recent annual financial statements
- The selected explanatory notes as required by this Standard
- Additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading
- In the statement that presents the components of profit or loss for an interim period, an entity shall present basic and diluted earnings per share for that period when the entity is within the scope of Ind AS 33, *'Earnings per Share'*.

8.21.5 Significant Events and Transactions

The following is a list of events and transactions for which disclosures would be required if they are significant (the list is not exhaustive):

(a) the write-down of inventories to net realisable value and the reversal of such a write-down;

(b) recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss;

> In addition to disclosing significant events and transactions in accordance with paragraphs 15–15C, an entity shall include the following information, in the notes to its interim financial statements or elsewhere in the interim financial report. The following disclosures shall be given either in the interim financial statements or incorporated by cross-reference from the interim financial statements to some other statement (such as management commentary or risk report) that is available to users of the financial statements on the same terms as the interim financial statements and at the same time. If users of the financial statements do not have access to the information incorporated by cross-reference on the same terms and at the same time, the interim financial report is incomplete. The information shall normally be reported on a financial year-to-date basis.

(c) the reversal of any provisions for the costs of restructuring;

(d) acquisitions and disposals of items of property, plant and equipment;

(e) commitments for the purchase of property, plant and equipment;

(f) litigation settlements;

(g) corrections of prior period errors;

(h) changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;

(i) any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;

(j) related party transactions;

(k) transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;

(l) changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and

(m) changes in contingent liabilities or contingent assets.

8.21.6 Interim Reporting Periods

Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

(a) Balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year.

(b) Statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.

(c) Statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

(d) Statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

(e) For an entity whose business is highly seasonal, financial information for the twelve months up to the end of the interim period and comparative information for the prior twelve-month period may be useful.

8.21.7 Recognition and Measurement

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality shall be assessed in relation to the interim period financial data. In making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

The measurement procedures to be followed in an interim financial report shall be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

8.21.7.1 Same Accounting Policies as Annual: An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on a year-to-date basis.

8.21.7.2 Revenues received Seasonally, Cyclically, or Occasionally: Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year.

8.21.7.3 Costs incurred unevenly during the financial year: Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

8.21.7.4 Use of Estimates: The measurement procedures to be followed in an interim financial report shall be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

8.21.8 Restatement of Previously Reported Interim Periods

A change in accounting policy, other than one for which the transition is specified by a new Ind AS, shall be reflected by:

(a) restating the financial statements of prior interim periods of the current financial year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements in accordance with Ind AS 8; or

(b) when it is impracticable to determine the cumulative effect at the beginning of the financial year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current financial year, and comparable interim periods of prior financial years to apply the new accounting policy prospectively from the earliest date practicable.

There is an issue that whether an entity reverse impairment losses recognised in an interim period on goodwill if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period. Appendix A of Ind AS 34 prescribes that an entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill. Further this Appendix also prescribes that an entity shall not extend this accounting principle by analogy to other areas of potential conflict between Ind AS 34 and other Indian Accounting Standards.

8.21.9 Major Changes in Ind AS 34 vis-à-vis IAS* 34 Not Resulting in Carve Outs

(i) ***Addition of a footnote regarding Unaudited Financial Results:*** A footnote has been added to paragraph 1 of Ind AS 34, *'Interim Financial Reporting'* that Unaudited Financial Results required to be prepared and presented under Clause 41 of Listing Agreement with stock exchanges is not an 'Interim Financial Report' as defined in paragraph 4 of this Standard.

(ii) ***Single Statement Approach:*** IAS 34 provides option either to follow single statement approach or to follow two statement approaches. Ind AS 34 allows only single statement approach on the lines of Ind AS 1, *'Presentation of Financial Statements',* which also allows only single statement approach.

8.21.10 Major Differences between Ind AS 34 vis a vis Notified AS 25

(i) ***Scope:*** Under the existing AS 25, if an entity is required or elects to prepare and present an interim financial report, it should comply with that standard. Ind AS 34 applies only if an entity is required or elects to prepare and present an interim financial report in accordance with Accounting Standards. Consequently, it is specifically stated in Ind AS 34 that the fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with Ind AS 34 does not prevent the entity's annual financial statements from conforming to Ind AS if they otherwise do so.

(ii) ***Complete set of Financial Statements:*** In Ind AS 34, the term 'complete set of financial statements' appearing in the definition of interim financial report has been expanded as compared to AS 25. Accordingly, the said term (as described in Ind AS 1, '*Presentation of Financial Statements*') includes balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements and comparative information in respect of the preceding period as specified in paragraphs 38 and 38A of Ind AS 1.

(iii) ***Contents of Interim Report:*** As per the existing standard, the contents of an interim financial report include, at a minimum, a condensed balance sheet, a condensed statement of profit and loss, a condensed cash flow statement and selected explanatory notes. Ind AS 34 requires, in addition to the above, a condensed statement of changes in equity.

(iv) ***Reversal of Impairment Loss:*** Ind AS 34 prohibits reversal of impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost. There is no such specific prohibition in the existing standard. Ind AS 34 includes Appendix A which addresses the interaction between the requirements of Ind AS 34 and the recognition of impairment losses on goodwill in Ind

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

AS 36 and certain financial assets in Ind AS 109, and the effect of that interaction on subsequent interim and annual financial statements.

(v) ***Inclusion of the Parent's Separate Statements and The Consolidated Financial Statements in the Entity's Interim Report:*** Under the existing standard, if an entity's annual financial report included the consolidated financial statements in addition to the separate financial statements, the interim financial report should include both the consolidated financial statements and separate financial statements, complete or condensed. Ind AS 34 states that it neither requires nor prohibits the inclusion of the parent's separate statements in the entity's interim report prepared on a consolidated basis.

(vi) ***Accounting Policies:*** The existing standard requires the Notes to interim financial statements, (if material and not disclosed elsewhere in the interim financial report), to contain a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, in case of change in those policies, a description of the nature and effect of the change. Ind AS 34 additionally requires the above information in respect of methods of computation followed.

(vii) ***Dividends:*** The existing standard requires furnishing information, in interim financial report, of dividends, aggregate or per share (in absolute or percentage terms), for equity and other shares. Ind AS 34 requires furnishing of information, in interim financial report, on dividends paid, aggregate or per share separately for equity and other shares.

(viii) ***Contingent Liabilities and Contingent Assets:*** While the existing standard requires furnishing of information on contingent liabilities only, Ind AS 34 requires furnishing of information on both contingent liabilities and contingent assets, if they are significant.

(ix) ***Extraordinary Items:*** In comparison to AS 25, reference to extraordinary items (in the context of materiality) is deleted in Ind AS 34 in line with the Ind AS 1.

(x) ***Interim Financial Statements prepared on Complete Basis:*** Ind AS 34 requires that, where an interim financial report has been prepared in accordance with the requirements of Ind AS 34, that fact should be disclosed. Further, an interim financial report should not be described as complying with Ind AS unless it complies with all of the requirements of Ind AS. (The latter statement is applicable when interim financial statements are prepared on complete basis instead of 'condensed basis'). The existing standard does not contain these requirements.

(xi) ***Change in Accounting Policy:*** Under the existing standard, a change in accounting policy, other than the one for which the transitional provisions are specified by a new Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year. Ind AS 34 additionally requires restatement of the comparable interim periods of prior financial years that will be restated in annual financial statements in accordance with Ind AS 8, subject to specific provisions when such restatement is impracticable.

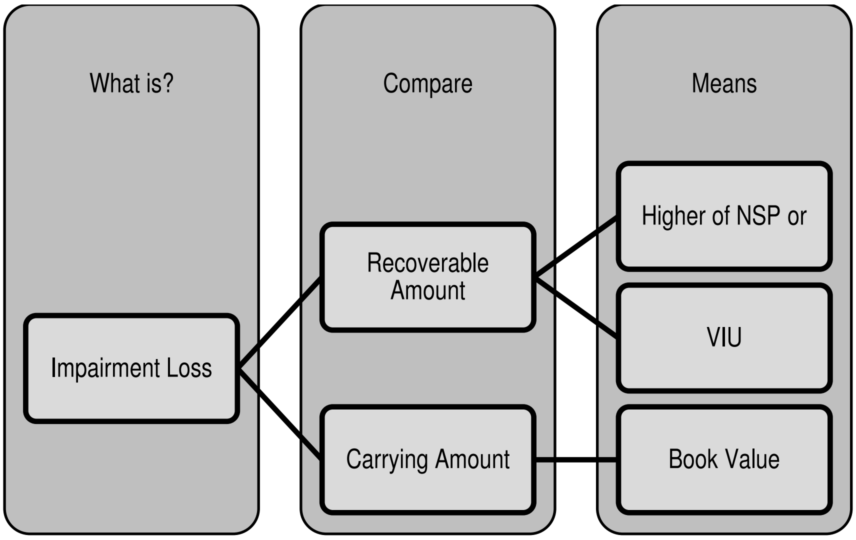
(xii) ***Impact of Convergence:*** Convergence of all other standards with IFRS also has impact on interim financial reporting. For example, treatment of constructive obligation in Ind AS 37, etc. will have impact in interim financial reporting which could be different in the context of relevant existing standards. There are other consequential impacts also. For example, existing AS 20 requires EPS with and without extraordinary items. Since the concept of extraordinary items is no longer valid in the context of Ind AS 1 the question of EPS with and without extraordinary items does not arise in the context of Ind AS 33. This changed requirement of Ind AS 33 is equally applicable to interim financial reporting under Ind AS 34.

(xiii) ***Transitional Provision:*** Under the existing standard, when an interim financial report is presented for the first time in accordance with that Standard, an entity need not present, in respect of all the interim periods of the current financial year, comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year and comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year. Ind AS 34 does not have this transitional provision.

8.22 Ind AS 36 : Impairment of Assets

8.22.1 Objective

The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.



8.22.2 Scope

This Standard shall be applied in accounting for the impairment of all assets, other than:

1. • Inventories: Ind AS 2
2. • Assets arising from construction contracts; Ind AS 11
3. • Deferred Tax Assets; Ind AS 12
4. • Assets arising from Employee Benefits; Ind AS 19
5. • Financial assets that are within the scope of Ind AS 109
6. • Biological assets related to agricultural activity that are measured at fair value less costs to sell; Ind AS 41
7. • Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of Ind AS 104
8. • Non-current assets (or disposal groups) classified as held for sale in accordance with Ind AS 105

This Standard applies to financial assets classified as:

- Subsidiaries, as defined in Ind AS 110 Consolidated Financial Statements
- Associates, as defined in Ind AS 28 Investments in Associates and Joint Ventures
- Joint ventures, as defined in Ind AS 111 Joint Arrangements.

8.22.3 Identifying an Asset that may be Impaired

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

Irrespective of whether there is any indication of impairment, an entity shall also:

(a) test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different intangible assets may be tested for impairment at different times.

However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.

(b) test goodwill acquired in a business combination for impairment annually.

In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External Sources of Information

(a) there are observable indications that the asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use.

(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

(d) the carrying amount of the net assets of the entity is more than its market capitalisation.

Internal Sources of Information

(a) evidence is available of obsolescence or physical damage of an asset.

(b) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.

(c) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

(d) for an investment in a subsidiary, joint venture or associate, the investor recognises a dividend from the investment and evidence is available that:

  (i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or

  (ii) the dividend exceeds the total comprehensive income of the subsidiary, joint venture or associate in the period the dividend is declared.

8.22.4 Recognising and Measuring an Impairment Loss

If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in Ind AS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.

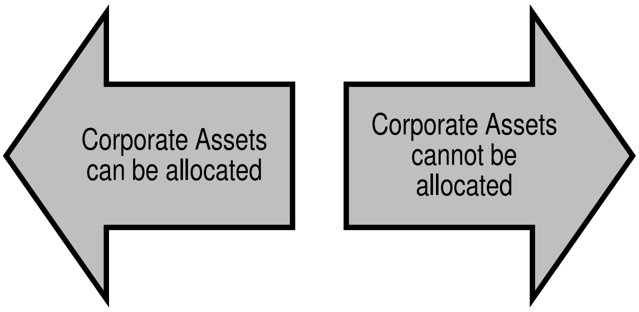
After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

If there is an indication that an asset may be impaired, recoverable amount shall be estimated for individual asset. If it is not possible to estimate the recoverable amount of the individual asset, the entity shall determine the recoverable amount of the cash generating unit to which the asset belongs (the asset's cash generating unit).

8.22.5 Cash Generating Unit

A *cash-generating unit* is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Corporate Assets



Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre.

Because corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset. As a consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit or group of cash-generating units to which the corporate asset belongs, and is compared with the carrying amount of this cash-generating unit or group of cash-generating units.

In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

(a) can be allocated on a reasonable and consistent basis to that unit, the entity shall compare the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss shall be recognised.

(b) cannot be allocated on a reasonable and consistent basis to that unit, the entity shall:

(i) compare the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss;

(ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and

(iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised.

8.22.5.1 Measuring Cash Generating Unit: The *recoverable amount* of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use.

It is not always necessary to determine both an asset's fair value less costs of disposal and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Costs of disposal are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

The following elements shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Estimates of future cash flows shall include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) improving or enhancing the asset's performance.

Estimates of future cash flows shall not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

8.22.5.2 Impairment Loss for a Cash Generating Unit: An impairment loss shall be recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

(b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be treated as impairment losses on individual assets.

In allocating an impairment loss, an entity shall not reduce the carrying amount of an asset below the highest of:

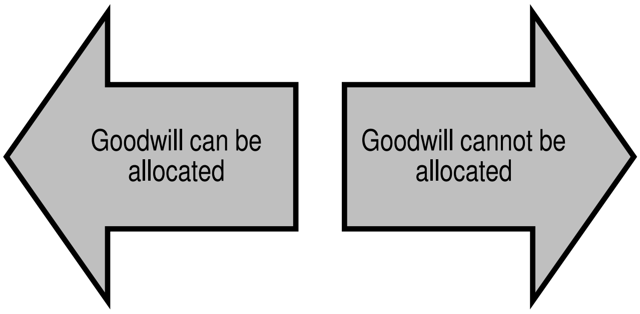
(a) its fair value less costs of disposal (if measurable);

(b) its value in use (if determinable); and

(c) zero.

The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).

8.22.5.3 Allocating goodwill to cash generating units



For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each **unit or group of units to which the goodwill is so allocated** shall:

(a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(b) not be larger than an operating segment as defined by Ind AS 108, 'Operating Segments', before aggregation.

If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:

(a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

When, goodwill relates to a cash-generating unit but **has not been allocated to that unit**, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount.

8.22.6 Reversing an Impairment Loss

An entity shall assess at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.

In assessing whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

External Sources of Information

(a) there are observable indications that the asset's value has increased significantly during the period.

(b) significant changes with a favourable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated.

(c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

Internal Sources of Information

(a) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs.

(b) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

8.22.6.1 Reversing an Impairment Loss for an Individual Asset: The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

A reversal of an impairment loss for an asset other than goodwill shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Indian Accounting Standard (for example, the revaluation model in Ind AS 16). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other Indian Accounting Standard.

NOTE: After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

8.22.6.2 Reversing an Impairment Loss for a Cash-generating Unit: A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets.

In allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset shall not be increased above the lower of:

(a) its recoverable amount (if determinable); and

(b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit, except for goodwill.

8.22.6.3 Reversing an impairment loss for goodwill: An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

8.22.7 Major Change in Ind AS 36 vis-à-vis IAS* 36 Not Resulting in Carve Out

Impairment of Investment Property: Paragraph 2(f) of IAS 36 provides that this standard is not applied to the accounting for impairment of investment property that is measured at fair value. Paragraph 2(f) is deleted in Ind AS 36 as Ind AS 40 requires cost model for measurement of investment property.

8.22.8 Major Differences between Ind AS 36 vis a vis Notified AS 28

(i) ***Financial Assets:*** Ind AS 36 applies to financial assets classified as subsidiaries, as defined in Ind AS 110, associates as defined in Ind AS 28, joint ventures as defined in Ind AS 111. The existing AS 28 does not apply to the above assets.

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

(ii) ***Biological Assets:*** Ind AS 36 specifically excludes biological assets related to agricultural activity. Existing AS 28 does not specifically exclude biological assets.

(iii) ***Impairment Testing for an Intangible Asset with an Indefinite Useful Life:*** Ind AS 36 requires annual impairment testing for an intangible asset with an indefinite useful life or not yet available for use and goodwill acquired in a business combination. The existing AS 28 does not require the annual impairment testing for the goodwill unless there is an indication of impairment.

(iv) ***Additional Guidance:*** Ind AS 36 gives additional guidance on, *inter alia*, the following aspects compared to the existing AS 28:

(a) estimating the value in use of an asset;

(b) for managements to assess the reasonableness of the assumptions on which cash flows are based; and

(c) using present value techniques in measuring an asset's value in use.

(v) ***Reversal of Goodwill:*** The existing AS 28 requires that the impairment loss recognised for goodwill should be reversed in a subsequent period when it was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events that have occurred that reverse the effect of that event whereas Ind AS 36 prohibits the recognition of reversals of impairment loss for goodwill.

(vi) ***Bottom up and Top Down Test:*** In the existing AS 28, goodwill is allocated to CGUs only when the allocation can be done on a reasonable and consistent basis. If that requirement is not met for a specific CGU under review, the smallest CGU to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis must be identified and the impairment test carried out at this level. Thus, when all or a portion of goodwill cannot be allocated reasonably and consistently to the CGU being tested for impairment, two levels of impairment tests are carried out, viz., bottom-up test and top-down test.

In Ind AS 36, goodwill is allocated to cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. There is no bottom-up or top-down approach for allocation of goodwill.

(viii) ***Disclosures:*** Ind AS 36 requires certain extra disclosures as compared to the existing AS 28.

8.23 Ind AS 37: Provisions, Contingent Liabilities and Contingent Assets

8.23.1 Objective

The objective of this Standard is to ensure that

- appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and
- that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

8.23.2 Scope

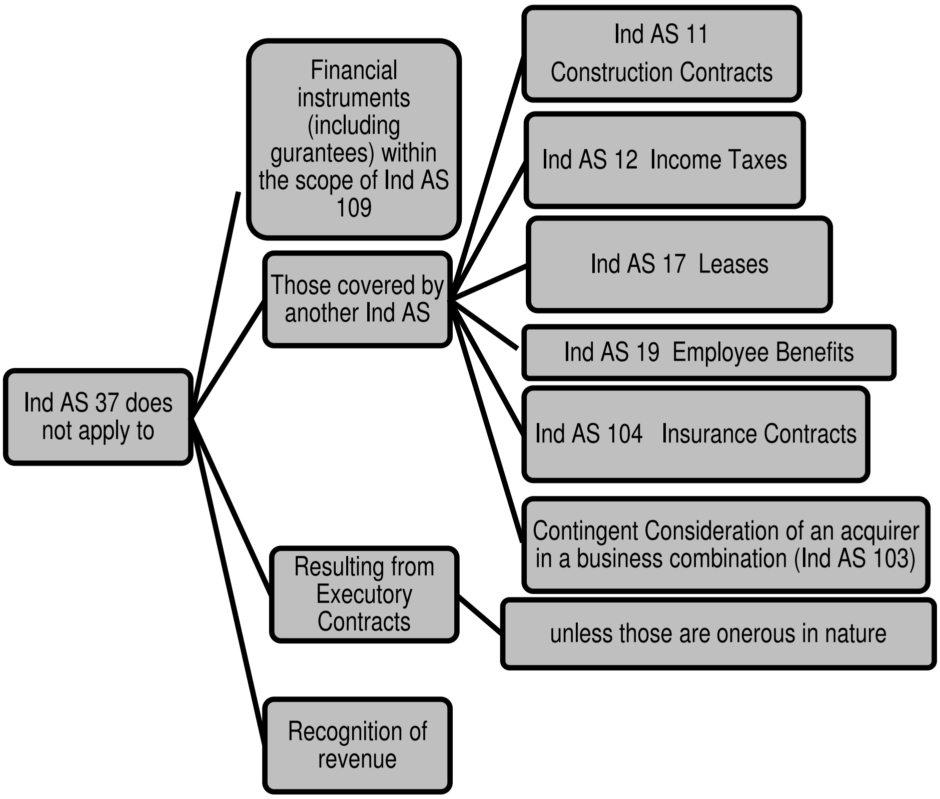
Executory contracts are contracts under which

- neither party has performed any of its obligations nor

➢ both parties have partially performed their obligations to an equal extent.

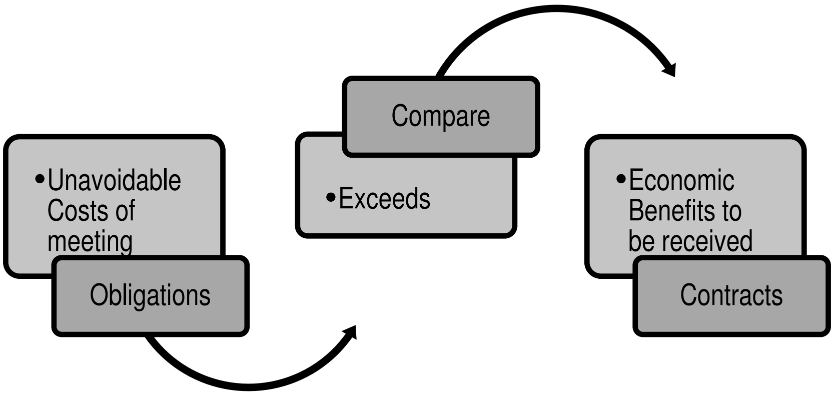
This Standard does not apply to executory contracts unless they are onerous.

Some amounts treated as provisions may relate to the recognition of revenue, for example, where an entity gives guarantees in exchange for fee. Ind AS 37 does not address the recognition of revenue. Ind AS 18, Revenue, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. Ind AS 37 does not change the requirements of Ind AS 18.



8.23.3 Onerous contracts

An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.



If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation.

The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of

- the cost of fulfilling it and
- any compensation or penalties arising from failure to fulfil it.

Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (Ind AS 36).

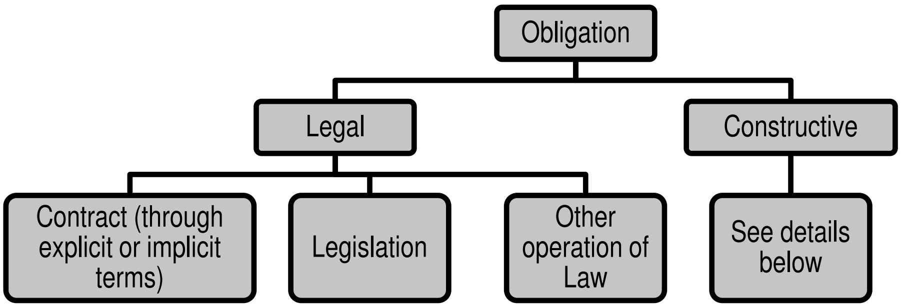
8.23.4 Provision

A **provision** is a liability of uncertain timing or amount.

A liability

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

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.



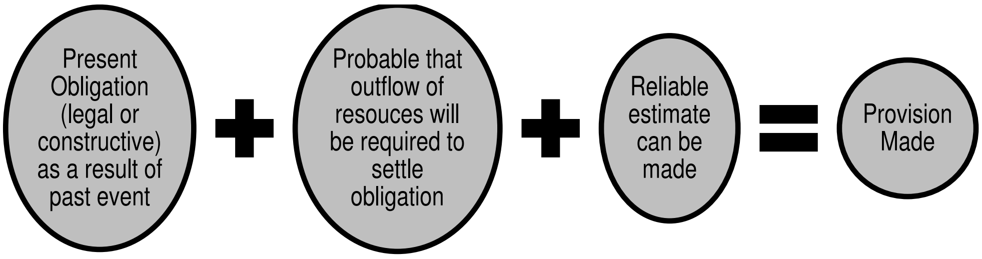
8.23.4.1 Recognition Principle of Provision: A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) that is a result of a past event;

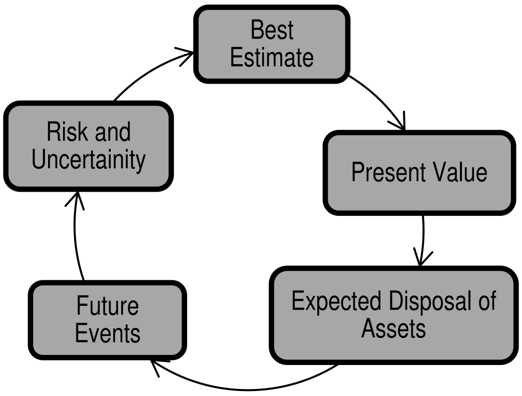
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

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



8.23.4.2 Measurement of Provision



1. **Best estimate:** The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

   Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes.

   The estimates of outcome and financial effect are determined

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

2. **Risks and uncertainties:** The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision**.**
   - Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured.
   - Disclosure of the uncertainties surrounding the amount of the expenditure is made under Ind AS 37.
3. **Present value:** Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.
   - The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability.
   - The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.
   - Government bond rate can be used as discount rate, as it is a risk-free pre-tax rate reflecting the time value of money.
   - Discount rate should also be reassessed at the end of each reporting period, including the interim reporting date, if any.
4. **Future events:** Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.
5. **Expected disposal of assets:** Gains from the expected disposal of assets shall not be taken into account in measuring a provision. These are not recognised even if the expected disposal is closely linked to the event giving rise to the provision.

Reimbursements: Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

8.23.4.4 Changes in Provisions: Provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate.

If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.

Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

8.23.4.5 Application of the Recognition and Measurement Rules: Future operating losses: Provisions shall not be recognised for future operating losses.

Future operating losses do not meet the definition of a liability.

An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under Ind AS 36 *'Impairment of Assets'.*

8.23.5 Contingent Liability

A contingent liability is

- a present obligation that arises from past events but is not recognised because:
  - It is not **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation.
  - The amount of the obligation cannot be measured with sufficient reliability.
- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

For the purpose of Ind AS 37, the word 'probable' is defined as 'more likely than not'. 'More likely than not' means that the probability that the event will occur is greater than the probability that it will not occur. A percentage of over 50% chance that the event will occur can be used for this purpose.

8.23.6 Contingent Assets

A contingent asset

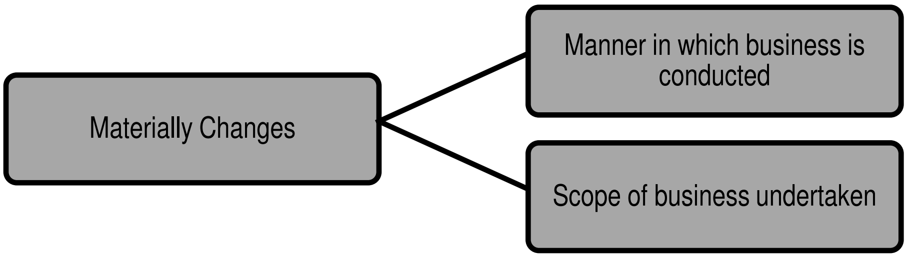
- is a possible asset
- that arises from past events and
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

An entity shall not recognise a contingent asset. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

8.23.7 Restructuring

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



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

(a) sale or termination of a line of business;

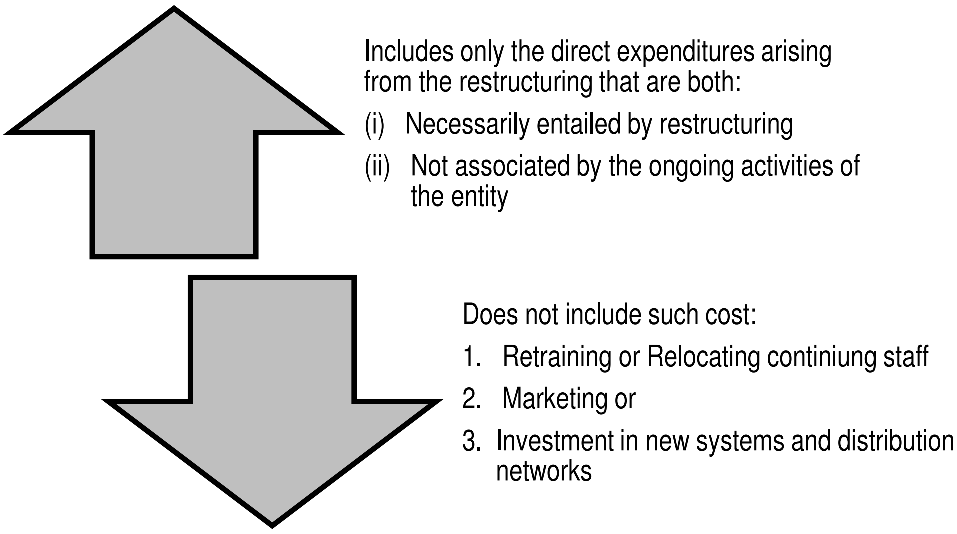
(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

A provision for restructuring costs is recognised only when the general recognition criteria for provisions discussed earlier are met. The standard further sets out how the general recognition criteria apply to restructurings.

Restructuring cost provision will include and exclude the following:



Appendix A of Ind AS 37 provides guidance on (a) how a contributor account for its interest in a fund and (b) when a contributor has an obligation to make additional contributions, for example, in the event of the bankruptcy of another contributor or if the value of the investment assets held by the fund decreases to an extent that they are insufficient to fulfil the fund's reimbursement obligations, how that obligation be accounted for. The Appendix prescribes that the contributor shall recognise its obligation to pay decommissioning costs as a liability and recognise its interest in the fund separately unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. When a contributor has an obligation to make potential additional contributions, this obligation is a contingent liability that is within the scope of Ind AS 37. The contributor shall recognise a liability only if it is probable that additional contributions will be made.

Appendix B of Ind AS 37 provides guidance on the recognition, in the financial statements of producers, of liabilities for waste management under the European Union's Directive on Waste Electrical and Electronic Equipment (WE&EE), in respect of sales of historical household equipment. This Appendix addresses neither new waste nor historical waste from sources other than private households. The liability for such waste management is adequately covered in Ind AS 37. However, if, in national legislation, new waste from private households is treated in a similar manner to historical waste from private households, the principles of this Appendix apply by reference to the hierarchy in paragraphs 10-12 of Ind AS 8. The Ind AS 8 hierarchy is also relevant for other regulations that impose obligations in a way that is similar to the cost attribution model specified in the EU Directive.

Appendix C to Ind AS 16 addresses the accounting for a liability to pay a levy if that liability is within the scope of Ind AS 37. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain. The Appendix prescribes that obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. An entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period as a result of the entity being economically compelled to continue to operate in that future period. The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time

8.23.8 Major Differences between Ind AS 37 vis a vis Notified AS 29

(i) ***Constructive obligations and Change in the Definition of Provision and Obligating Event:*** Unlike the existing AS 29, Ind AS 37 requires creation of provisions in respect of constructive obligations also. [However, the existing standard requires creation of provisions arising out of normal business practices, custom and a desire to maintain good business relations or to act in an equitable manner]. This has resulted in some consequential changes also. For example, definitions of provision and obligating event have been revised in Ind AS 37, while the terms 'legal obligation' and 'constructive obligation' have been inserted and defined in Ind AS 37. Similarly, the portion of existing AS 29 pertaining to restructuring provisions has been revised in Ind AS 37.

(ii) ***Discounting Provisions: The existing AS 29 prohibits discounting the amounts of provisions except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. Ind AS 37 requires discounting the amounts of provisions, if effect of the time value of money is material.***

(iii) ***Disclosure of Contingent Assets:*** The existing AS 29 notes the practice of disclosure of contingent assets in the report of the approving authority but prohibits disclosure of the same in the financial statements. Ind AS 37 requires disclosure of contingent assets in the financial statements when the inflow of economic benefits is probable. The disclosure, however, should avoid misleading indications of the likelihood of income arising.

(iv) ***Onerous Contracts:*** Ind AS 37 makes it clear that before a separate provision for an onerous contract is established, an entity should recognise any impairment loss that has occurred on assets dedicated to that contract in accordance with Ind AS 36. There is no such specific provision in the existing standard.

(v) ***Future Operating Losses:*** The existing AS 29 states that identifiable future operating losses up to the date of restructuring are not included in a provision. Ind AS 37 gives an exception to this principle viz. such losses related to an onerous contract.

(vi) ***Appendix:*** Ind AS 37 gives guidance on:

(a) Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

(b) Liabilities arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment

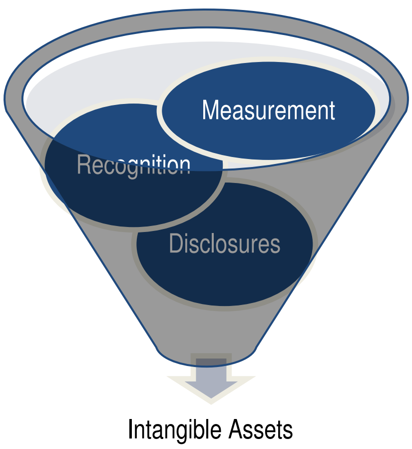
(c) Levies (imposed by government).

Existing AS 29 does not give such guidance.

8.24 Ind AS 38 : Intangible Assets

8.24.1 Objective

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.



8.24.2 Scope

This Standard shall be applied in accounting for intangible assets, **except**

1. • Intangible assets that are within the scope of another Standard (See below)
2. • Financial assets, as defined in Ind AS 32 'Financial Instruments: Presentation'
3. • The recognition and measurement of exploration and evaluation assets (Ind AS 106 'Exploration for and Evaluation of Mineral Resources')
4. • Expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources

If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard **does not apply to:**

1. • Intangibles held for sale in ordinary course of business (Ind AS 2 and Ind AS 11)
2. • Deferred Tax Assets (Ind AS 12)
3. • Leases (Ind AS 17)
4. • Assets arsing from Employee Benefits (Ind AS 19)
5. • Financial Assets (Ind AS 32)
6. • Goodwill acquired in business combination (Ind AS 103)
7. • Insurance Contracts (Ind AS 104)
8. • Non-current Assets held for sale (Ind AS 105)

Caution: In determining whether an asset that incorporates both intangible and tangible elements should be treated under Ind AS 16 'Property, Plant and Equipment' or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant.

For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

1. This Standard applies to, among other things;
   - expenditure on advertising,

- training,
- start-up,
- research and development activities.

Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (e.g. a prototype), the physical element of the asset is secondary to its intangible component, i.e. the knowledge embodied in it.

2. In the case of a **finance lease**, the underlying asset may be either tangible or intangible. After initial recognition, a lessee accounts for an intangible asset held under a finance lease in accordance with this Standard. Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of Ind AS 17 and are within the scope of this Standard.
3. Exclusions from the scope of a Standard may occur if activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the accounting for expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. Therefore, this Standard does not apply to expenditure on such activities and contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

8.24.3 Intangible Asset

Intangible asset is an:

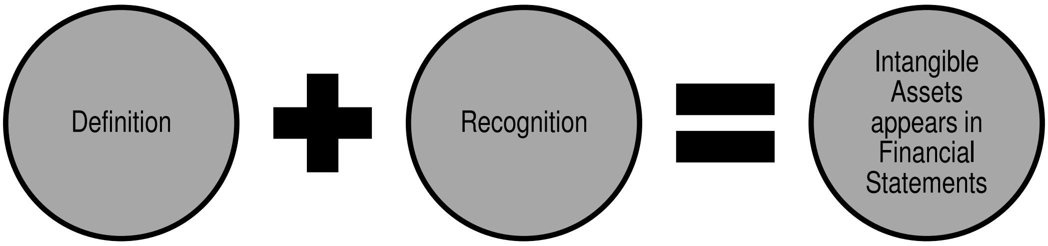
- Identifiable
- Non-monetary
- Asset
- Without physical substance.

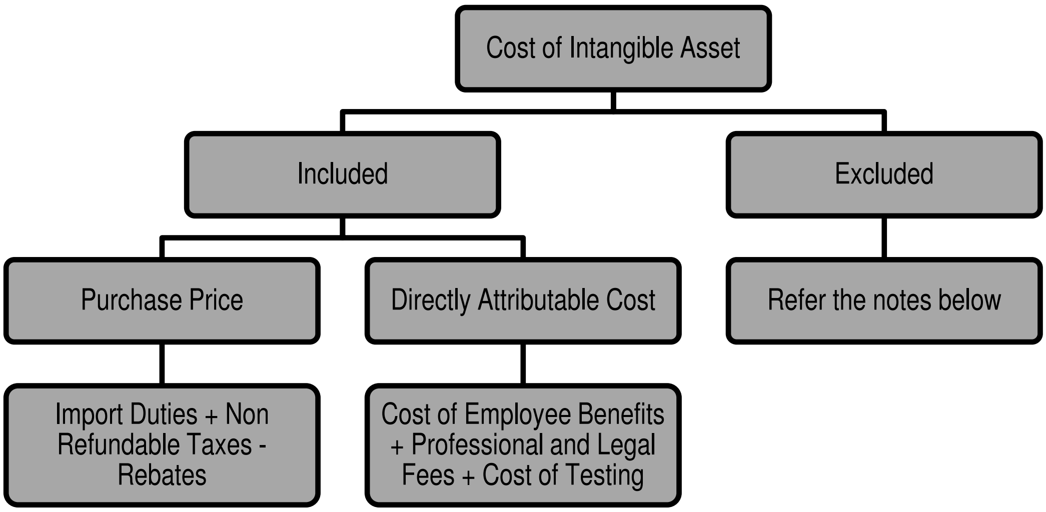
8.24.4 Recognition and Measurement

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

(a) the **definition** of an intangible asset; and

(b) the **recognition** criteria.





Examples of expenditures that are **not part** of the cost of an intangible asset are:

(a) costs of introducing a new product or service (including costs of advertising and promotional activities);

(b) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(c) administration and other general overhead costs.

Deferred Payment

- If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent.
- The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with Ind AS 23 Borrowing Costs.

8.24.4.1 Separate Acquisition: The cost of a separately acquired intangible asset would comprise:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

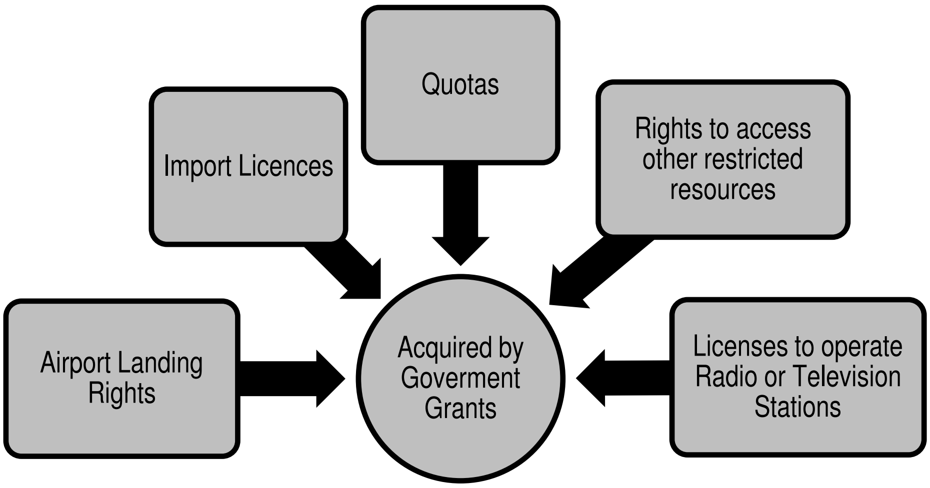
(b) any directly attributable cost of preparing the asset for its intended use.

8.24.4.2 Acquisition as part of a Business Combination: In accordance with Ind AS 103, '*Business Combinations'*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information would exist to measure reliably the fair value of the asset.

In accordance with this Standard and Ind AS 103, an acquirer should recognise at the acquisition date, separately from goodwill, an intangible asset of the acquiree, if it meets the definition and recognition criteria for an intangible asset irrespective of whether the asset had been recognised by the acquiree before the business combination. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset.

8.22.4.3 Acquisition by way of a Government Grant: In some cases, an intangible asset may be acquired free of charge, or for nominal consideration by way of a government grant.

This may happen when a government transfers or allocates to an entity intangible assets such as:



Note: In accordance with Ind AS 20 *'Accounting for Government Grants and Disclosure of Government Assistance'*, an entity recognises both the intangible asset and the grant **initially at fair value.**

8.24.4.4 Exchange of Assets: One or more intangible assets may be acquired in exchange for:

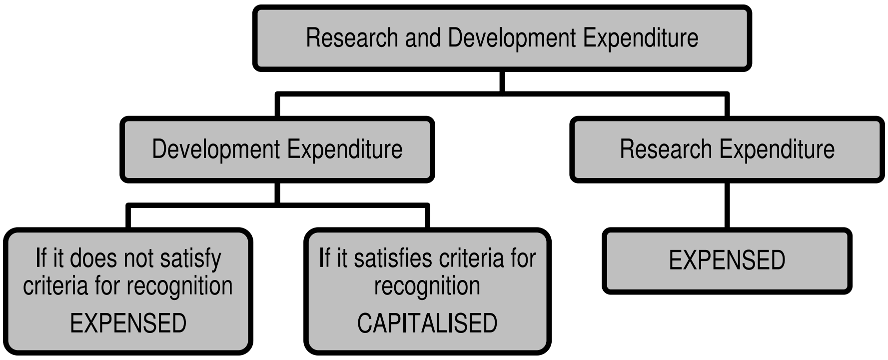
- A non-monetary asset or assets, or
- A combination of monetary and non-monetary assets.

The cost of such an intangible asset is measured at fair value unless:

(a) the exchange transaction lacks commercial substance or

(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

8.24.5 Subsequent Expenditure on an Acquired In-process Research and Development Project



8.24.6 Internally Generated Goodwill

Internally generated goodwill shall **not be** recognised as an asset.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is neither separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill.

Differences between the fair value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the fair value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

8.24.6.1 Internally Generated Intangible Assets -Requirements and Guidance: To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

1. **Research Phase:** No intangible asset arising from research (or from the research phase of an internal project) shall be recognised.

   Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

2. **Development Phase:** An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can **demonstrate all** of the following:

   (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

   (b) its intention to complete the intangible asset and use or sell it.

   (c) its ability to use or sell the intangible asset.

   (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

   (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

   (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

8.24.6.2 Cost of an Internally Generated Intangible Asset: The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria and the condition relating to development phase.

Ind AS 38 prohibits reinstatement of expenditure previously recognised as an expense.

The cost of an internally generated intangible asset comprises **all directly attributable costs** necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

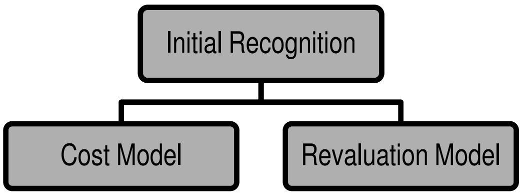
Examples of directly attributable costs are:

- Costs of materials and services used or consumed in generating the intangible asset
- Costs of employee benefits (as defined in Ind AS 19) arising from the generation of the intangible asset
- Fees to register a legal right
- Amortisation of patents and licences that are used to generate the intangible asset

Ind AS 23 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

8.24.7 Measurement after Recognition



An entity shall choose either the cost model or the revaluation model as its accounting policy.

If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.

1. **Cost Model:** After initial recognition, an intangible asset shall be carried at cost less any accumulated amortisation less any accumulated impairment losses
2. **Revaluation Model:** After initial recognition, an intangible asset shall be carried at a revalued amount, being fair value at the date of the revaluation less any subsequent accumulated amortisation less any subsequent accumulated impairment losses

Treatment of Revaluation Gains and Losses: If an intangible asset's carrying amount is increased as a result of a revaluation, the increase should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset.

8.24.8 Useful Life

An entity shall assess whether the useful life of an intangible asset is:

- Finite {If finite, the length of, or number of production or similar units constituting, that useful life} OR
- Indefinite {An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity}

The accounting for an intangible asset is based on its useful life.

- An intangible asset with a finite useful life is amortised.
- An intangible asset with an indefinite useful life is not.

8.24.8.1 Intangible Assets with Finite Useful Lives

Amortisation

- The **depreciable amount** of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.
- Amortisation **shall begin** when the asset is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.
- Amortisation **shall cease** at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with Ind AS 105 and the date that the asset is derecognised.
- The **amortisation method** used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used.
- The amortisation charge for each period shall be recognised in **profit or loss** unless this or another Standard permits or requires it to be included in the carrying amount of another asset.

Residual Value: The residual value of an intangible asset with a finite useful life shall be **assumed to be zero unless:**

- there is a commitment by a third party to purchase the asset at the end of its useful life; or
- there is an active market (as defined in Ind AS 113) for the asset and:
  - I. residual value can be determined by reference to that market; and
  - II. it is probable that such a market will exist at the end of the asset's useful life.

Review of Amortisation Period and Amortisation Method

- The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be <u>reviewed at least at each financial year-end</u>.
- If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern. Such changes shall be accounted for <u>as changes in accounting estimates</u> in accordance with Ind AS 8.
- During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.
- Over time, the pattern of future economic benefits expected to flow to an entity from an intangible asset may change.

8.24.8.2 Intangible Assets with Indefinite Useful Lives: An intangible asset with an indefinite useful life shall not be amortised.

In accordance with Ind AS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount:

- Annually AND
- Whenever there is an indication that the intangible asset may be impaired

8.24.8.3 Review of Useful Life Assessment: The useful life of an intangible asset that is not being amortised should be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate in accordance with Ind AS 8.

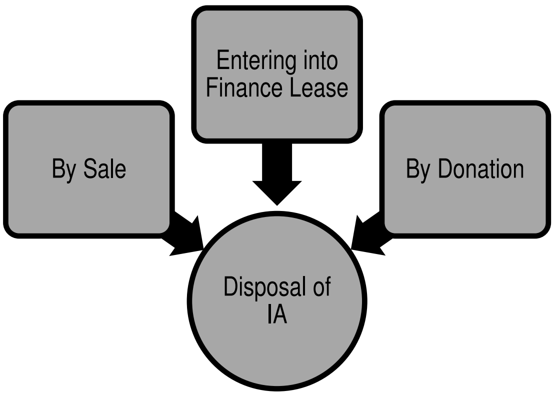
8.24.9 Retirements and Disposals

An intangible asset shall be derecognised:

- On Disposal OR
- When no future economic benefits are expected from its use or disposal

- The gain or loss arising from derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset.
- It shall be recognised in profit or loss when the asset is derecognised (unless Ind AS 17 requires otherwise on a sale and leaseback).
- Gains shall not be classified as revenue.

The disposal of an intangible asset may occur in a variety of ways:



In determining the date of disposal of such an asset, an entity applies the criteria in Ind AS 18, Revenue, for recognising revenue from the sale of goods. Ind AS 17 applies to disposal by a sale and leaseback.

Appendix A of Ind AS 38 provides guidance on whether the web site is an internally generated intangible asset that is subject to the requirements of Ind AS 38; and the appropriate accounting treatment of such expenditure. The Appendix prescribes that an entity's own web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of Ind AS 38. Any internal expenditure on the development and operation of an entity's own web site shall be accounted for in accordance with Ind AS 38. The nature of each activity for which expenditure is incurred (eg training employees and maintaining the web site) and the web site's stage of development or post-development shall be evaluated to determine the appropriate accounting treatment. A web site that is recognised as an intangible asset under this Appendix shall be measured after initial recognition by applying the requirements of paragraphs 72-87 of Ind AS 38. The best estimate of a web site's useful life should be short.

8.24.10 Major Change in Ind AS 38 vis-à-vis IAS* 38 Not Resulting in Carve Out

Intangible Assets acquired by way of Government Grant: With regard to the acquisition of an intangible asset by way of a government grant, IAS 38, Intangible Assets, provides the option to an entity to recognise both asset and grant initially at fair value or at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use. Ind AS 38 allows only fair value for recognising the intangible asset and grant in accordance with Ind AS 20.

8.24.11 Major Changes in Ind AS 38 vis a vis Notified AS 26

(i) ***Exclusions:*** The existing standard (paragraph 5), does not apply to accounting issues of specialised nature that arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Ind AS 38 does not include any such exclusion specifically as these are covered by other accounting standards.

Ind AS 38 contains a scope exclusion with regard to the amortisation method for intangible assets arising from service concession arrangements in respect of toll roads recognised in the financial statements before the beginning of the first Ind AS financial reporting period as per the previous GAAP, i.e., Schedule II to the Companies Act, 2013.

(ii) ***Definition of Intangible Assets:*** The existing standard defines an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes whereas in Ind AS 38, the requirement for the asset to be held for use in the production or supply

* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

of goods or services, for rental to others, or for administrative purposes has been removed from the definition of an intangible asset.

(iii) ***Identifiability:*** The existing standard does not define 'identifiability', but states that an intangible asset could be distinguished clearly from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability. Ind AS 38 provides detailed guidance in respect of identifiability.

(iv) ***Separately Acquired Intangible Assets:*** As per Ind AS 38, in the case of separately acquired intangibles, the criterion of probable inflow of expected future economic benefits is always considered satisfied, even if there is uncertainty about the timing or the amount of the inflow. However, there is no such provision in the existing standard.

(v) ***Revenue Based Amortisation Method:*** In Ind AS 38 there is a rebuttable presumption that an amortisation method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. Ind AS 38 allows use of revenue based method of amortisation of intangible asset, in a limited way. Existing AS 26 does not specifically deal with revenue based amortisation method.

(vi) ***Payment Deferred beyond Normal Credit Terms:*** Under Ind AS 38, if payment for an intangible asset is deferred beyond normal credit terms, the difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised as per Ind AS 23. However, there is no such provision in the existing standard.

(vii) ***Intangible Assets acquired in Business Combination:*** Ind AS 38 deals in detail in respect of intangible assets acquired in a business combination. On the other hand, the existing standard refers only to intangible assets acquired in an amalgamation in the nature of purchase and does not refer to business combinations as a whole.

(viii) ***Subsequent Expenditure on in Process Research and Development Project:*** The existing standard is silent regarding the treatment of subsequent expenditure on an in-process research and development project acquired in a business combination whereas Ind AS 38 gives guidance for the treatment of such expenditure

(ix) ***Intangible Assets Acquired in Exchange:*** Ind AS 38 requires that if an intangible asset is acquired in exchange of a non-monetary asset, it should be recognised at the fair value of the asset given up unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. However, the existing standard requires the principles of existing AS 10 to be followed which require that when an asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration also.

(x) ***Intangible Assets acquired Free of Charge or for a Nominal Consideration by way of Government Grant:*** As per Ind AS 38, when intangible assets are acquired free of charge or for nominal consideration by way of government grant, an entity should, in accordance with Ind AS 20, record both the grant and the intangible asset at fair value. As per the existing standard, intangible assets acquired free of charge or for nominal consideration by way of government grant is recognised at nominal value or at acquisition cost, as appropriate plus any expenditure that is attributable to making the asset ready for intended use.

(xi) ***Useful Life of an Intangible Asset:*** The existing standard is based on the assumption that the useful life of an intangible asset is always finite, and includes a rebuttable presumption that the useful life cannot exceed ten years from the date the asset is available for use. That rebuttable presumption is not there in Ind AS 38. Ind AS 38 recognizes that the useful life of an intangible asset can even be indefinite subject to fulfillment of certain conditions, in which case it should not be amortised but should be tested for impairment.

(xii) ***Guidance on Certain Issues:*** In Ind AS 38, guidance is available on cessation of capitalisation of expenditure, de-recognition of a part of an intangible asset and useful life of a reacquired right in a business combination. There is no such guidance in the existing standard on these aspects.

(xiii) ***Valuation Model as Accounting Policy:*** Ind AS 38 permits an entity to choose either the cost model or the revaluation model as its accounting policy, whereas in the existing standard, revaluation model is not permitted.

(xiv) ***Intangible Assets recognised as an Expense:*** Ind AS 38 provides more guidance on recognition of intangible items recognised as expense. Ind AS 38 clarifies that in respect of prepaid expenses, recognition of an asset would be permitted only upto the point at which the entity has the right to access the goods or upto the receipt of services. Further, unlike the existing standard, mail order catalogues have been specifically identified as a form of advertising and promotional activities which are required to be expensed.

(xv) ***Contractual or Legal Rights may be Shorter than Legal Life:*** Ind AS 38 acknowledges that the useful life of an intangible asset arising from contractual or legal rights maybe shorter than the legal life. The existing standard does not include such a provision.

(xvi) ***Amortisation Lower than under SLM:*** As per the existing standard, there will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under straight-line method. Ind AS 38 does not contain any such provision.

(xvii) ***Subsequent Increase of Residual Value for Changes in Prices or Value:*** Under Ind AS 38, the residual value is reviewed at least at each financial year-end. If it increases to an amount equal to or greater than the asset's carrying amount, amortisation charge is zero unless the residual value subsequently decreases to an amount below the asset's carrying amount. However, the existing standard specifically requires that the residual value is not subsequently increased for changes in prices or value.

(xviii) ***Change in Method of Amortization:*** As per the existing standard, change in the method of amortisation is a change in accounting policy whereas as per Ind AS 38, this would be a change in accounting estimate.

(xix) *Annual Impairment Testing:* The existing standard also requires annual impairment testing of an intangible asset not yet available for use. There is no such requirement in Ind AS 38.

(xx) *Disclosures:* Ind AS 38 also requires certain additional disclosures as compared to existing AS 26.

(xxi) *Intangible Assets Retired from Use and Held for Sale:* Intangible assets retired from use and held for sale are covered by the existing standard. However, Ind AS 38 does not include such intangible assets since they would be covered by Ind AS 105.

8.25 Ind AS 40 : Investment Property

8.25.1 Objective

The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

8.25.2 Scope

This Standard shall be applied in the recognition, measurement and disclosure of investment property.

Among other things, this Standard applies to

This Standard does not deal with matters covered in Ind AS 17 'Leases'.

This Standard does not apply to:

1. • Biological assets related to agricultural activity (Ind AS 41)
2. • Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

8.25.3 Investment Property and Owner Occupied Property

Investment property is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes; or

(b) sale in the ordinary course of business.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

CASE STUDY

S.No.	Property	Does it meet definition of Investment Property	Which Ind AS is Applicable
1.	Owned by a Company and leased out under an Operating Lease	Yes	Ind AS 40
2.	Held Under Finance Lease and Leased out under an Operating Lease	Yes	Ind AS 40
3.	Held under Finance Lease and Leased out under Finance Lease	No	Ind AS 17
4.	Property acquired with a view for development and resale	No	Ind AS 2
5.	Property developed on behalf of 3rd party	No	Ind AS 11
6.	Property partly owner occupied and partly leased out under Operating Lease	Depends	Ind AS 16 Ind AS 40
7.	Land held for currently undetermined use	Yes	Ind AS 40
8.	Property occupied by Employees paying rent at less than market rate	No	Ind AS 16
9.	Investment Property held for sale	No	Ind AS 105
10.	Existing Investment Property that is being redeveloped for continued use as Investment Property	Yes	Ind AS 40

8.25.4 Recognition

Investment property shall be recognised as an asset **when, and only when:**

(a) it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

(b) the cost of the investment property can be measured reliably.

An entity evaluates under this recognition principle all its investment property costs at the time they are incurred. These costs include

Costs incurred initially to acquire an investment property and Costs incurred subsequently to add to, replace part of, or service a property.	Under the recognition principle, an entity does not recognise in the carrying amount of an investment property the costs of the day-to-day servicing of such a property. Rather, these costs are recognised in profit or loss as incurred. *

*Costs of day-to-day servicing are primarily the cost of labour and consumables, and may include the cost of minor parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the property.

8.25.5 Measurement at Recognition

An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.

Purchase Price

Any directly attributable expenditure

Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

The cost of an investment property is **not increased by:**

(a) start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),

(b) operating losses incurred before the investment property achieves the planned level of occupancy, or

(c) abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease by paragraph 20 of Ind AS 17, ie the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability in accordance with that same paragraph.

8.25.6 Measurement After Recognition

Accounting policy: An entity shall adopt as its accounting policy the **cost model** to all of its investment property. However, the Standard requires all entities to measure the fair value of investment property, for the purpose of disclosure.

After initial recognition, an entity shall measure all of its investment properties in accordance with Ind AS 16's requirements for cost model, other than those that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) in accordance with Ind AS 105, '*Non-current Assets Held for Sale and Discontinued Operations*'. Investment properties that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) shall be measured in accordance with Ind AS 105.

8.25.7 Transfers

Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:

(a) commencement of owner-occupation, for a transfer from investment property to owner-occupied property;

(b) commencement of development with a view to sale, for a transfer from investment property to inventories;

(c) end of owner-occupation, for a transfer from owner-occupied property to investment property; or

(d) commencement of an operating lease to another party, for a transfer from inventories to investment property.

CASE STUDY

S. No.	Property	Transfer from to
1.	Office space previously rented to a third party, now the entity would use for its own	Investment Property to Owner Occupied
2.	Real Estate Company had a building given on rent for residential purpose. After 8 years the Company decides to build Commercial complex to sell	Investment Property to Inventory
3.	Building used as corporate office was vacated for an office in a better location	Owner Occupied to Investment Property
4.	Real Estate Company decides not to sell a building and give it on operating lease to a third party	Inventory to Investment Property

8.25.8 Disposals

1. An investment property shall be derecognised (eliminated from the balance sheet)
   - on disposal or
   - when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.
2. The disposal of an investment property may be achieved
   - by sale or
   - by entering into a finance lease.

In determining the date of disposal for investment property, an entity applies the criteria in Ind AS 18 for recognising revenue from the sale of goods. Ind AS 17 applies to a disposal effected by entering into a finance lease and to a sale and leaseback.

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss (unless Ind AS 17 requires otherwise on a sale and leaseback) in the period of the retirement or disposal.

The consideration receivable on disposal of an investment property is recognized initially at fair value. In particular, if payment for an investment property is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with Ind AS 18 using the effective interest method.

8.25.9 Major Changes in Ind AS 40 vis-à-vis IAS* 40 Not Resulting in Carve Outs

1. ***Valuation Models:*** IAS 40 permits both cost model and fair value model (except in some situations) for measurement of investment properties after initial recognition. Ind AS 40 permits only the cost model. Fair value model is not permitted because the unrealised gain and losses would have been required to be recognised in the statement of profit and loss. The fair value of investment property in India is not reliable and also using fair value model may lead to recognition and distribution of unrealised gains.

2. ***Operating Lease:*** IAS 40 permits treatment of property interest held in an operating lease as investment property, if the definition of investment property is otherwise met and fair value model is applied. In such cases, the operating lease would be accounted as if it were a finance lease. Since Ind AS 40 prohibits the use of fair value model, this treatment is prohibited in Ind AS 40. Also the expression 'investment property under a finance or operating lease' appearing in IAS 40 has been modified as 'investment property under finance lease' in Ind AS 40.

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* The term 'IFRS' includes not only the International Financial Reporting Standards (IFRSs) issued by the IASB, it also includes the International Accounting Standards (IASs), IFRICs and SICs.

8.25.10 Major Changes in Ind AS 40 *vis-a-vis* Notified AS 13

AS 13 provides limited guidance on investment properties, as per the existing standard enterprise holding investment properties should account for them as per cost model prescribed in AS 10, Property, Plant and Equipment. However, Ind AS 40 is a detailed standard dealing with various aspects of investment property accounting.

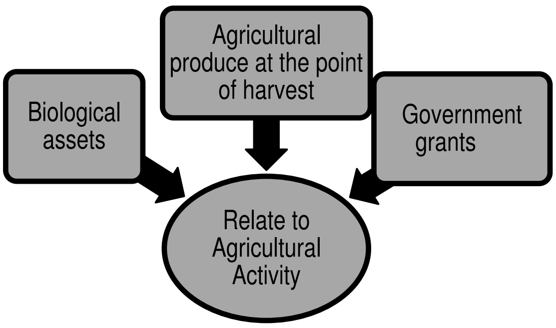
8.26 Ind AS 41 : Agriculture

8.26.1 Objective

The objective of Ind AS 41 is to prescribe the accounting treatment and disclosures related to agricultural activity.

8.26.2 Scope

This Standard shall be applied to account for the following when they relate to agricultural activity:



This Standard **does not apply to:**

1.
   - Land related to agricultural activity
   - Ind AS 16 'Property, Plant and Equipment' and Ind AS 40 'Investment Property'
2.
   - Bearer plants related to agricultural activity (Ind AS 16)
   - However, this Standard applies to the produce on those bearer plants
3.
   - Government grants related to bearer plants
   - Ind AS 20 'Accounting for Government Grants and Disclosure of Government Assistance'
4.
   - Intangible assets related to agricultural activity
   - Ind AS 38 'Intangible Assets'

Table below provides examples of biological assets, agricultural produce, and products that are the result of processing after harvest:

Biological assets	Agricultural produce	Products that are the result of processing after harvest
Sheep	Wool	Yarn, carpet
Trees in a timber plantation	Felled Trees	Logs, lumber
Dairy Cattle	Milk	Cheese
Pigs	Carcass	Sausages, cured hams
Cotton plants	Harvested cotton	Thread, clothing
Sugarcane	Harvested cane	Sugar
Tobacco plants	Picked leaves	Cured tobacco
Tea bushes	Picked leaves	Tea
Grape vines	Picked grapes	Wine
Fruit trees	Picked fruit	Processed fruit
Oil palms	Picked fruit	Palm oil
Rubber trees	Harvested latex	Rubber products

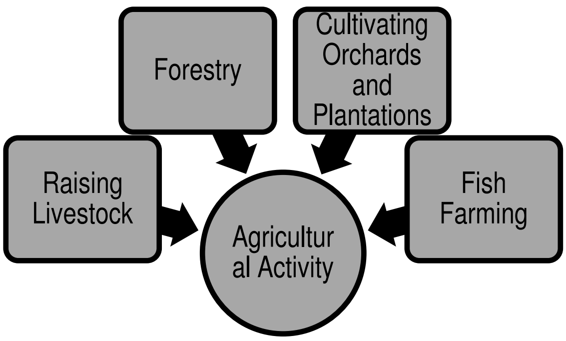
Some plants, for example, tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of Ind AS 16.

However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, is within the scope of Ind AS 41.

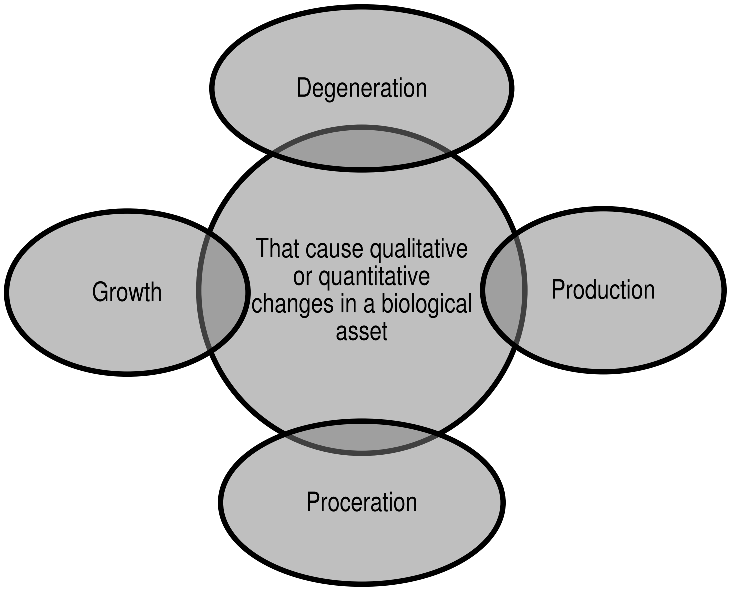
8.26.3 Agriculture Related Definitions

1. **Agricultural activity:**
   - Is the management by an entity of the biological transformation and harvest of biological asset.
   - for sale or for conversion into agricultural produce or into additional biological assets.

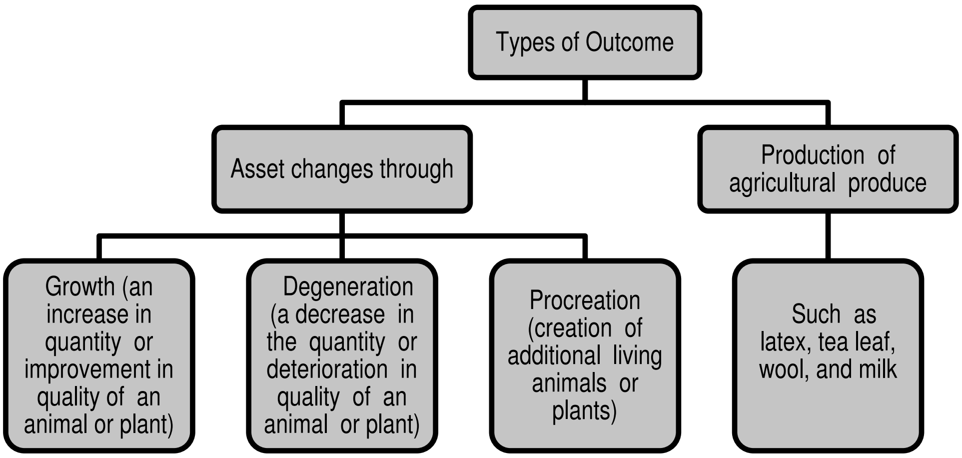
   Agricultural activity covers a diverse range of activities.



Biological transformation comprises the processes of:



Biological transformation results in the following types of outcomes:



2. A **biological asset** is a:
   - Living animal; **Or**
   - Plant.

   A group of biological assets is an aggregation of similar living animals or plants.
3. **Agricultural produce** is the harvested product of the entity's biological assets.
4. **Harvest** is the:
   - Detachment of produce from a biological asset; Or
   - The cessation of a biological asset's life processes.

5. A **bearer plant** is a living plant that:

- Is used in the production or supply of agricultural produce
- Is expected to bear produce for more than one period
- Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales

The following are **NOT** bearer plants:

Not Bearer Plant

- Plants cultivated to be harvested as agricultural produce
  - Example: Trees grown for use as lumber
- Annual crops
  - Example: Maize and wheat
- Plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales
  - Example: Trees that are cultivated both for their fruit and their lumber

When bearer plants are no longer used to bear produce they might be cut down and sold as scrap, for example, for use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant.

Produce growing on bearer plants is a biological asset.

8.26.4 Recognition and Measurement

An entity shall recognise a biological asset or agricultural produce when, and only when:

- The entity controls the asset as a result of past events
- It is probable that future economic benefits associated with the asset will flow to the entity
- The fair value or cost of the asset can be measured reliably

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Costs to sell exclude transport and other costs necessary to get the asset to a market.

A biological asset shall be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell, except for the case described in paragraph 30 where the fair value cannot be measured reliably.

Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest. Such measurement is the cost at that date when applying Ind AS 2 'Inventories' or another applicable Standard.

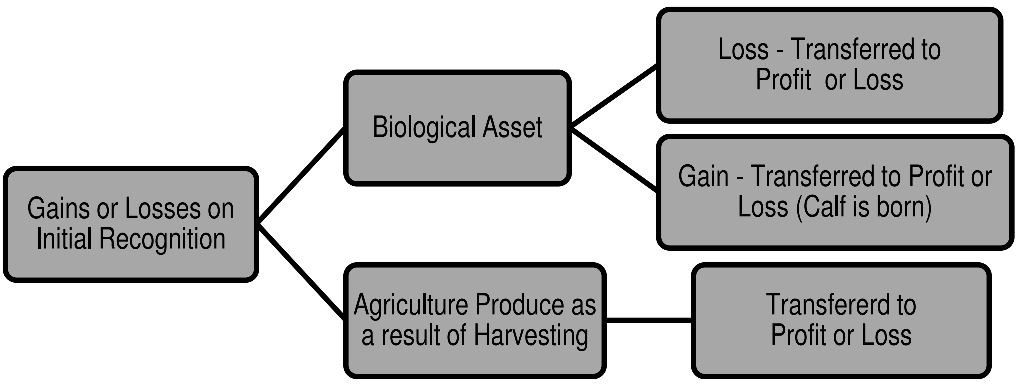
8.26.4.1 Gains and Losses

On Biological Asset: A gain or loss arising on initial recognition of a biological asset at fair value less costs to sell and from a change in fair value less costs to sell of a biological asset shall be included in profit or loss for the period in which it arises.

A loss may arise on initial recognition of a biological asset, because costs to sell are deducted in determining fair value less costs to sell of a biological asset. A gain may arise on initial recognition of a biological asset, such as when a calf is born.

On Agricultural Produce: A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in profit or loss for the period in which it arises.

A gain or loss may arise on initial recognition of agricultural produce as a result of harvesting.



8.26.5 Government Grants

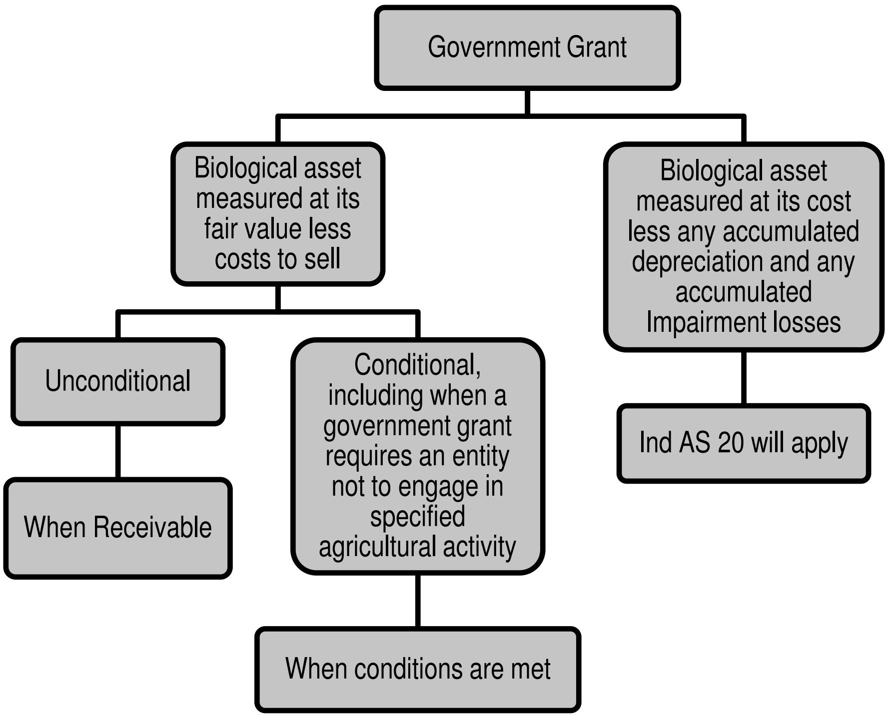
An unconditional government grant related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when, and only when, the government grant becomes receivable.

If a government grant related to a biological asset measured at its fair value less costs to sell is conditional, including when a government grant requires an entity not to engage in specified agricultural activity, an entity shall recognise the government grant in profit or loss when, and only when, the conditions attaching to the government grant are met.

For example: A grant may require an entity to farm in a particular location for five years and require the entity to return all of the grant if it farms for a period shorter than five years. In this case, the grant is not recognised in profit or loss until the five years have passed. However, if the terms of the grant allow part of it to be retained according to the time that has elapsed, the entity recognises that part in profit or loss as time passes.

If a government grant relates to a biological asset measured at its cost less any accumulated depreciation and any accumulated Impairment losses, Ind AS 20 is applied.

This Standard requires a different treatment from Ind AS 20, if a government grant relates to a biological asset measured at its fair value less costs to sell or a government grant requires an entity not to engage in specified agricultural activity. Ind AS 20 is applied only to a government grant related to a biological asset measured at its cost less any accumulated depreciation and any accumulated impairment losses.



8.27 Ind AS 101: First time Adoption of Indian Accounting Standards

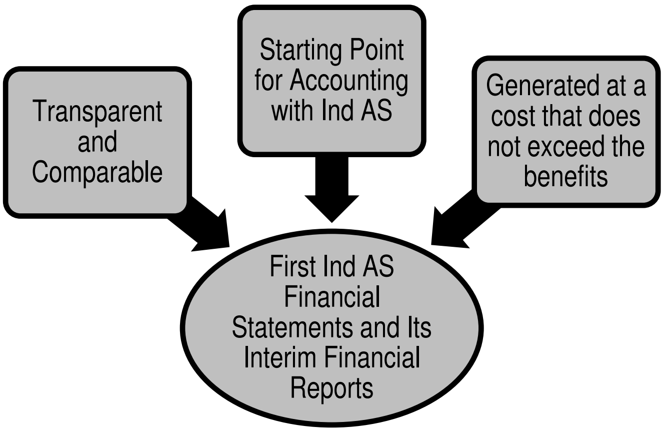
8.27.1 Objective

The objective of this Ind AS is to ensure that an entity's first Ind AS financial statements, and its interim financial reports for part of the period covered by those financial statements contain high quality information that:

(a) is transparent for users and comparable over all periods presented;

(b) provides a suitable starting point for accounting in accordance with Ind AS; and

(c) can be generated at a cost that does not exceed the benefits.



8.27.2 Scope

An entity shall apply this Ind AS in:

(a) its first Ind AS financial statements; and

(b) each interim financial report, if any, that it presents in accordance with Ind AS 34, 'Interim Financial Reporting', for part of the period covered by its first Ind AS financial statements.

An entity's first Ind AS financial statements are the first annual financial statements in which the entity adopts Ind AS, in accordance with Ind AS notified under the Companies Act, 2013 and makes ***an explicit and unreserved statement*** in those financial statements of compliance with Ind AS.

8.27.3 Recognition and Measurement

Opening Ind AS Balance Sheet: An entity shall prepare and present an opening Ind AS Balance Sheet at the date of transition to Ind AS. This is the starting point for its accounting in accordance with Ind AS.

An entity shall, in its opening Ind AS Balance Sheet:

(a) recognise all assets and liabilities whose recognition is required by Ind AS;

(b) not recognise items as assets or liabilities if Ind AS do not permit such recognition;

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with Ind AS; and

(d) apply Ind AS in measuring all recognised assets and liabilities.

Accounting Policies: An entity shall use the same accounting policies in its opening Ind AS Balance Sheet and throughout all periods presented in its first Ind AS financial statements. The accounting policies in opening Ind AS Balance Sheet may differ from those that it used for the same date using previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to Ind AS shall be recognised directly in retained earnings.

Those accounting policies shall comply with each Ind AS effective at the end of its first Ind AS reporting period, subject to:

- Mandatory Exceptions
- Optional Exemptions

This Ind AS establishes two categories of exceptions to the principle that an entity's opening Ind AS Balance Sheet shall comply with each Ind AS:

- Ind AS 101 prohibit retrospective application of some specific aspects of other Ind AS.
- Ind AS 101 grant exemptions from some specific requirements of other Ind AS.

8.27.4 Exceptions to the Retrospective Application of Other Ind AS

This Ind AS prohibits retrospective application of some aspects of other Ind AS. These exceptions are as under:

8.27.4.1 Mandatory Exceptions

1. ***Estimates:*** An entity's estimates in accordance with Ind AS at the date of transition to Ind AS shall be consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

2. ***Derecognition of Financial Assets or Financial Liabilities:*** A first-time adopter shall apply the derecognition requirements in Ind AS 109 prospectively for transactions occurring on or after the date of transition to Ind AS.

3. ***Hedge Accounting:*** An entity shall not reflect in its opening Ind AS Balance Sheet a hedging relationship of a type that does not qualify for hedge accounting in accordance with Ind AS 109.

4. ***Non-controlling Interests:*** A first-time adopter shall apply the following requirements of Ind AS 110 prospectively from the date of transition to Ind AS:

   (a) Total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

(b) Accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and

(c) Accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of Ind AS 105, *'Non-current Assets Held for Sale and Discontinued Operations'*.

5. ***Classification and Measurement of Financial Assets**:* An entity shall assess whether a financial asset meets the conditions in paragraph 4.1.2 or the conditions in paragraph 4.1.2A of Ind AS 109 on the basis of the facts and circumstances that exist at the date of transition to Ind AS.

6. ***Impairment of Financial Assets:*** An entity should seek to approximate the credit risk on initial recognition by considering all reasonable and supportable information that is available without undue cost or effort.

   An entity is not required to undertake an exhaustive search for information when determining, at the date of transition to Ind AS, whether there have been significant increases in credit risk since initial recognition. If an entity is unable to make this determination without undue cost or effort paragraph B8G of this Ind AS applies.

7. ***Embedded Derivatives:*** A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date of a reassessment.

8. ***Government Loans:*** A first-time adopter shall classify all government loans received as a financial liability or an equity instrument in accordance with Ind AS 32.

8.27.4.2 Optional Exemptions

1. ***Exemptions for Business Combinations:*** A first-time adopter may elect not to apply Ind AS 103 retrospectively to past business combinations (business combinations that occurred before the date of transition to Ind AS).

   However, if a first-time adopter restates any business combination to comply with Ind AS 103, it shall restate all later business combinations and shall also apply Ind AS 110 from that same date.

2. ***Share-based Payment Transactions:*** A first-time adopter is encouraged, but not required, to apply Ind AS 102 '*Share-based Payment'* to equity instruments that vested before date of transition to Ind AS.

3. ***Insurance Contracts:*** An entity shall apply Ind AS 104 *'Insurance Contracts'* for annual periods beginning on or after date of transition to Ind AS. Earlier application is encouraged. If an entity applies this Ind AS 104 for an earlier period, it shall disclose that fact.

4. ***Deemed Cost:*** An entity may elect to measure an item of property, plant and equipment or an intangible asset at the date of transition to Ind AS at its fair value and use that fair value as its deemed cost at that date.

A first-time adopter may elect to use a previous GAAP revaluation of an item of property, plant and equipment or an intangible asset at, or before, the date of transition to Ind AS as deemed cost at the date of the revaluation, if the revaluation was, at the date of the revaluation, broadly comparable to:

(a) fair value; or

(b) cost or depreciated cost in accordance with Ind AS, adjusted to reflect, for example, changes in a general or specific price index.

5. ***Leases:*** A first-time adopter may apply paragraphs 6-9 of the Appendix C of Ind AS 17 Determining whether an Arrangement contains a Lease to determine whether an arrangement existing at the date of transition to Ind AS contains a lease on the basis of facts and circumstances existing at the date of transition to Ind AS, except where the effect is expected to be not material.

6. ***Cumulative Translation Differences:*** Ind AS 21 requires an entity:

(a) to recognise some translation differences in other comprehensive income and accumulate these in a separate component of equity; and

(b) on disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation (including, if applicable, gains and losses on related hedges) from equity to profit or loss as part of the gain or loss on disposal.

However, a first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to Ind AS. If a first-time adopter uses this exemption:

(a) the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to Ind AS; and

(b) the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to Ind AS and shall include later translation differences.

7. ***Long-term Foreign Currency Monetary Items;*** A first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

8. ***Investments in Subsidiaries, Joint Ventures and Associates:*** When an entity prepares separate financial statements, Ind AS 27 requires it to account for its investments in subsidiaries, joint ventures and associates either:

(a) at cost; or

(b) in accordance with Ind AS 109.

If a first-time adopter measures such an investment at cost in accordance with Ind AS 27, it shall measure that investment at one of the following amounts in its separate opening Ind AS Balance Sheet:

(a) cost determined in accordance with Ind AS 27; or

(b) deemed cost. The deemed cost of such an investment shall be its:

(i) fair value at the entity's date of transition to Ind AS in its separate financial statements; or

(ii) previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, joint venture or associate that it elects to measure using a deemed cost.

9. ***Assets and Liabilities of Subsidiaries, Associates and Joint ventures:*** If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:

(a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to Ind AS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this election is not available to a subsidiary of an investment entity, as defined in Ind AS 110, that is required to be measured at fair value through profit or loss); or

(b) the carrying amounts required by the rest of this Ind AS, based on the subsidiary's date of transition to Ind AS. These carrying amounts could differ from those described in (a):

(i) when the exemptions in this Ind AS result in measurements that depend on the date of transition to Ind AS.

(ii) when the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in Ind AS 16 *'Property, Plant and Equipment'*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

10. ***Compound Financial Instruments:*** Ind AS 32 *'Financial Instruments: Presentation'* requires an entity to split a compound financial instrument at inception into separate liability and equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component.

However, in accordance with this Ind AS, a first-time adopter need not separate these two portions if the liability component is no longer outstanding at the date of transition to Ind AS.

11. ***Designation of previously recognised Financial Instruments:*** Ind AS 109 permits a financial liability (provided it meets certain criteria) to be designated as a financial liability at fair value through profit or loss. Despite this requirement an entity is permitted to designate, at the date of transition to Ind AS, any financial liability as at fair value through profit or loss provided the liability meets the criteria in paragraph 4.2.2 of Ind AS 109 at that date.

12. ***Fair Value Measurement of Financial Assets or Financial Liabilities at Initial Recognition:*** Despite the requirements of paragraphs 7 and 9 of this Ind AS, an entity may apply the requirements of Ind AS 109 prospectively to transactions entered into on or after the date of transition to Ind AS.

13. ***Decommissioning Liabilities included in the Cost of Property, Plant and Equipment:*** A first-time adopter need not comply with these requirements for changes in such liabilities that occurred before the date of transition to Ind AS. If a first-time adopter uses this exemption, it shall:

    (a) measure the liability as at the date of transition to Ind AS in accordance with Ind AS 37;

    (b) to the extent that the liability is within the scope of Appendix A of Ind AS 16, estimate the amount that would have been included in the cost of the related asset when the liability first arose, by discounting the liability to that date using its best estimate of the historical risk-adjusted discount rate(s) that would have applied for that liability over the intervening period; and

    (c) calculate the accumulated depreciation on that amount, as at the date of transition to Ind AS, on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity in accordance with Ind AS.

14. ***Financial assets or intangible assets accounted for in accordance with Appendix A, Service Concession Arrangements to Ind AS 11:*** D22 A first-time adopter may apply the following provisions while applying the Appendix A to Ind AS 11:

    (a) Subject to paragraph (ii), changes in accounting policies are accounted for in accordance with Ind AS 8, i.e. retrospectively, except for the policy adopted for amortization of intangible assets arising from service concession arrangements related to toll roads recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP.

    (b) If, for any particular service arrangement, it is impracticable for an operator to apply this Appendix retrospectively at the date of transition to Ind AS, it shall:

        (i) recognise financial assets and intangible assets that existed at the date of transition to Ind AS;

        (ii) use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date; and

(iii) test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

(c) There are two aspects to retrospective determination: reclassification and remeasurement. It will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in an operator's Balance Sheet, but that retrospective remeasurement of service arrangement assets might not always be practicable. However, the fact should be disclosed.

15. ***Extinguishing Financial Liabilities with Equity Instruments:*** A first-time adopter may apply the Appendix E of Ind AS 109 Extinguishing Financial Liabilities with Equity Instruments from the date of transition to Ind AS.

16. ***Severe Hyperinflation:*** If an entity has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of transition to Ind AS. This applies to entities that are adopting Ind AS for the first time, as well as entities that have previously applied Ind AS.

17. ***Joint Ventures - Transition from Proportionate Consolidation to the Equity Method:*** When changing from proportionate consolidation to the equity method, an entity shall recognise its investment in the joint venture at transition date to Ind AS. That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any goodwill arising from acquisition. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the relative carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged.

18. ***Joint Operations—Transition from the Equity Method to Accounting for Assets and Liabilities:*** When changing from the equity method to accounting for assets and liabilities in respect of its interest in a joint operation, an entity shall, at the date of transition to Ind AS, derecognise the investment that was previously accounted for using the equity method and any other items that formed part of the entity's net investment in the arrangement in accordance with paragraph 38 of Ind AS 28 and recognise its share of each of the assets and the liabilities in respect of its interest in the joint operation, including any goodwill that might have formed part of the carrying amount of the investment.

19. ***Transition Provisions in an Entity's Separate Financial Statements:*** An entity that, in accordance with paragraph 10 of Ind AS 27, was previously accounting in its separate financial statements for its interest in a joint operation as an investment at cost or in accordance with Ind AS 109 shall:

(a) derecognise the investment and recognise the assets and the liabilities in respect of its interest in the joint operation at the amounts determined.

(b) provide a reconciliation between the investment derecognised, and the assets and liabilities recognised, together with any remaining difference adjusted in retained earnings, at the date of transition to Ind AS.

20. ***Stripping Costs in the Production Phase of a Surface Mine:*** A first-time adopter may apply the Appendix B of Ind AS 16 Stripping Costs in the Production Phase of a Surface Mine from the date of transition to Ind AS. As at transition date to Ind AS, any previously recognised asset balance that resulted from stripping activity undertaken during the production phase ('predecessor stripping asset') shall be reclassified as a part of an existing asset to which the stripping activity related, to the extent that there remains an identifiable component of the ore body with which the predecessor stripping asset can be associated. Such balances shall be depreciated or amortised over the remaining expected useful life of the identified component of the ore body to which each predecessor stripping asset balance relates. If there is no identifiable component of the ore body to which that predecessor stripping asset relates, it shall be recognised in opening retained earnings at the transition date to Ind AS.

21. ***Designation of Contracts to Buy or Sell a Non-financial Item:*** Ind AS 109 permits some contracts to buy or sell a non-financial item to be designated at inception as measured at fair value through profit or loss (Ind AS 109). Despite this requirement an entity is permitted to designate, at the date of transition to Ind AS, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the requirements of paragraph 2.5 of Ind AS 109 at that date and the entity designates all similar contracts.

22. ***Non-current Assets Held for Sale and Discontinued Operations:*** Ind AS 105 requires non-current assets (or disposal groups) that meet the criteria to be classified as held for sale, non-current assets (or disposal groups) that are held for distribution to owners and operations that meet the criteria to be classified as discontinued and carried at lower of its carrying amount and fair value less cost to sell on the initial date of such identification. A first time adopter can:

(a) measure such assets or operations at the lower of carrying value and fair value less cost to sell at the date of transition to Ind AS in accordance with Ind AS 105; and

(b) recognise directly in retained earnings any difference between that amount and the carrying amount of those assets at the date of transition to Ind AS determined under the entity's previous GAAP.

23. ***Transfers of Assets from Customers:*** An entity shall apply Appendix C of Ind AS 18 prospectively to transfers of assets from customers received on or after the transition date.

8.27.5 Presentation and Disclosure

The Standard does not provide exemptions from the presentation and disclosure requirements in other Ind AS. The Standard requires that an entity's first Ind AS financial statements shall include at least three Balance Sheets, two Statements of profit and loss, two Statements of cash flows and two Statements of changes in equity and related notes, including comparative information for all statements presented.

8.27.6 Explanation of Transition to Ind AS

The Standard requires that an entity shall explain how the transition from previous GAAP to Ind AS affected its reported balance sheet, financial performance and cash flows.

8.27.7 Reconciliation

An entity's first Ind AS financial statements shall include:

(a) reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with Ind AS for both of the following dates:

  (i) the date of transition to Ind AS; and

  (ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.

(b) a reconciliation to its total comprehensive income in accordance with Ind AS for the latest period in the entity's most recent annual financial statements.

(c) if the entity recognised or reversed any impairment losses for the first time in preparing its opening Ind AS Balance Sheet, the disclosures that Ind AS 36, *'Impairment of Assets'*, would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to Ind AS.

8.27.8 Major Changes in Ind AS 101 vis-à-vis IFRS 1

8.27.8.1 Resulting in Carve Outs

(i) *Definition of Previous GAAP under Ind AS 101*

***As per IFRS**:* IFRS 1 defines previous GAAP as the basis of accounting that a first-time adopter used immediately before adopting IFRS.

***Carve out**:* Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirement in India immediately before adopting Ind AS. The changes made it mandatory for Indian entities to consider the financial statements prepared in accordance with existing notified Accounting Standards as was applicable to them as previous GAAP when it transitions to Ind AS.

***Reason**:* The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with existing Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India recognises the financial statements prepared in accordance with the Companies Act.

(ii) *Allowing the use of Carrying Cost of Property, Plant and Equipment (PPE) on the Date of Transition of Ind AS 101.*

As per IFRS: IFRS 1 *First time adoption of International Accounting Standards* provides that on the date of transition either the items of Property, Plant and Equipment shall be determined by applying IAS 16 '*Property, Plant and Equipment'* retrospectively or the same should be recorded at fair value.

Carve out: Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

Reason: In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

(iii) ***Long-term Foreign Currency Monetary Items***

As per IFRS: No provision in IFRS 1.

Carve out: Paragraph D13AA of Appendix D to Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in paragraph D13AA of Appendix D to Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason: Para 46A of AS 11 provides an option to recognise long term foreign currency monetary items in the statement of profit and loss as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of First IFRS reporting period.

8.27.8.2 Not Resulting in Carve Outs

1. ***First Financial Statements:*** Paragraph 3 of Ind AS 101 specifies that an entity's first Ind AS financial statements are the first annual financial statements in which the entity adopts Ind AS in accordance with Ind AS notified under the Companies Act, 2013 whereas IFRS 1 provides various examples of first IFRS financial statements.
2. ***Examples when an Entity does not apply IFRS 1:*** IFRS 1 provide various examples of instances when an entity does not apply this IFRS. Ind AS 101 does not provide the same.
3. ***Previous GAAP:*** IFRS 1 requires the first-time adopter shall exclude from its opening Ind AS Balance Sheet any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under IFRS. The first-time adopter shall account for the resulting change in the retained earnings as at the transition date except in certain specific instances where it requires adjustment in the goodwill. In such specific instances where IFRS 1 allows adjustment in the goodwill, under Ind AS 101 it can be

adjusted with the Capital Reserve to the extent such adjustment amount does not exceed the balance available in Capital Reserve.

4. ***Optional Exemptions:*** IFRS 1 provides for various optional exemptions that an entity can seek while an entity transitions to IFRS from its previous GAAP. Similar provisions have been retained under Ind AS 101. However, there are few changes that have been made, which can be broadly categorized as follows:

   (a) *Elimination of Effective Dates Prior to Transition Date to Ind AS:* IFRS 1 provides for various dates from which a standard could have been implemented. For example, Paragraph D2 of IFRS 1 provides that an entity is encouraged, but not required, to apply IFRS 2 '*Share-based Payment'* to equity instruments that were granted on or before 7 November 2002 or to instruments that were granted after 7 November 2002 and vested before the later of (a) the date of transition to IFRS and (b) 1 January 2005. However, for Ind AS 101 purposes, all these dates have been changed to coincide with the transition date elected by the entity adopting these converged standards i.e. Ind AS.

   (b) *Deletion of Borrowing Cost Exemptions not relevant for India:* Paragraph D23 of IFRS 1 provides for transitional adjustment requiring companies to apply the provisions of IAS 23 prospectively after the transition date to IFRS. IAS 23 provided an option to expense out such borrowing cost. However, this paragraph has not been included in Appendix D of Ind AS 101 since this was considered as not relevant in Indian situation as existing Accounting Standard 16 always required an entity to capitalize borrowing costs.

5. ***Short-term Exemptions from IFRS:*** Appendix E of IFRS 1 provides for 'Short-term exemptions from IFRS', however Ind AS 101 does not provide the above said short-term exemption.

6. ***Consequential Amendments of Ind AS 109:*** The consequential amendments of Ind AS 109 '*Financial Instruments'*, which have been early adopted in India have been incorporated in all the Ind AS including Ind AS 101. Further, the transitional provisions of these Ind AS have also been appropriately incorporated in Ind AS 101.

7. ***Transitional Provisions:*** Paragraph D9AA of Ind AS 101 provides that when a lease includes both land and building elements, a first time adopter may assess the classification of each element as finance or an operating lease at the transition date to Ind AS on the basis of the facts and circumstances existing as at that date. If there is any land lease newly classified as finance lease then the first time adopter may recognise assets and liability at fair value on that date; any difference between those fair values is recognised in retained earnings.

8. ***Optional Exemptions relating to the Long-term Foreign Currency Monetary Items and Service Concession Arrangements relating to Toll Roads:*** Ind AS 101 in addition to exemptions provided under IFRS 1, also provides certain optional exemptions relating to the long-term foreign currency monetary items and service concession arrangements relating to toll roads.

9. ***Business Combinations:*** Under Ind AS 101, para C4(c) requires, the first-time adopter shall exclude from its opening Ind AS Balance Sheet any item recognised in accordance with previous GAAP that does not qualify for recognition as an asset or liability under Ind AS. The first-time adopter shall account for the resulting change in the retained earnings as at the transition date except in certain specific instances where it requires adjustment in the goodwill.

   In such specific instances where IFRS 1 allows adjustment in the goodwill, under Ind AS 101 it can be adjusted with the Capital reserve to the extent such adjustment amount does not exceed the balance available in Capital reserve.

10. ***Option to take Fair Value for Investment Property:*** Paragraph D7 (a) of IFRS 1 provides that option to take fair value at the date of transition to Ind AS or previous GAAP revalued amount may be exercised by a first item adopter for investment property. However, this option has not been provided under Ind AS 101, as Ind AS 40 permits only the cost model.

8.28 Ind AS 102 : Share-Based Payment

8.28.1 Objective

The objective of this Standard is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.

8.28.2 Scope

An entity shall apply this Standard in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including:

- Equity-settled share-based payment transactions
- Cash-settled share-based payment transactions
- Transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments

Not applicable to:

- Transactions in which the entity acquires goods as part of the net assets acquired in a business combination as defined by Ind AS 103, *'Business Combinations'*.

- This Standard does not apply to share-based payment transactions in which the entity receives or acquires goods or services under a contract within the scope of Ind AS 32, *'Financial Instruments: Presentation'*, Ind AS 109, *'Financial Instruments'*.

For the purposes of this Standard, a transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction.

8.28.3 Share-based Payment Transaction

A transaction in which the entity:

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

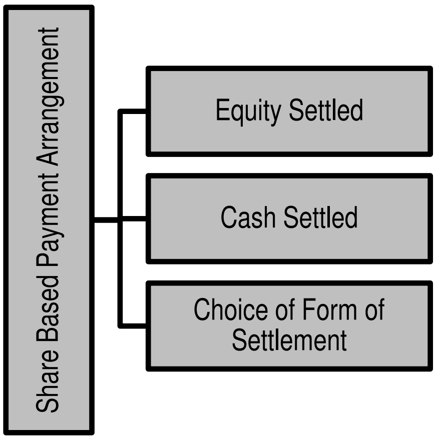
(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Share-based Payment Arrangement

An agreement between the entity (or another group entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) equity instruments (including shares or share options) of the entity or another group entity, provided the specified vesting conditions, if any, are met.



1. **Equity-settled Share-based Payment Transaction:** A share-based payment transaction in which the entity:

   (a) receives goods or services as consideration for its own equity instruments (including shares or share options), or

   (b) receives goods or services but has no obligation to settle the transaction with the supplier.

2. **Cash-settled Share-based Payment Transaction:** A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

8.28.4 Recognition

- An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received.
- The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.
- When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses.

8.28.5 Equity-settled Share-based Payment Transactions

For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

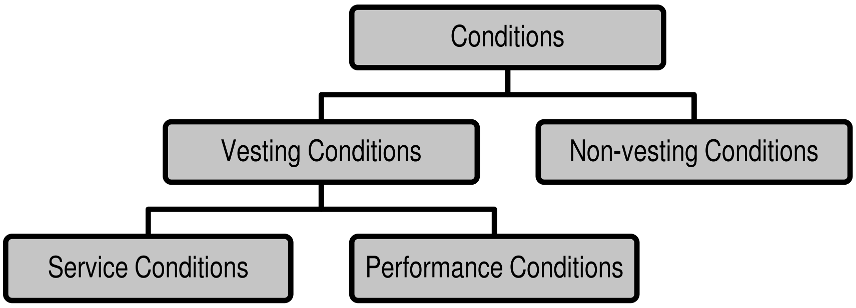
8.28.5.1 Transactions with Employees and Others providing similar Services

- The entity shall measure the fair value of the services received by reference to the fair value of the equity instruments granted, because typically it is not possible to estimate reliably the fair value of the services received.
- The fair value of those equity instruments shall be measured at grant date.

8.28.5.2 Transactions with Non-employees

- For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. In other words, there shall be a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.
- If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

8.28.6 Treatment of Vesting Conditions



8.28.6.1 Treatment of Vesting Conditions

- Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date.
- Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest.

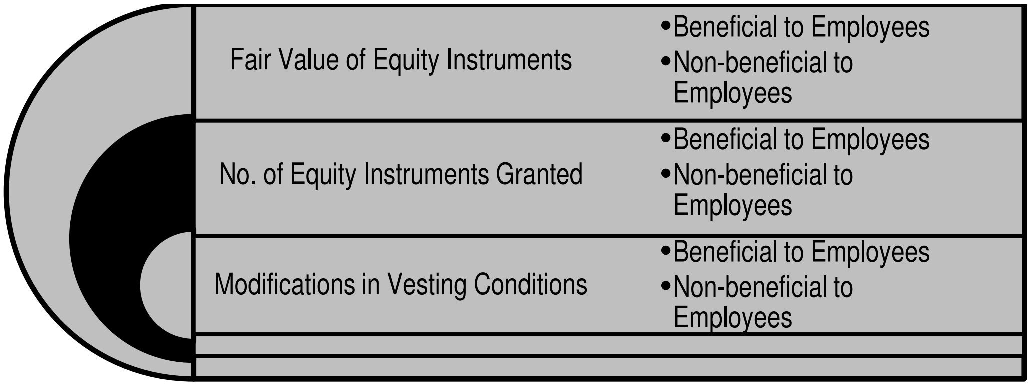
8.28.6.2 Treatment of Non-vesting Conditions

Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted.

Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.

8.28.7 Modifications to the Terms and Conditions on which Equity Instruments were granted, including Cancellations and Settlements

An entity might modify the terms and conditions on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.



8.28.7.1 Fair Value

1. **Increases (Beneficial to Employees):** If the modification increases the fair value of the equity instruments granted (e.g. by reducing the exercise price), measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the equity instruments granted. The incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the modification.
2. **Decreases (Non-beneficial to Employees):** If the modification reduces the fair value of the equity instruments granted, measured immediately before and after the modification, the entity shall not take into account that decrease in fair value and shall continue to measure the amount recognised for services received as consideration for the equity instruments based on the grant date fair value of the equity instruments granted.

8.28.7.2 Number of Equity Instruments Granted

1. **Increases (Beneficial to Employees):** If the modification increases the number of equity instruments granted, the entity shall include the fair value of the additional equity instruments granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the equity instruments granted.
2. **Decreases (Non-beneficial to Employees):** If the modification reduces the number of equity instruments granted to an employee, that reduction shall be accounted for as a cancellation of that portion of the grant.

8.28.7.3 Vesting Conditions

1. **Increases (Beneficial to Employees):** If the entity modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition), the entity shall take the modified vesting conditions into account.
2. **Decreases (Non-beneficial to Employees):** If the entity modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting

period or by modifying or adding a performance condition (other than a market condition), the entity shall not take the modified vesting conditions into account.

8.28.7.4 Cancellation/Settlement: If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, i.e. as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall re-measure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

(c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments.

    The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted.

    The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.

8.28.8 Cash-settled Share-based Payment Transactions

For cash-settled share-based payment transactions, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity shall re-measure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period.

8.28.9 Share-based Payment Transactions with Cash Alternatives

For share-based payment transactions in which the terms of the arrangement provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments, the entity shall account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash or other assets, or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

8.29 Ind AS 103: Business Combinations

8.29.1 Objective

The objective of this Indian Accounting Standard (Ind AS) is to improve the:

- Relevance
- Reliability
- Comparability

of the information that a reporting entity provides in its financial statements about a business combination and its effects.

To accomplish that, this Ind AS establishes principles and requirements for how the acquirer:

- Recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Recognises and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination

8.29.2 Scope

This Ind AS applies to a transaction or other event that meets the definition of a business combination. This Ind AS does not apply to:

1. The accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.
2. The acquisition of an asset or a group of assets that does not constitute a business.
3. The requirements of this Standard do not apply to the acquisition by an investment entity, as defined in Ind AS 110, *'Consolidated Financial Statements'*, of an investment in a subsidiary that is required to be measured at fair value through profit or loss.

8.29.3 Variety of ways in which a Business Combination may be Structured

A business combination may be structured in a variety of ways for legal, taxation or other reasons, which include but are not limited to:

(a) one or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer;

(b) one combining entity transfers its net assets, or its owners transfer their equity interests to another combining entity or its owners;

(c) all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or

(d) a group of former owners of one of the combining entities obtains control of the combined entity.

8.29.4 Acquisition Method

An entity shall account for each business combination by applying the acquisition method. Applying the acquisition method requires:

Step I
- Identifying the Acquirer

Step II
- Determining the Acquisition date

Step III
- Recognising and Measuring the Identifiable Assets acquired, the Liabilities assumed and any Non-controlling Interest in the Acquiree

Step IV
- Recognising and Measuring any Goodwill or Bargain Purchase

The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquire - the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date.

Recognition Principle

On the acquisition date, the acquirer shall recognise, separately from goodwill:

- The identifiable assets acquired
- The liabilities assumed
- Any non-controlling interest in the acquiree

Exceptions to the Recognition Principles

Contingent Liabilities

- the acquirer shall recognise if it is a present obligation that arises from past events and its fair value can be measured reliably

Measurement Principle

The acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

<u>Exceptions to the Measurement Principles</u>

- Reacquired rights
    - ✓ measured at fair value based on remaining contractual term ignoring the fair value effect of renewal
- Share-based payment transactions
    - ✓ measured in accordance with Ind AS 102(Market Based Measure)
- Assets held for sale
    - ✓ measured in accordance with Ind AS 105 (i.e. fair value less costs to sell)

<u>Exceptions to the Recognition and Measurement Principles</u>

- Income taxes
    - ✓ deferred tax assets or liabilities arising from acquired assets or liabilities accounted for using Ind AS 12
- Employee benefits
    - ✓ accounted for using Ind AS 19
- Indemnification assets
    - ✓ Shall be measured and recognized on the basis of the indemnified item

Recognition and Measurement of Goodwill or Bargain Purchase

The acquirer shall recognise goodwill as of the acquisition date measured as the excess of (a) over (b) below:

(a) the aggregate of:

  (i) the consideration transferred, which generally requires acquisition-date fair value;

  (ii) the amount of any non-controlling interest in the acquiree; and

  (iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.

In extremely rare circumstances, an acquirer will make a bargain purchase in a business combination, where the value of acquired identifiable assets and liabilities exceeds the consideration transferred; the acquirer shall recognize a gain (bargain purchase). The gain shall be recognized by the acquirer in Other Comprehensive Income on the acquisition date and accumulate the same in equity as capital reserve, if there exists a clear evidence of the underlying reasons for classifying the business combination as a bargain purchase.

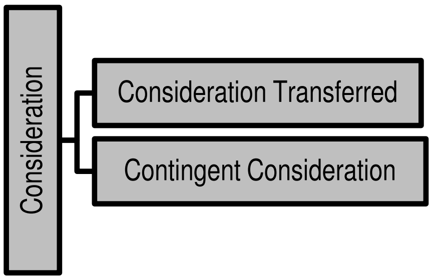
If there does not exist clear evidence of the underlying reasons for classifying the business combination as a bargain purchase, then the gain shall be recognised directly in equity as capital reserve.

<u>A Business Combination achieved in Stages (Step Acquisition):</u> In a business combination achieved in stages, the acquirer shall re-measure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate.

In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income.

If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

8.29.5 Consideration



8.29.5.1 Consideration Transferred: The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of:

- The acquisition-date fair values of the assets transferred by the acquirer
- The liabilities incurred by the acquirer to former owners of the acquire; and
- The equity interests issued by the acquirer.

8.29.5.2 Contingent Consideration

- The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement.
- The acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

8.29.6 Reverse Acquisitions

A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting. The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.

8.29.7 Measurement Period

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete.

During the measurement period, the acquirer shall retrospectively adjust the provisional amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

During the measurement period, the acquirer shall also recognise additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date.

The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.

However, the measurement period shall not exceed one year from the acquisition date.

8.29.8 Acquisition Related Costs

Acquisition-related costs are costs the acquirer incurs to effect a business combination. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with Ind AS 32 and Ind AS 109.

8.29.9 Subsequent Measurement and Accounting

In general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination in accordance with other applicable Ind AS for those items, depending on their nature. However, Ind AS 103 provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred and equity instruments issued in a business combination:

(a) reacquired rights;

(b) contingent liabilities recognised as of the acquisition date;

(c) indemnification assets; and

(d) contingent consideration.

8.29.10 Business Combinations of Entities under Common Control

Common control business combination means a business combination involving entities or businesses in which all the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory.

Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interests method.

The pooling of interest method is considered to involve the following:

(a) The assets and liabilities of the combining entities are reflected at their carrying amounts.

(b) No adjustments are made to reflect fair values, or recognise any new assets or liabilities. The only adjustments that are made are to harmonise accounting policies.

(c) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.

(d) The balance of the retained earnings appearing in the financial statements of the transferor is aggregated with the corresponding balance appearing in the financial statements of the transferee. Alternatively, it is transferred to General Reserve, if any.

(e) The identity of the reserves shall be preserved and shall appear in the financial statements of the transferee in the same form in which they appeared in the financial statements of the transferor.

(f) The difference, if any, between the amounts recorded as share capital issued plus any additional consideration in the form of cash or other assets and the amount of share capital of the transferor shall be transferred to capital reserve and should be presented separately from other capital reserves with disclosure of its nature and purpose in the notes.

8.29.11 Major Change in Ind AS 103 vis-à-vis IFRS 3 Resulting in Carve Out

(A) Resulting in Carve Out

As per IFRS: IFRS 3 requires bargain purchase gain arising on business combination to be recognised in profit or loss as income.

Carve out: Ind AS 103 requires the bargain purchase gain to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. A similar carve-out is made in Ind AS 28, Investments in Associates and Joint Ventures

Reasons: At present, since bargain purchase gain occurs at the time of acquiring a business, these are considered as capital reserve. Recognition of such gains in profit or loss would result into recognition of unrealised gains, which may get distributed in the form of dividends. Moreover, such a treatment may lead to structuring through acquisitions, which may not be in the interest of the stakeholders of the company.

(B) Resulting in Carve-in

As per IFRS

IFRS 3 excludes from its scope business combinations of entities under common control.

Carve-in

Appendix C of Ind AS 103 Business Combinations gives guidance in this regard.

8.29.12 Major Changes in Ind AS 103 vis-à-vis Notified AS 14

(i) ***Scope**:* Ind AS 103 defines a business combination which has a wider scope whereas the existing AS 14 deals only with amalgamation ***and mergers***.

(ii) ***Methods for Accounting**:* Under the existing AS 14 there are two methods of accounting for amalgamation viz - the pooling of interest method and the purchase method. Ind AS 103 prescribes only the acquisition method for every business combination.

(iii) ***Assets and Liabilities**:* Under the existing AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method. Ind AS 103 requires the acquired identifiable assets liabilities and non-controlling interest to be recognised at fair value under acquisition method.

(iv) ***Minority / Non–controlling**:* Ind AS 103 requires that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. On other hand, the existing AS 14 states that the minority interest is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made and it is shown outside shareholders' equity.

(v) ***Amortisation of Goodwill**:* Under Ind AS 103, the goodwill is not amortised but tested for impairment on annual basis in accordance with Ind AS 36. The existing AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.

(vi) ***Reverse Acquisitions**:* Ind AS 103 deals with reverse acquisitions whereas the existing AS 14 does not deal with the same.

(vii) ***Contingent Consideration**:* Ind AS 103 deals with the contingent consideration in case of business combination, i.e., an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. The existing AS 14 does not provide specific guidance on this aspect.

(viii) ***Bargain Purchase Gain**:* Ind AS 103 requires bargain purchase gain arising on business combination to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. Under existing AS 14 the excess amount is treated as capital reserve.

(ix) ***Accounting for Common Control Transactions**:* Appendix C of Ind AS 103 deals with accounting for common control transactions, which prescribes a method of accounting different from Ind AS 103. Existing AS 14 does not prescribe accounting for such transactions different from other amalgamations.

8.30 Ind AS 104: Insurance Contract

8.30.1 Objective

The objective of this Indian Accounting Standard (Ind AS) is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described as an insurer).

In particular, this Ind AS requires:

(a) limited improvements to accounting by insurers for insurance contracts.

(b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

8.30.2 Scope

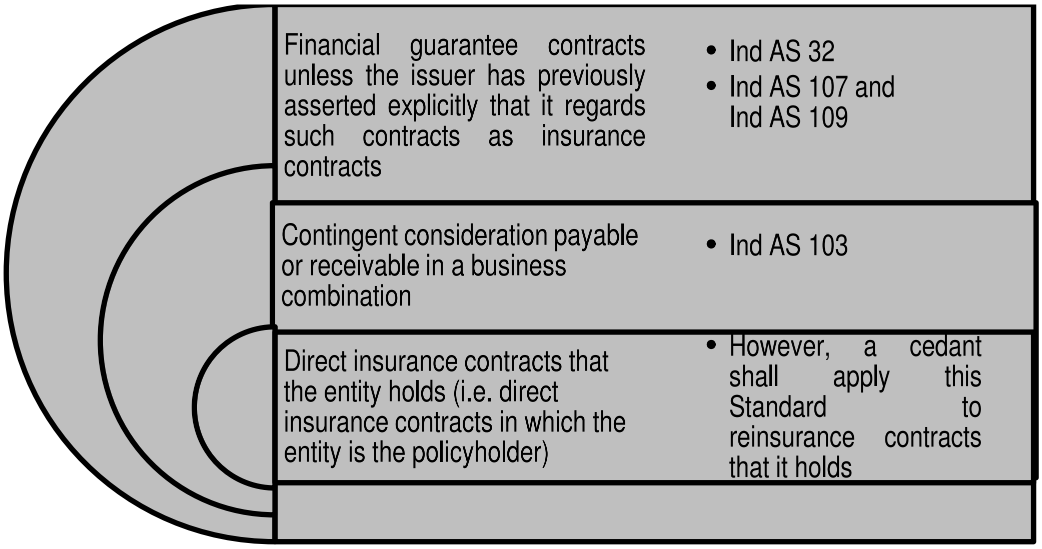
An entity shall apply this Ind AS to:

(a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

(b) financial instruments that it issues with a discretionary participation feature.

An entity shall not apply this Ind AS to:

Product warranties issued directly by a manufacturer, dealer or retailer	• Ind AS 18 • Ind AS 37
Employers' assets and liabilities under employee benefit plans	• Ind AS 19 • Ind AS 102
Contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item as well as a lessee's residual value guarantee embedded in a finance lease	• Ind AS 17 • Ind AS 18 and Ind AS 38



8.30.3 Insurance Contract

An insurance contract is a contract:

- under which one party (the insurer)
- accepts significant insurance risk
- from another party (the policyholder)
- by agreeing to compensate the policyholder
- if a specified uncertain future event (the insured event) adversely affects the policyholder.

8.30.4 Recognition and Measurement

The Ind AS exempts an insurer from some requirements of other Ind AS. Specifically, an insurer:

(a) shall not recognise as a liability any provisions for possible future claims, if those claims arise under insurance contracts that are not in existence at the end of the reporting period (such as catastrophe provisions and equalisation provisions).

(b) shall carry out the liability adequacy test.

(c) shall remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished — i.e. when the obligation specified in the contract is discharged or cancelled or expires.

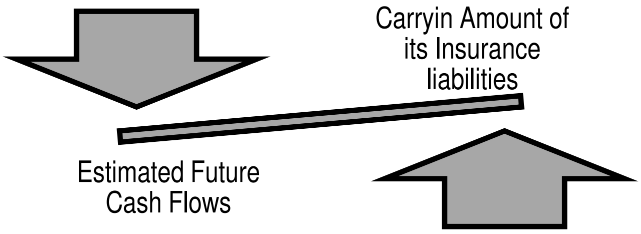
(d) shall not offset:

   i. reinsurance assets against the related insurance liabilities; or

   ii. income or expense from reinsurance contracts against the expense or income from the related insurance contracts.

(e) shall consider whether its reinsurance assets are impaired.

8.30.4.1 Liability Adequacy Test: An insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.



8.30.4.2 Impairment of Reinsurance Assets: If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss.

A reinsurance asset is impaired if, and only if:

(a) there is objective evidence, as a result of an event that occurred after initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and

(b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

8.30.5 Changes in Accounting Policies

An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. In particular, an insurer may continue any of the following practices, although it may continue using accounting policies that involve them:

(a) measuring insurance liabilities on an undiscounted basis.

(b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services.

(c) using non-uniform accounting policies for the insurance contracts of subsidiaries.

The Ind AS permits an insurer to change its accounting policies so that it re-measures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss. Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

The Ind AS requires disclosure to help users understand:

(a) the amounts in the insurer's financial statements that arise from insurance contracts.

(b) the nature and extent of risks arising from insurance contracts.

8.31 Ind AS 105: Non-current Assets Held for Sale and Discontinued Operations

8.31.1 Objective

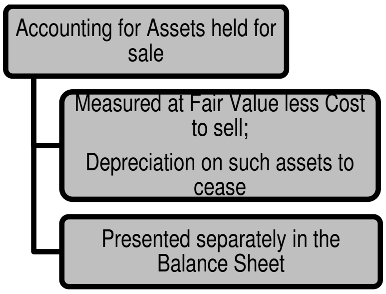
The objective of this Indian Accounting Standard (Ind AS) is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations.

In particular, this Ind AS requires:

(a) assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and fair value less costs to sell, and depreciation on such assets to cease; and

(b) assets that meet the criteria to be classified as held for sale to be presented separately in the balance sheet and

(c) the results of discontinued operations to be presented separately in the statement of profit and loss.



8.31.2 Scope

The classification and presentation requirements of this Ind AS apply to all recognised non-current assets and to all disposal groups of an entity.

The measurement provisions of this Ind AS do not apply to the following assets, which are covered by the Ind AS listed, either as individual assets or as part of a disposal group:

- Deferred tax assets (Ind AS 12, *'Income Taxes'*)
- Assets arising from employee benefits (Ind AS 19, *'Employee Benefits'*)
- Financial assets within the scope of Ind AS 109, *'Financial Instruments'*
- Non-current assets that are measured at fair value less costs to sell in accordance with Ind AS 41, *'Agriculture'*
- Contractual rights under insurance contracts as defined in Ind AS 104, *'Insurance Contracts'*

Additional disclosures about non-current assets (or disposal groups) classified as held for sale or discontinued operations may be necessary to comply with the general requirements of Ind AS 1.

8.31.3 Discontinued Operations

A component of an entity that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations,

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

Disposal Group: A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a cash-generating unit to which goodwill has been allocated in accordance with the requirements of Ind AS 36, *'Impairment of Assets'*, or if it is an operation within such a cash-generating unit.

8.31.4 Classification of Non-current Assets (or Disposal Groups) as Held for Sale or as Held for Distribution to Owners

An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

To be classified as held for sale/distribution the asset (or disposal group):

1. Must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and
2. Its sale must be highly probable.

When the sale/distribution is considered highly probable?

For the sale to be highly probable:

1. The appropriate level of management must be committed to a plan to sell the asset (or disposal group).
2. An active programme to locate a buyer and complete the plan must have been initiated.
3. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
4. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.
5. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

Exception to Point 5: Events or circumstances may extend the period to complete the sale beyond one year.

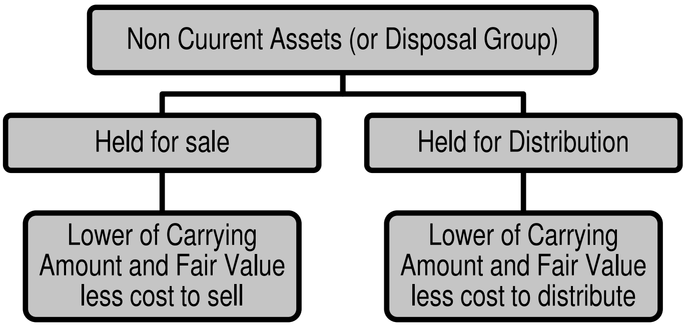
An extension of the period required to complete a sale does not preclude an asset (or disposal group) from being classified as held for sale if the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).

An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned.

8.31.5 Measurement of Non-current Assets (or Disposal Groups) Classified as Held for Sale or Held for Distribution

Measurement of a Non-current Asset (or Disposal Group)

- An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.
- An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the lower of its carrying amount and fair value less costs to distribute.



When the sale is expected to occur beyond one year, the entity shall measure the costs to sell at their present value. Any increase in the present value of the costs to sell that arises from the passage of time shall be presented in profit or loss as a financing cost.

8.31.6 Changes to a Plan of Sale or to a Plan of Distribution to Owners

If an entity has classified an asset (or disposal group) as held for sale or as held for distribution to owners, but the criteria specified are no longer met, the entity shall cease to classify the asset (or disposal group) as held for sale or held for distribution to owners (respectively).

If an entity reclassifies an asset (or disposal group) directly from being held for sale to being held for distribution to owners, or directly from being held for distribution to owners to being held for sale, then the change in classification is considered a continuation of the original plan of disposal. The entity:

(a) The entity shall apply the classification, presentation and measurement requirements in this Ind AS that are applicable to the new method of disposal.

(b) shall measure the non-current asset (or disposal group) either if reclassified as held for sale or if reclassified as held for distribution to owners, and recognise any reduction or increase in the fair value less costs to sell/costs to distribute of the non-current asset.

(c) shall not change the date of classification. This does not preclude an extension of the period required to complete a sale or a distribution to owners if the specified conditions are met.

The entity shall measure a non-current asset (or disposal group) that ceases to be classified as held for sale or as held for distribution to owners (or ceases to be included in a disposal group classified as held for sale or as held for distribution to owners) at the lower of:

(a) its carrying amount before the asset (or disposal group) was classified as held for sale or as held for distribution to owners, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale or as held for distribution to owners, and

(b) its recoverable amount at the date of the subsequent decision not to sell or distribute.

8.31.7 Major Changes in Ind AS 105 vis-à-vis IFRS 5 Not Resulting in Carve Outs

1. ***Classification of a Non-current Asset****:* IFRS 5 prescribes the conditions for classification of a non-current asset (or disposal group) as held for sale. In Ind AS 105, a clarification has also been added that the non-current asset (or disposal group) cannot be classified as held for sale, if the entity intends to sell it in a distant future.

2. ***Non-current Assets accounted as per the Fair Value Model****:* IFRS 105 deals with non-current assets that are accounted for in accordance with the fair value model in IAS 40. Since Ind AS 40 prohibits the use of fair value model, this has not been included in Ind AS 105.

3. ***Presentation of Discontinued Operations****:* IFRS 5 requires presentation of discontinued operations in the separate income statement, where separate income statement is presented. This requirement is not provided in Ind AS 105 consequential to the removal of option regarding two statement approach in Ind AS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

4. ***Transitional Provisions****:* Ind AS 101 provides transitional relief, similar to the transitional provisions in IFRS 5, that while applying Ind AS 105, an entity may use the transitional date circumstances to measure such assets or operations at the lower of carrying value and fair value less cost to sell. This would facilitate smooth convergence with Ind AS.

8.31.8 Major Difference between Ind AS 105 vis a vis Notified AS 24

(i) ***Scope and Objective****:* Ind AS 105 specifies the accounting for non-current assets held for sale, and the presentation and disclosure of *discontinued operations*. The existing AS 24 establishes principles for reporting information about *discontinuing operations*. It does not deal with the non-current assets held for sale; fixed assets retired from active used and held for sale, are dealt in existing AS 10, '*Accounting for Fixed Assets'.*

(ii) ***Cash Flow Statement:*** In the existing AS 24, requirements related to cash flow statement are applicable when the enterprise presents a cash flow statement. Ind AS 105 does not mention so.

(iii) ***Discontinued vs Discontinuing Operations:*** Under Ind AS 105, a discontinued operation is a component of an entity that either has been disposed of or is classified as held for sale. In the existing AS 24, there is no concept of discontinued operations but it deals with discontinuing operations.

(iv) ***Time Period:*** As per Ind AS 105, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification with certain exceptions. The existing AS 24 does not specify any time period in this regard as it relates to discontinuing operations

(v) ***Initial Disclosure Event:*** The existing AS 24 specifies about the initial disclosure event in respect to a discontinuing operation. Ind AS 105 does not mention so as it relates to discontinued operation.

(vi) ***Measurement:*** Under Ind AS 105, non-current assets (disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell, and are presented separately in the balance sheet. The existing AS 24 requires to apply the principles set out in other relevant Accounting Standards, e.g., the existing AS 10 requires that the fixed assets retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

(vii) ***Abandonment of Assets:*** Ind AS 105 specifically mentions that abandonment of assets should not be classified as held for sale. In the existing AS 24, abandonment of assets is classified as a discontinuing operation; however, changing the scope of an operations or the manner in which it is conducted is not abandonment and hence not a discontinuing operation.

(viii) ***Guidance Regarding Measurement of Changes to a Plan of Change:*** Ind AS 105 provides guidance regarding changes to the plan to sell non-current assets (or disposal groups) which are classified as held for sale. The existing AS 24 does not give any specific guidance regarding this aspect.

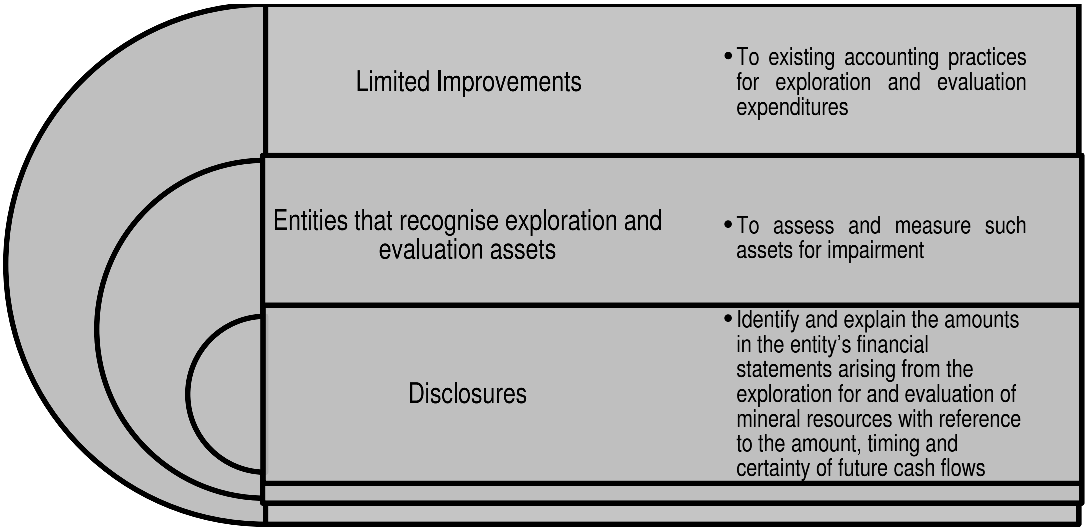
(ix) ***Definition:*** As per Ind AS 105, a discontinued operation is a component of an entity that represents a separate major line of business or geographical area, or is a subsidiary acquired exclusively with a view to resale. Under the existing AS 24, a discontinuing operation is a component of an entity that represents the major line of business or geographical area of operations and that can be distinguished operationally and for financial reporting purposes.

8.32 Ind AS 106: Exploration for and Evaluation of Mineral Resources

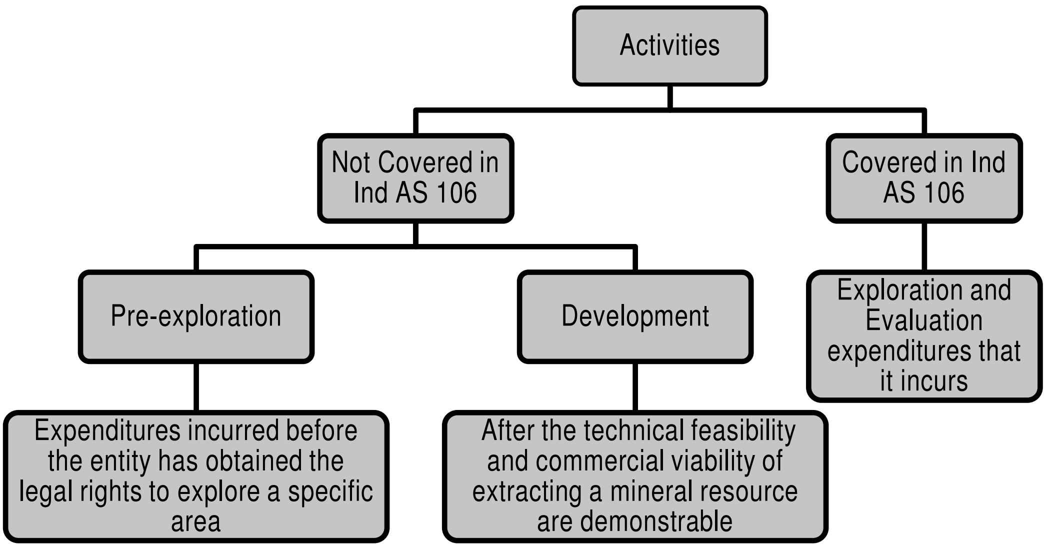
8.32.1 Objective

The objective of this Indian Accounting Standard (Ind AS) is to specify the financial reporting for the exploration for and evaluation of mineral resources.

In particular, the Ind AS requires:



8.32.2 Scope



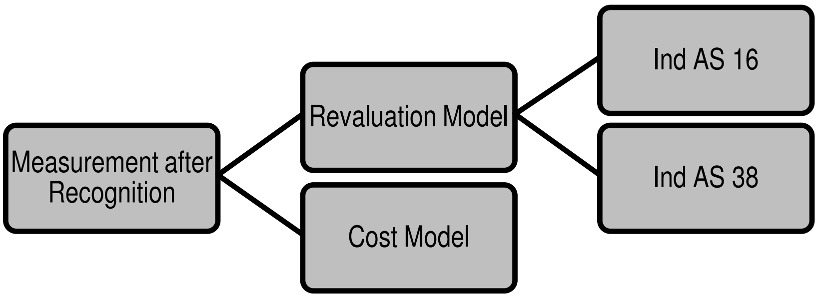
8.32.3 Measurement of Exploration and Evaluation of Assets

8.32.3.1 Measurement at Recognition: Exploration and evaluation assets shall be measured at cost.

8.32.3.2 Elements of Cost of Exploration and Evaluation of Assets: An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently.

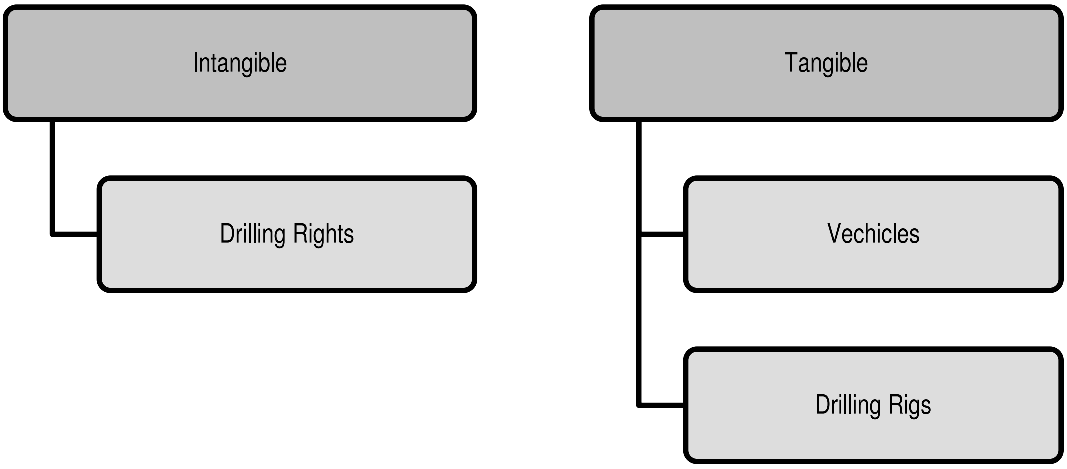
8.32.3.3 Measurement after Recognition: After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets.

If the revaluation model is applied (either the model in Ind AS 16 *'Property, Plant and Equipment'* or the model in Ind AS 38) it shall be consistent with the classification of the assets.



8.32.4 Presentation

8.32.4.1 Classification of Exploration and Evaluation Assets: An entity shall classify exploration and evaluation assets as tangible or intangible according to the nature of the assets acquired and apply the classification consistently.



8.32.5 Impairment

Recognition and Measurement: Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount.

When facts and circumstances suggest that the carrying amount exceeds the recoverable amount, an entity shall measure, present and disclose any resulting impairment loss in accordance with Ind AS 36

An entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. Each cash-generating unit or group of units to which an exploration and evaluation asset is allocated shall not be larger than an operating segment determined in accordance with Ind AS 108, '*Operating Segments'*.

One or more of the following facts and circumstances indicate that an entity should test exploration and evaluation assets for impairment (the list is not exhaustive):

(a) the period for which the entity has the right to explore in the specific area has expired during the period or will expire in the near future, and is not expected to be renewed.

(b) substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.

(c) exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.

(d) sufficient data exist to indicate that, although a development in the specific area is likely to proceed, the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.

8.33 Ind AS 107: Financial Instruments: Disclosures

8.33.1 Objective

The objective of this Indian Accounting Standard (Ind AS) is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

8.33.2 Scope

This Ind AS shall be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with Ind AS 110 *'Consolidated Financial Statements'*, Ind AS 27 *'Separate Financial Statements'*, or Ind AS 28 *'Investments in Associates and Joint Ventures'*.

(b) employers' rights and obligations arising from employee benefit plans, to which Ind AS 19, *'Employee Benefits'*, applies.

(c) insurance contracts as defined in Ind AS 104, *'Insurance Contracts'*.

(d) financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102, *'Share-based Payment'*, applies.

(e) instruments that are required to be classified as equity instruments in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32.

This Ind AS applies to recognised and unrecognised financial instruments.

Recognised financial instruments include financial assets and financial liabilities that are within the scope of Ind AS 109. Unrecognised financial instruments include some financial instruments that, although outside the scope of Ind AS 109, are within the scope of this Ind AS.

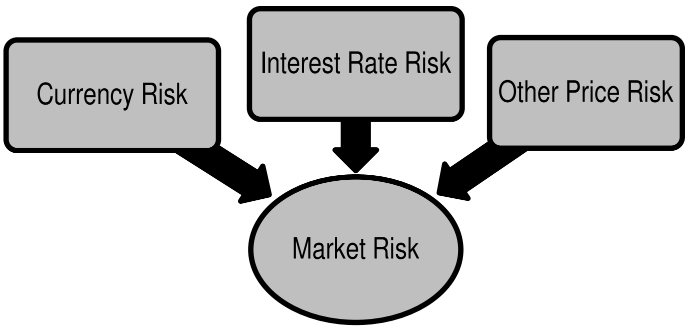
8.33.3 Credit Risk, Liquidity Risk and Market Risk

Credit Risk: The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Liquidity Risk: The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

Market Risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.

Market risk comprises three types of risk:



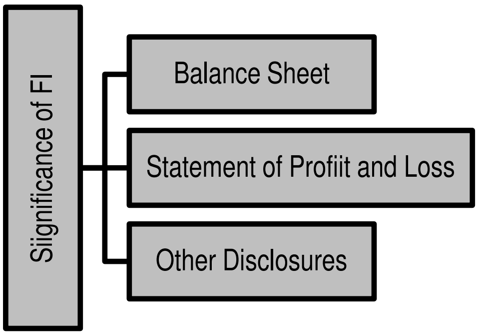
Interest Rate Risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Currency Risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Other Price Risk: The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market.

8.33.4 Significance of Financial Instruments for Financial Position and Performance

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.



8.33.4.1 Balance Sheet

Categories of Financial Assets and Financial Liabilities: The carrying amounts of each of the following categories, as specified in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

1. financial assets measured at fair value through profit or loss, showing separately
   - (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
   - (ii) those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.
2. financial liabilities at fair value through profit or loss, showing separately
   - (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
   - (ii) those that meet the definition of held for trading in Ind AS 109.
3. financial assets measured at amortised cost.
4. financial liabilities measured at amortised cost.
5. financial assets measured at fair value through other comprehensive income, showing separately
   - (i) financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109; and
   - (ii) investments in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.

Financial Assets or Financial Liabilities at Fair Value through Profit or Loss: If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

(a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

  (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

  (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

Investments in Equity Instruments designated at Fair Value through Other Comprehensive Income

If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by Ind AS 109, it shall disclose:

(a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

(b) the reasons for using this presentation alternative.

(c) the fair value of each such investment at the end of the reporting period.

(d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.

(e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

Reclassification: An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose:

(a) the date of reclassification.

(b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

(c) the amount reclassified into and out of each category.

Collateral: An entity shall disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and

(b) the terms and conditions relating to its pledge.

Allowance Account for Credit Losses: The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the balance sheet as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

Compound Financial Instruments with Multiple Embedded Derivatives: If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

Defaults and Breaches: For loans payable recognised at the end of the reporting period, an entity shall disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

(b) the carrying amount of the loans payable in default at the end of the reporting period; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were approved for issue.

8.33.4.2 Statement of Profit and Loss

Items of Income, Expense, Gains or Losses: An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (e.g. financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

(ii) financial liabilities measured at amortised cost.

(iii) financial assets measured at amortised cost.

(iv) investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS 109.

(v) financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets and financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

8.33.4.3 Other Disclosures

Accounting Policies: In accordance with Ind AS 1 *'Presentation of Financial Statements'*, an entity discloses its significant accounting policies, comprising the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge Accounting: An entity shall apply the disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

(i) an entity's risk management strategy and how it is applied to manage risk;

(ii) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(iii) the effect that hedge accounting has had on the entity's balance sheet, statement of profit and loss and statement of changes in equity.

Fair Value: For each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

(b) for a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably.

8.33.5 Nature and Extent of Risks arising from Financial Instruments

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Qualitative Disclosures: The qualitative disclosures describe management's objectives, policies and processes for managing those risks.

For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

Quantitative Disclosures: The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel.

For each type of risk arising from financial instruments, an entity shall disclose:

(a) summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in Ind AS 24, *'Related Party Disclosures'*), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in accordance with (a).

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

Together, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create.

The Ind AS applies to all entities, including entities that have few financial instruments (eg a manufacturer whose only financial instruments are accounts receivable and accounts payable) and those that have many financial instruments (eg a financial institution most of whose assets and liabilities are financial instruments).

When this Ind AS requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

The principles in this Ind AS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Ind AS 32, '*Financial Instruments: Presentation'* and Ind AS 109, *'Financial Instruments'*.

8.33.6 Major Change in Ind AS 107 vis-à-vis IFRS 7 Not Resulting in Carve Out

Disclosure of description of Gains and Losses presented in the Separate Income Statement: IFRS 7 requires disclosure of description of gains and losses presented in the separate income statement, where separate income statement is presented. This requirement is not provided in Ind AS 107 consequential to the removal of option regarding two statement approach in Ind AS 1 as compared to IAS 1. Ind AS 1 requires that the components of profit or loss and components of other comprehensive income shall be presented as a part of the statement of profit and loss.

8.34 Ind AS 108: Operating Segments

8.34.1 Core Principle

An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the **business activities** in which it engages and the **economic environments** in which it operates.

Accordingly, the objective of segment reporting is to provide financial information on the different business activities that an entity engages in and the different economic environments under which it operates to help users of financial statements to:

(a) better understand the entity's performance;

(b) better assess its prospects for future net cash flows;

(c) make more informed judgments about the entity as a whole.

8.34.2 Scope

This Accounting Standard shall apply to companies to which Indian Accounting Standards (Ind AS) notified under the Companies Act apply.

If an entity that is not required to apply this Ind AS chooses to disclose information about segments that does not comply with this Ind AS, it shall not describe the information as segment information.

If a financial report contains both the consolidated financial statements of a parent that is within the scope of this Indian Accounting Standard as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

8.34.3 Operating Segments

An operating segment is a component of an entity:

(a) that engages in business activities from which it may earn revenues and incur expenses

(b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(c) for which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues. Not every part of an entity is necessarily an operating segment or part of an operating segment.

For example: A corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of this Ind AS, an entity's post-employment benefit plans are not operating segments.

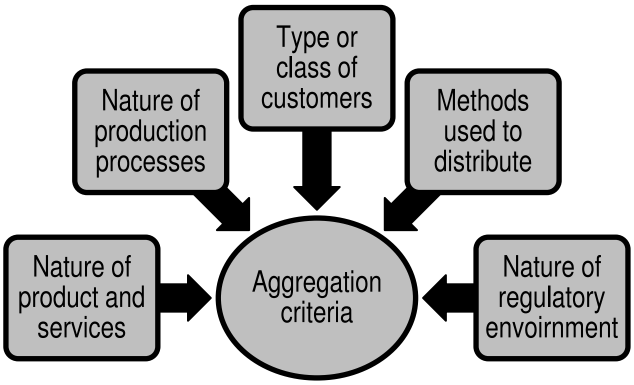
8.34.4 Reportable Segments

An entity shall report separately information about each operating segment that:

(a) has been identified or results from aggregating two or more of segments, and

(b) exceeds the quantitative thresholds as specified in the standard.

8.34.4.1 Aggregation Criteria: Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics.



8.34.4.2 Quantitative Thresholds: An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments.

(b) The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of

(i) the combined reported profit of all operating segments that did not report a loss and

(ii) the combined reported loss of all operating segments that reported a loss.

(c) Its assets are 10 per cent or more of the combined assets of all operating segments.

Notes:

1. Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

2. An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria listed in paragraph 12.
3. If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet the criteria in paragraph 13) until at least 75 per cent of the entity's revenue is included in reportable segments.

8.34.5 General Information

The Standard requires an entity to report a measure of operating segment profit or loss and of segment assets. It also requires an entity to report a measure of segment liabilities and particular income and expense items if such measures are regularly provided to the chief operating decision maker. It requires reconciliations of total reportable segment revenues, total profit or loss, total assets, liabilities and other amounts disclosed for reportable segments to corresponding amounts in the entity's financial statements.

The Standard requires an entity to report information about the revenues derived from its products or services (or groups of similar products and services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether that information is used by management in making operating decisions. However, the Standard does not require an entity to report information that is not prepared for internal use if the necessary information is not available and the cost to develop it would be excessive.

The Standard also requires an entity to give descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and those used in the entity's financial statements, and changes in the measurement of segment amounts from period to period.

8.34.6 Major Change in Ind AS 108 vis-à-vis IFRS 8 Not Resulting in Carve Out

Paragraph 2 of IFRS 8 requires that the standard shall apply to :

a) the separate or individual financial statements of an entity:
   i. whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or
   ii. that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and
b) the consolidated financial statements of a group with a parent:
   i. whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

ii. that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

The above have been deleted in the Ind AS 108 as the applicability or exemptions to the Indian Accounting Standards are governed by the Companies Act and the Rules made thereunder.

8.34.7 Major Changes in Ind AS 108 vis a vis Notified AS 17

(i) ***Identification of Segments**:* Identification of segments under Ind AS 108 is based on 'management approach' i.e. operating segments are identified based on the internal reports regularly reviewed by the entity's chief operating decision maker. Existing AS 17 requires identification of two sets of segments; one based on related products and services, and the other on geographical areas based on the risks and returns approach. One set is regarded as primary segments and the other as secondary segments.

(ii) ***Basis of Measurement for Amounts to be Reported in Segments**:* Ind AS 108 requires that the amounts reported for each operating segment shall be measured on the same basis as that used by the chief operating decision maker for the purposes of allocating resources to the segments and assessing its performance. Existing AS 17 requires segment information to be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements. Accordingly, existing AS 17 also defines segment revenue, segment expense, segment result, segment assets and segment liabilities.

(iii) ***Aggregation Criteria**:* Ind AS 108 specifies aggregation criteria for aggregation of two or more segments and also requires the related disclosures in this regard. Existing AS 17 does not deal specifically with this aspect.

(iv) ***Single Reportable Segment**:* An explanation has been given in the existing AS 17 that in case there is neither more than one business segment nor more than one geographical segment, segment information as per this standard is not required to be disclosed. However, this fact shall be disclosed by way of footnote. Ind AS 108 requires certain disclosures even in case of entities having single reportable segment.

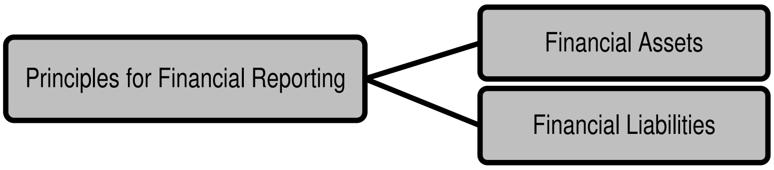
(v) ***Interest Expense**:* An explanation has been given in the existing AS 17 that interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense. It also provides that in case interest is included as a part of the cost of inventories and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. These aspects are specifically dealt with keeping in view that the definition of 'segment expense' given in AS 17 excludes interest. Ind AS 108 requires the separate disclosures about interest revenue and interest expense of each reportable segment, therefore, these aspects have not been specifically dealt with.

(vi) ***Disclosures**:* Ind AS 108 requires disclosures of revenues from external customers for each product and service. With regard to geographical information, it requires the disclosure of revenues from customers in the country of domicile and in all foreign countries, non-current assets in the country of domicile and all foreign countries. It also requires disclosure of information about major customers. Disclosures in existing AS 17 are based on the classification of the segments as primary or secondary segments. Disclosure requirements for primary segments are more detailed as compared to secondary segments.

8.35 Ind AS 109 : Financial Instruments

8.35.1 Objective

The objective of this Standard is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.



8.35.2 Scope

This Standard shall be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with the permission given by Ind AS 110, Ind AS 27 or Ind AS 28

(b) rights and obligations under leases to which Ind AS 17 'Leases' applies. However:

 (i) lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of this Standard;

 (ii) finance lease payables recognised by a lessee are subject to the derecognition requirements of this Standard; and

 (iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of this Standard.

(c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 'Employee Benefits' applies.

(d) financial instruments issued by the entity that meet the definition of an equity instrument in Ind AS 32 (including options and warrants)

(e) rights and obligations arising under

 (i) an insurance contract as defined in Ind AS 104 *'Insurance Contracts'*,

 (ii) a contract that is within the scope of Ind AS 104 because it contains a discretionary participation feature.

(f) any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 at a future acquisition date.

(g) loan commitments other than those which entity designates as financial liabilities at fair value through profit or loss, loan commitments that can be settled net in cash or by delivering or issuing another financial instrument and commitments to provide a loan at a below-market interest rate

(h) financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 102 *'Share-based Payment'* applies.

(i) rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with Ind AS 37 *'Provisions, Contingent Liabilities and Contingent Assets'*, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.

(j) rights and obligations within the scope of Ind AS 11, Construction Contracts, and Ind AS 18, Revenue, that are financial instruments, except for those that Ind AS 11 and Ind AS 18 specify are accounted for in accordance with this Standard.

(k) Contracts to buy or sell a non-financial item which cannot be settled net in cash or another financial instrument, or by exchanging financial instruments.

8.35.3 Recognition

8.35.3.1 Initial Recognition: An entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

8.35.4 Derecognition

8.35.4.1 Derecognition of Financial Assets: A financial asset shall be derecognised when and only when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) it transfers the financial asset and the transfer qualifies for derecognition.

On derecognition of a financial asset in its entirety, the difference between the carrying amount (measured at the date of derecognition) and the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

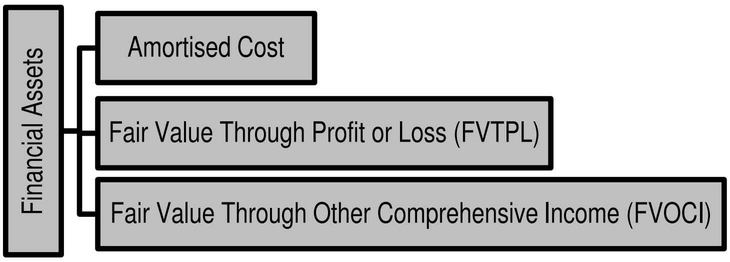
In case of partial derecognition of a financial asset, the previous carrying amount of the whole asset shall be allocated between the part that continues to be recognised and the part that is derecognised, on the basis of the relative fair values of those parts on the date of the transfer.

8.35.4.2 Derecognition of Financial Liabilities: A financial liability (or a part of a financial liability) shall be derecognised when, and only when, it is extinguished (obligation specified in the contract is discharged or cancelled or expires).

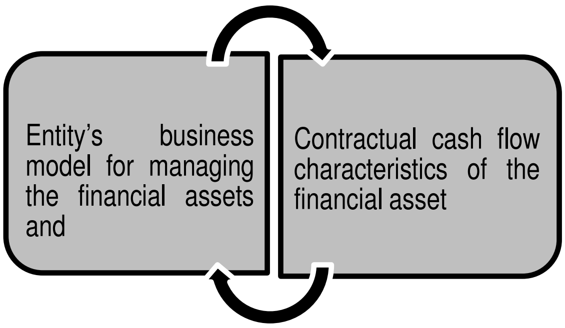
An entity shall account for a substantial modification of the terms of contracts as an extinguishment of the original financial liability and the recognition of a new financial liability. Any difference between the carrying amount of a financial liability extinguished or transferred and the consideration paid should be recognised in profit or loss.

8.35.5 Classification

8.35.5.1 Classification of Financial Assets



An entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

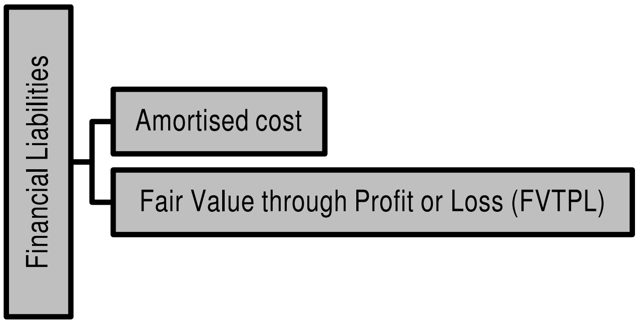


1. ***Amortised Cost*:** A financial asset shall be measured at amortised cost if both of the following conditions are met:
   (i) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and
   (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
2. ***Fair Value through Other Comprehensive Income (FVOCI)*:** A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:
   (i) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
   (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
3. ***Fair Value through Profit or Loss (FVTPL)*:** A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost or at fair value through other comprehensive income.

However, an entity maymake an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income.

Option to designate a financial asset at fair value through profit or loss: An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

8.35.5.2 Classification of Financial Liabilities: An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:



1. ***Amortised Cost*****:** An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for those mentioned below to be measured at FVTPL.
2. ***Financial Liabilities at Fair Value through Profit or Loss*****:** Such liabilities, include
   - Derivatives that are liabilities, shall be subsequently measured at fair value through profit or loss.
   - Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies.
   - Financial guarantee contracts.
   - Commitments to provide a loan at a below-market interest rate.
   - Contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

Option to designate a financial liability at fair value through profit or loss: An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss

8.35.6 Reclassification

When and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets. An entity shall not reclassify any financial liability.

8.35.7 Measurement

8.35.7.1 Initial Measurement: At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

8.35.7.2 Subsequent Measurement of Financial Assets: After initial recognition, an entity shall measure a financial asset in accordance with its classification i.e.:

(i) amortised cost;

(ii) fair value through other comprehensive income; or

(iii) fair value through profit or loss.

An entity shall apply the impairment requirements to financial assets that are measured at amortised cost and to financial assets that are measured at fair value through other comprehensive income.

8.35.7.3 Subsequent Measurement of Financial Liabilities: After initial recognition, an entity shall measure a financial liability in accordance with amortised cost method using effective interest method.

8.35.7.4 Gains and Losses: An entity shall recognise a loss allowance for *expected credit losses* on a financial asset that is measured at FVTOCI and FV at amortised cost, a lease receivable, a *contract asset* or a loan commitment and a financial guarantee contract to which the impairment requirements of this standard applies.

An entity shall measure expected credit losses of a financial instrument in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes; the time value of money; and reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:

(i) it is part of a hedging relationship;

(ii) it is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income;

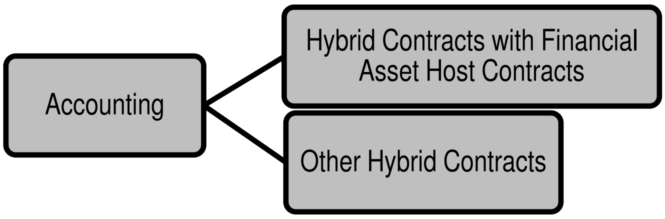
(iii) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income; or

(iv) it is a financial asset measured at fair value through other comprehensive income and the entity is required to recognise some changes in fair value in other comprehensive income.

8.35.8 Embedded Derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.



8.35.8.1 Hybrid Contracts with Financial Asset Hosts: If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements of this standard to the entire hybrid contract.

8.35.8.2 Other Hybrid Contracts: If a hybrid contract contains a host that is not an asset, an embedded derivative shall be separated from the host and accounted for as a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

8.35.9 Hedge Accounting

8.35.9.1 Objective and Scope of Hedge Accounting: The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

8.35.9.2 Hedging Instruments

Qualifying Items: A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options.

A non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.

For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.

Only contracts entered into by the entity with party external to the reporting entity can be designated as hedging instruments.

8.35.9.3 Designation of Hedging Instruments: A qualifying instrument must be designated in its entirety as a hedging instrument. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value;

(b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; similarly, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument; and

(c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

8.35.9.4 Hedged Items:

Qualifying Items: A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a forecast transaction or a net investment in a foreign operation. The hedged item can be:

- a single item; or
- a group of items.

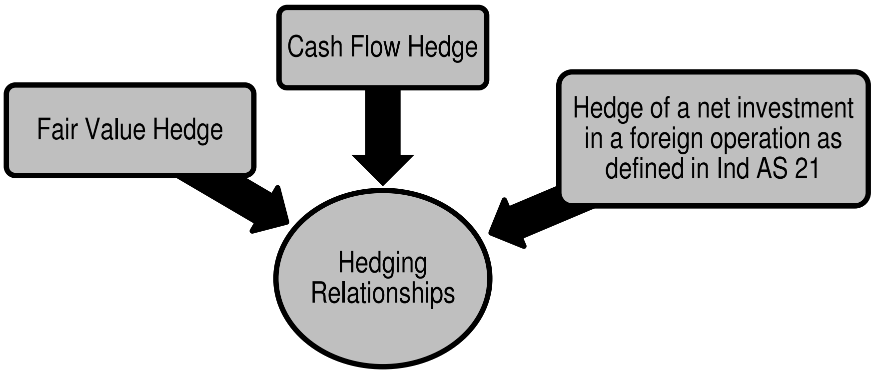
8.35.9.5 Types of Hedging Relationship: An entity applies hedge accounting to hedging relationships that meet the qualifying criteria (which include the entity's decision to designate the hedging relationship).

There are three types of hedging relationships:

(a) Fair Value Hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

(b) Cash Flow Hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss.

(c) **Hedge of a Net Investment in a Foreign Operation** as defined in Ind AS 21.



8.35.9.6 Qualifying Criteria for Hedge Accounting: A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

(a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items.

(b) at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

(c) the hedging relationship meets all of the following hedge effectiveness requirements:

  (i) there is an economic relationship between the hedged item and the hedging instrument;

  (ii) the effect of credit risk does not dominate the value changes that result from that economic relationship; and

  (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

In case a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again called as 'rebalancing'.

An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

Ind AS 109 prescribes principles for hedge accounting and also requires detailed disclosures. These disclosures explain both the effect that hedge accounting has had on the financial statements and an entity's risk management strategy, as well as providing details about derivatives that have been entered into and their effect on the entity's future cash flows.

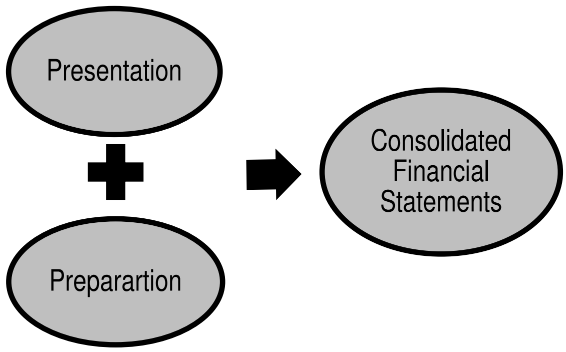
8.35.10 Major Change in Ind AS 109 vis-à-vis IFRS 9 Not Resulting in Carve Out

Fair Value Hedge: IFRS 9 provides an option to apply requirements of IAS 39 *'Financial Instruments: Recognition and Measurement'* for fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities. The said option has been removed in Ind AS 109.

8.36 Ind AS 110: Consolidated Financial Statements

8.36.1 Objective

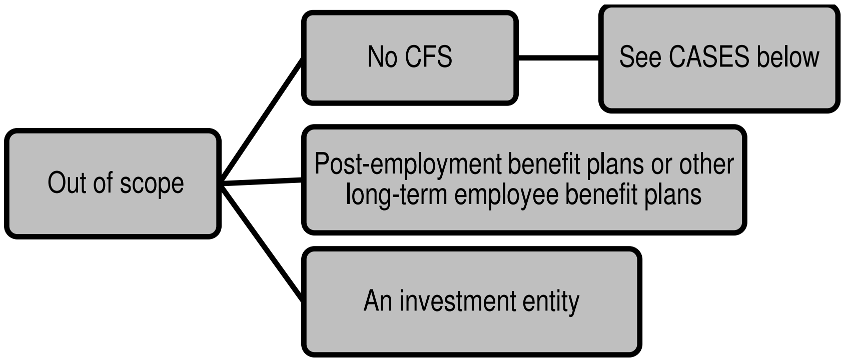
The objective of this Indian Accounting Standard (Ind AS) is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.



This Ind AS does not deal with the accounting requirements for business combinations and their effect on consolidation, including goodwill arising on a business combination.

8.36.2 Scope

An entity that is a parent shall present consolidated financial statements. This Ind AS applies to all entities, except as follows:



(a) A parent need not present consolidated financial statements if it meets all the following conditions:

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to;

(ii) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(iv) its ultimate or any intermediate parent produces financial statements that are available for public use and comply with Ind AS, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with this Ind AS.

This Ind AS does not apply to post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19, Employee Benefits, applies.

A parent that is an investment entity shall not present consolidated financial statements if it is required, to measure all of its subsidiaries at fair value through profit or loss.

8.36.3 Consolidated Financial Statements

The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

8.36.4 Control

An investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee.

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Thus, an investor controls an investee if and only if the investor has all the following:

- Power over an investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of the investor's returns

8.36.4.1 Power

- An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the investee's returns.
- Power arises from rights.
- Sometimes assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights granted by equity instruments such as shares
- Power may result from one or more contractual arrangements.

8.36.4.2 Returns

- An investor is exposed, or has rights, to variable returns from its involvement with the investee when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.
- The investor's returns can be only positive, only negative or both positive and negative.
- Although only one investor can control an investee, more than one party can share in the returns of an investee. For example, holders of non-controlling interests can share in the profits or distributions of an investee.

8.36.4.3 Link between Power and Returns

- An investor controls an investee if the investor not only has power over the investee and exposure or rights to variable returns from its involvement with the investee, but also has the ability to use its power to affect the investor's returns from its involvement with the investee.
- An investor with decision-making rights shall determine whether it is a principal or an agent.
- An investor that is an agent does not control an investee when it exercises decision-making rights delegated to it.

A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

8.36.5 Accounting Requirements

A parent shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee.

8.36.5.1 Non-controlling Interests

- A parent shall present non-controlling interests in the consolidated balance sheet within equity, separately from the equity of the owners of the parent.
- Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners).

8.36.5.2 Loss of Control

If a parent loses control of a subsidiary, the parent shall:

(a) derecognise the assets and liabilities of the former subsidiary from the consolidated balance sheet.

(b) recognise any investment retained in the former subsidiary at its fair value in accordance with relevant Ind AS.

(c) recognises the gain or loss associated with the loss of control attributable to the former controlling interest.

8.36.5.3 Consolidation Procedures

Consolidated financial statements:

(a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.

(b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary.

(c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full).

8.36.5.4 Uniform Accounting Policies: If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies.

8.36.5.5 Measurement

- An entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary.
- Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date.

For example: Depreciation expense recognised in the consolidated statement of profit and loss after the acquisition date is based on the fair values of the related depreciable assets recognised in the consolidated financial statements at the acquisition date.

8.36.5.6 Potential Voting Rights

- When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives.
- Ind AS 109 does not apply to interests in subsidiaries that are consolidated. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in a subsidiary, the instruments are not subject to the requirements of Ind AS 109. In all other cases, instruments containing potential voting rights in a subsidiary are accounted for in accordance with Ind AS 109.

8.36.5.7 Reporting Date

- The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall have the same reporting date.
- When the end of the reporting period of the parent is different from that of a subsidiary, the subsidiary prepares, for consolidation purposes, additional financial information as of the same date as the financial statements of the parent to enable the parent to consolidate the financial information of the subsidiary, unless it is impracticable to do so.
- If it is impracticable to do so, the parent shall consolidate the financial information of the subsidiary using the most recent financial statements of the subsidiary adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements.
- In any case, the difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall be no more than three months, and the length of the reporting periods and any difference between the dates of the financial statements shall be the same from period to period.

8.36.6 Determining whether an Entity is an Investment Entity

A parent shall determine whether it is an investment entity. An investment entity is an entity that:

- Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services
- Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both
- Measures and evaluates the performance of substantially all of its investments on a fair value basis

A parent that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status prospectively from the date at which the change in status occurred.

8.36.7 Investment Entities: Exception to Consolidation

- An investment entity shall not consolidate its subsidiaries or apply Ind AS 103 when it obtains control of another entity.
- Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with Ind AS 109.
- If an investment entity has a subsidiary that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities, it shall consolidate that subsidiary in accordance with this Ind AS and apply the requirements of Ind AS 103 to the acquisition of any such subsidiary.
- A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

8.36.8 Major Change in Ind AS 110 vis-à-vis IFRS 10 Not Resulting in Carve Out

Investment Properties: IFRS 10 requires all investments to be measured at fair value to qualify for the exemption from consolidation available to an investment entity. Ind AS 40 *'Investment Properties'* requires all investment properties to be measured at cost initially and cost less depreciation subsequently. Accordingly, the relevant paragraph of IFRS 10 has been deleted in Ind AS 110 as investment property measured at fair value is not relevant in the Indian context.

8.36.9 Major Changes in Ind AS 110 *vis-a-vis* Notified AS 21

(i) ***Mandatory preparation of Consolidated Financial Statements****:* Ind AS 110 makes the preparation of Consolidated Financial Statements mandatory for a parent. Existing AS 21 does not mandate the preparation of Consolidated Financial Statements by a parent.

(ii) ***Control****:* As per AS 21, control is the ownership of more than one-half of the voting power of an enterprise or control of the composition of the board of directors or governing body. However, unlike rule based definition given in AS 21, definition of control in

Ind AS 110 is principle based which states that, an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

(iii) ***Clarification regarding inclusion of Notes****:* Existing AS 21 provides clarification regarding inclusion of notes appearing in the separate financial statements of the parent and its subsidiaries in the consolidated financial statements. However, Ind AS 110 does not provide any clarification in this regard.

(iv) ***Clarification on more than one Parent of a Subsidiary****:* Under AS 21 there can be more than one parent of a subsidiary therefore existing AS 21 provides clarification regarding consolidation in case an entity is controlled by two entities. No clarification has been provided in this regard in Ind AS 110, keeping in view that as per the definition of control given in Ind AS 110, control of an entity could be with one entity only.

(v) ***Difference in Reporting Dates****:* As per AS 21, difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall not exceed 6 months. However, as per Ind AS 110 the difference shall not be more than three months.

(vi) ***Loss of Control****:* Ind AS 110 provides detailed guidance as compared to existing AS 21 regarding accounting in case of loss of control over subsidiary.

(vii) ***Uniform Accounting Policies****:* Both the existing AS 21 and Ind AS 110, require the use of uniform accounting policies. However, existing AS 21 specifically states that if it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied. However, Ind AS 110 does not recognise the situation of impracticability.

(viii) ***Presentation of Non-controlling Interest in CFS****:* As per existing AS 21 minority interest should be presented in the consolidated balance sheet separately from liabilities and equity of the parent's shareholders. However, as per Ind AS 110 non-controlling interests shall be presented in the consolidated balance sheet within equity separately from the parent shareholders' equity.

(ix) ***Potential Equity Shares****:* For considering share ownership, potential equity shares of the investee held by investor are not taken into account as per existing AS 21. However, as per Ind AS 110, potential voting rights that are substantive are also considered when assessing whether an entity has control over the subsidiary.

(x) ***Exclusion from Consolidation****:* As per existing AS 21, subsidiary is excluded from consolidation when control is intended to be temporary or when subsidiary operates under severe long term restrictions. Ind AS 110 does not give any such exemption from consolidation.

(xi) ***Explanations****:* Existing AS 21 explains where an entity owns majority of voting power because of ownership and all the shares are held as stock-in-trade, whether this amounts to temporary control. Existing AS 21 also explains the term 'near future'. However, Ind AS 110 does not explain the same, as these are not relevant.

8.37 Ind AS 111 : Joint Arrangements

8.37.1 Objective

The objective of this Ind AS is to establish principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (i.e. joint arrangements).

The Standard requires an entity that is a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations and to account for those rights and obligations in accordance with that type of joint arrangement.

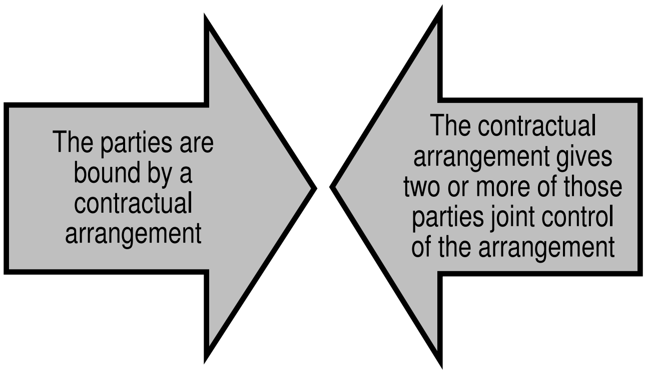
8.37.2 Scope

This Ind AS shall be applied by all entities that are a party to a joint arrangement.

8.37.3 Joint Arrangement and Joint Control

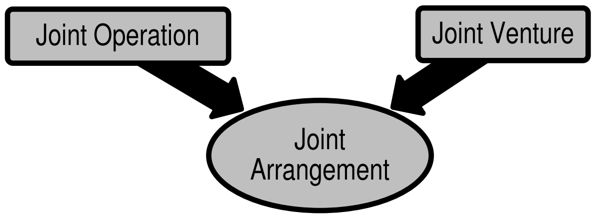
A joint arrangement is an arrangement of which two or more parties have ***joint control.***

A joint arrangement has the following characteristics:



Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint arrangement is either a joint operation or a joint venture.



The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

8.37.4 Financial Statements of Parties to a Joint Arrangement

8.37.4.1 Joint Operations: A joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;

(b) its liabilities, including its share of any liabilities incurred jointly;

(c) its revenue from the sale of its share of the output arising from the joint operation;

(d) its share of the revenue from the sale of the output by the joint operation; and

(e) its expenses, including its share of any expenses incurred jointly.

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the Ind AS applicable to the particular assets, liabilities, revenues and expenses.

8.37.4.2 Joint Ventures: A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with Ind AS 28, 'Investments in Associates and Joint Ventures', unless the entity is exempted from applying the equity method as specified in that standard.

A party that participates in, but does not have joint control of, a joint venture shall account for its interest in the arrangement in accordance with Ind AS 109, *'Financial Instruments'*, unless it has significant influence over the joint venture, in which case it shall account for it in accordance with Ind AS 28.

8.37.5 Separate Financial Statements

In its separate financial statements, a joint operator or joint venturer shall account for its interest in:

(a) a joint operation in accordance with this AS;

(b) a joint venture in accordance with Ind AS 27, *'Separate Financial Statements'*.

In its separate financial statements, a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:

(a) a joint operation in accordance with this AS;

(b) a joint venture in accordance with Ind AS 109, unless the entity has significant influence over the joint venture, in which case it shall apply Ind AS 27.

8.37.6 Major Change in Ind AS 110 vis-à-vis IFRS 10 Not Resulting in Carve Out

Appendix C 'Business Combinations under Common Control' : Paragraph B33D refers to the accounting specified in Appendix C 'Business Combinations under Common Control' of Ind AS 103 for the acquisition of an interest in a joint operation when the parties sharing joint control, including the entity acquiring the interest in the joint operation, are under the common control of the same ultimate controlling party or parties both before and after the acquisition, and that control is not transitory. IFRS 11 scopes out the same as IFRS 3, Business Combinations, does not deal with business combinations under common control.

8.37.7 Major Differences between Ind AS 110 *vis-a-vis* Notified AS 21

(i) ***Types of Joint Arrangement/Joint Venture****:* Existing AS 27 recognises three forms of joint venture namely: a) jointly controlled operations, b) jointly controlled assets and c) jointly controlled entities. As per Ind AS 111, a joint arrangement is either a joint operation or a joint venture. Such classification of joint arrangement depends upon the rights and obligations of the parties to the arrangement and disregards the legal structure.

(ii) ***Joint Control****:* Existing AS 27 provides that in some exceptional cases, an enterprise by a contractual arrangement establishes joint control over an entity which is a subsidiary of that enterprise within the meaning of AS 21, '*Consolidated Financial Statements'*. In those cases, the entity is consolidated under AS 21 by the said enterprise, and is not treated as a joint venture. Ind AS 111 does not recognise such cases keeping in view the definition of control given in Ind AS 110.

(iii) ***Equity Method****:* Ind AS 111 provides that a venturer can recognise its interest in joint venture using only equity method as per Ind AS 28. Existing AS 27 prescribes the use of proportionate consolidation method only.

(iv) ***Interest in Jointly Controlled Entity****:* In case of separate financial statements under existing AS 27, interest in jointly controlled entity is accounted for as per AS 13, Accounting for Investments, i.e., at cost less provision for other than temporary decline in the value of investment. Ind AS 111 requires that the joint operator shall recognise its interest in joint operation and a joint venture in accordance with Ind AS 28, *'Investments in Associates and Joint Ventures'*.

(v) ***Near Future****:* An explanation has been given in existing AS 27 regarding the term 'near future' used in an exemption given from applying proportionate consolidation method, i.e., where the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

This explanation has not been given in the Ind AS 111, as such situations are now covered by Ind AS 105, '*Non-current Assets Held for Sale and Discontinued Operations'*.

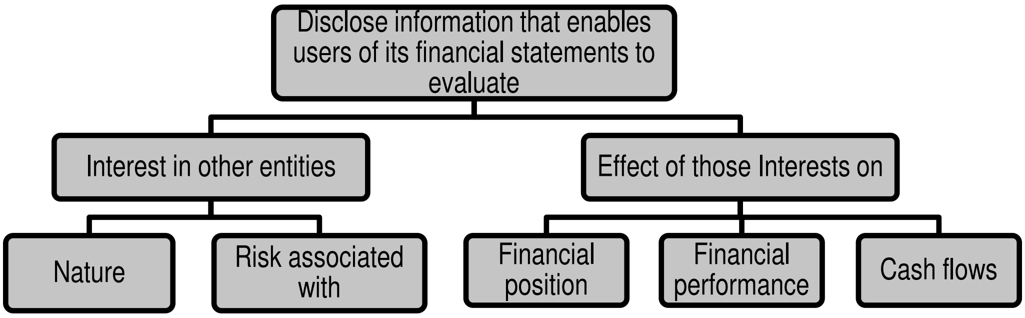
(vi) ***Application of the Proportionate Consolidation Method****:* Existing AS 27 requires application of the proportionate consolidation method only when the entity has subsidiaries and prepares Consolidated Financial Statements. Ind AS 111 requires application of equity method in financial statements other than separate financial statements in case of a joint venture, even if the venturer does not have any subsidiary in the financial statements

(vii) ***Disclosure of Venturer's Share in Post-acquisition Reserves***: Existing AS 21 provides clarification regarding disclosure of venturer's share in post-acquisition reserves of a jointly controlled entity. The same has not been dealt with in the Ind AS 111.

8.38 Ind AS 112: Disclosure of Interests in Other Entities

8.38.1 Objective

The objective of this Indian Accounting Standard (Ind AS) is to require an entity to disclose information that enables users of its financial statements to evaluate:



To meet the above objective, an entity shall disclose:

(a) the significant judgements and assumptions it has made in determining:

(i) the nature of its interest in another entity or arrangement;

(ii) the type of joint arrangement in which it has an interest;

(iii) that it meets the definition of an investment entity, if applicable; and

(b) information about its interests in:

(i) Subsidiaries;

(ii) Arrangements and Associates; and

(iii) Structured Entities that are not controlled by the entity (Unconsolidated Structured Entities).

If the disclosures required by this Ind AS, together with disclosures required by other Ind AS, do not meet the above objective, an entity shall disclose whatever additional information is necessary to meet that objective.

8.38.2 Scope

This Ind AS shall be applied by an entity that has an interest in any of the following:

- Subsidiaries
- Joint arrangements (i.e. Joint operations or Joint ventures)
- Associates
- Unconsolidated Structured Entities

This Ind AS does not apply to:

(a) post-employment benefit plans or other long-term employee benefit plans to which Ind AS 19, *'Employee Benefits'*, applies.

(b) an entity's separate financial statements to which Ind AS 27, *'Separate Financial Statements'*, applies. However:

(i) if an entity has interests in unconsolidated structured entities and prepares separate financial statements as its only financial statements, it shall apply the specified requirements when preparing those separate financial statements.

(ii) an investment entity that prepares financial statements in which all of its subsidiaries are measured at fair value through profit or loss in accordance with paragraph 31 of Ind AS 110 shall present the disclosures relating to investment entities required by this Ind AS.

(c) an interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the arrangement or is an interest in a structured entity.

(d) an interest in another entity that is accounted for in accordance with Ind AS 109, *'Financial Instruments'*. However, an entity shall apply this Ind AS:

(i) when that interest is an interest in an associate or a joint venture that, in accordance with Ind AS 28, *'Investments in Associates and Joint Ventures'*, is measured at fair value through profit or loss; or

(ii) when that interest is an interest in an unconsolidated structured entity.

8.38.3 Significant Judgements and Assumptions

An entity shall disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining:

That it has control of another entity, i.e. an investee as described in Ind AS 110 *'Consolidated Financial Statements'*

That it has joint control of an arrangement or significant influence over another entity

The type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle

8.38.4 Investment Entity Status

When a parent determines that it is an investment entity in accordance with Ind AS 110, the investment entity shall disclose information about significant judgements and assumptions it has made in determining that it is an investment entity.

If the investment entity does not have one or more of the typical characteristics of an investment entity, it shall disclose its reasons for concluding that it is nevertheless an investment entity.

When an entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including:

(a) the total fair value, as of the date of change of status, of the subsidiaries that cease to be consolidated;

(b) the total gain or loss, if any, calculated in accordance with Ind AS 110; and

(c) the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

8.38.5 Interests in Subsidiaries

An entity shall disclose information that enables users of its consolidated financial statements:

(a) to understand:

  (i) the composition of the group; and

  (ii) the interest that non-controlling interests have in the group's activities and cash flows; and

(b) to evaluate:

  (i) the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;

  (ii) the nature of, and changes in, the risks associated with its interests in consolidated structured entities;

  (iii) the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and

  (iv) the consequences of losing control of a subsidiary during the reporting period.

8.38.6 Interests in Unconsolidated Subsidiaries (Investment Entities)

An investment entity that, in accordance with Ind AS 110, is required to apply the exception to consolidation and instead account for its investment in a subsidiary at fair value through profit or loss shall disclose that fact.

For each unconsolidated subsidiary, an investment entity shall disclose:

- Subsidiary's name
- Principal place of business (and Country of incorporation if different from the principal place of business) of the Subsidiary
- Proportion of ownership interest held by the Investment Entity and, if different, the proportion of voting rights held

If an investment entity is the parent of another investment entity, the parent shall also provide the above disclosures for investments that are controlled by its investment entity subsidiary.

An investment entity is required to make disclosures regarding the nature and extent of any significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity and any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, etc.

8.38.7 Interests in Joint Arrangements and Associates

An entity shall disclose information that enables users of its financial statements to evaluate:

(i) the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and

(ii) the nature of, and changes in, the risks associated with its interests in joint ventures and associates.

8.38.8 Interests in Unconsolidated Structured Entities

An entity shall disclose information that enables users of its financial statements:

(i) to understand the nature and extent of its interests in unconsolidated structured entities; and

(ii) to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

8.39 Ind AS 113: Fair Value Measurement

8.39.1 Objective

- Defines fair value
- Sets out in a single Ind AS a framework for measuring fair value; and
- Requires disclosures about fair value measurements

Fair value is a market-based measurement, not an entity-specific measurement.

The objective of a fair value measurement is—

- To estimate the price
- At which an orderly transaction to sell the asset or to transfer the liability would take place
- Between market participants
- At the measurement date
- Under current market conditions

(i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

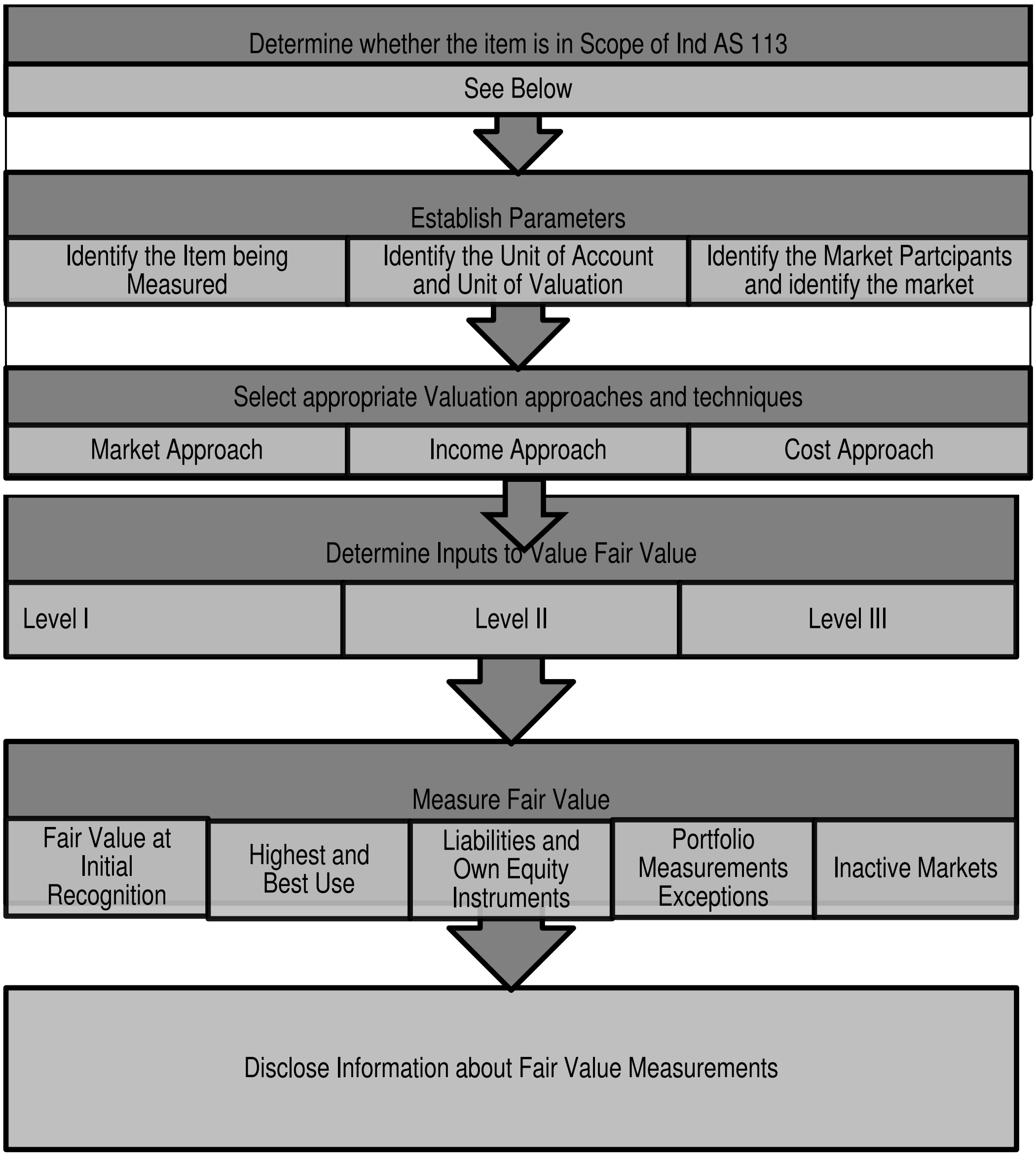
When a price for an identical asset or liability is not observable, an entity measures fair value using another valuation technique that:

- Maximises the use of relevant observable inputs and
- Minimises the use of unobservable inputs.

Because fair value is a market-based measurement, it is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

The definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. In addition, this Ind AS shall be applied to an entity's own equity instruments measured at fair value.

Manner to proceed for the understanding of Ind AS 113:



8.39.2 Scope

This Ind AS applies when another Ind AS requires or permits:

- Fair value measurements or
- Disclosures about fair value measurements

The measurement and disclosure requirements of this Ind AS do not apply to the following:

Share-based payment transactions	• Within the scope of Ind AS 102 Share- based Payment
Leasing transactions	• Within the scope of Ind AS 17 Leases
Measurements that have some similarities to fair value but are not fair value	• Such as NRV in Ind AS 2; or • 'Value in use' in Ind AS 36

The disclosures required by this Ind AS are not required for the following:

- Plan assets measured at fair value in accordance with Ind AS 19
- Assets for which recoverable amount is fair value less costs of disposal in accordance with Ind AS 36

The fair value measurement framework described in this Ind AS applies to both initial and subsequent measurement if fair value is required or permitted by other Ind AS.

8.39.3 Measurement

Definition of fair value: This Ind AS defines fair value as:

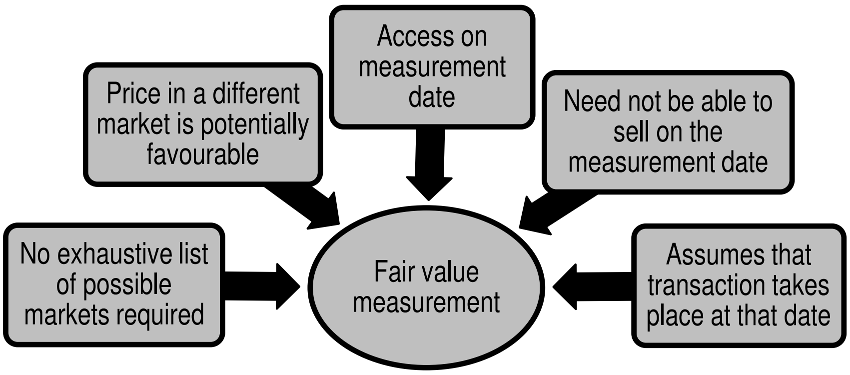
Fair Value			
The price that would be received to sell an asset or paid to transfer a liability	In an orderly transaction	Between market participants	At the measurement date

***Asset or liability*:** A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Such characteristics include, the condition and location of the asset; and restrictions, if any, on the sale or use of the asset.

***The transaction*:** A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions. A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either, in the principal market for the asset or liability or in the absence of a principal market, in the most advantageous market for the asset or liability.

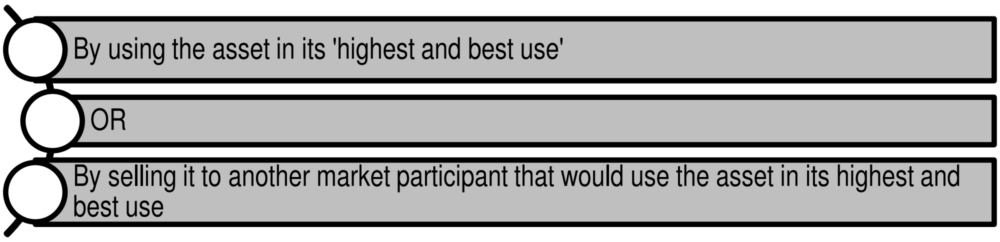
***Market participants*:** An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their best economic interest.

***The price*:** Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (ie an exit price) regardless of whether that price is directly observable or estimated using another valuation technique.



8.39.4 Application to Non-financial Assets

Highest and best use for non-financial assets: A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits:



The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible.

8.39.5 Application to Liabilities and an Entity's Own Equity Instruments

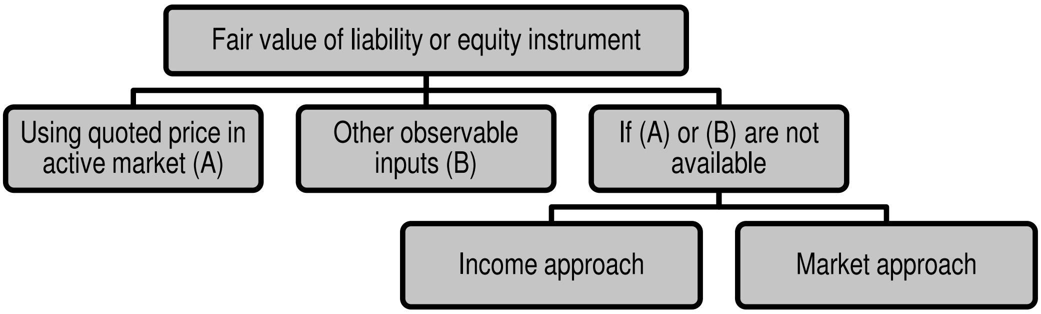
General Principles: A fair value measurement assumes that a financial or non-financial liability or an entity's own equity instrument (e.g. equity interests issued as consideration in a business combination) is transferred to a market participant at the measurement date. The transfer of a liability or an entity's own equity instrument assumes the following:

a) A liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.

b) An entity's own equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date.

8.39.5.1 Liabilities and equity instruments held by other parties as assets: When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date.

In such cases, an entity shall measure the fair value of the liability or equity instrument as follows:



8.39.5.2 Liabilities and Equity Instruments not held by Other Parties as Assets: When a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available and the identical item is not held by another party as an asset, an entity shall measure the fair value of the liability or equity instrument using a valuation technique from the perspective of a market participant that owes the liability or has issued the claim on equity.

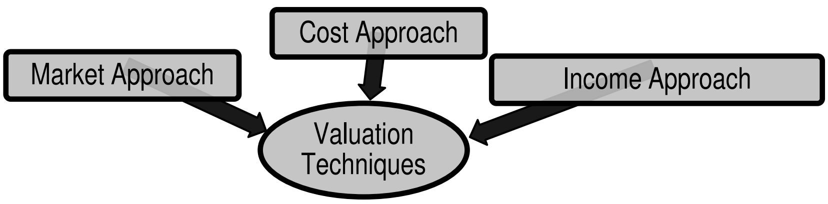
8.39.6 Valuation Techniques

An entity shall use valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value by

- Maximising the use of relevant observable inputs and
- Minimising the use of unobservable inputs

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.

Three widely used valuation techniques are:



1. ***Income Approach*: ** The income approach converts future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

   Those valuation techniques include, for example, the following:

   - Present value techniques
   - Option pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e. a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option
   - The multi-period excess earnings method, which is used to measure the fair value of some intangible assets

2. ***Market Approach*: ** The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

   For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables. Multiples might be in ranges with a different multiple for each comparable. The selection of the appropriate multiple within the range requires judgement, considering qualitative and quantitative factors specific to the measurement.

   Valuation techniques consistent with the market approach include matrix pricing. Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities' relationship to other benchmark quoted securities.

An entity shall use valuation techniques consistent with one or more of those approaches to measure fair value.

8.39.7 Fair Value Hierarchy

To increase consistency and comparability in fair value measurements and related disclosures, this Ind AS establishes a fair value hierarchy that categorises into three levels, the inputs to valuation techniques used to measure fair value.

The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

In some cases, the inputs used to measure the fair value of an asset or a liability might be categorised within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to the entire measurement requires judgement, taking into account factors specific to the asset or liability. Adjustments to arrive at measurements based on fair value, such as costs to sell when measuring fair value less costs to sell, shall not be taken into account when determining the level of the fair value hierarchy within which a fair value measurement is categorised.

The availability of relevant inputs and their relative subjectivity might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritises the inputs to valuation techniques, not the valuation techniques used to measure fair value.

For example: A fair value measurement developed using a present value technique might be categorised within Level 2 or Level 3, depending on the inputs that are significant to the entire measurement and the level of the fair value hierarchy within which those inputs are categorised. If an observable input requires an adjustment using an unobservable input and that adjustment results in a significantly higher or lower fair value measurement, the resulting measurement would be categorised within Level 3 of the fair value hierarchy.

For example: If a market participant would take into account the effect of a restriction on the sale of an asset when estimating the price for the asset, an entity would adjust the quoted price to reflect the effect of that restriction. If that quoted price is a Level 2 input and the adjustment is an unobservable input that is significant to the entire measurement, the measurement would be categorised within Level 3 of the fair value hierarchy.

8.39.7.1 Level 1 Inputs: Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.

A quoted price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available.

A Level 1 input will be available for many financial assets and financial liabilities, some of which might be exchanged in multiple active markets (e.g. on different exchanges). Therefore, the emphasis within Level 1 is on determining both of the following:

- The principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability
- Whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date

8.39.7.2 Level 2 Inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

(a) quoted prices for similar assets or liabilities in active markets.

(b) quoted prices for identical or similar assets or liabilities in markets that are not active.

(c) inputs other than quoted prices that are observable for the asset or liability, for example:
   (i) interest rates and yield curves observable at commonly quoted intervals;
   (ii) implied volatilities; and
   (iii) credit spreads.
   (iv) market-corroborated inputs.

8.39.7.3 Level 3 Inputs

Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability.

For example: It might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability, or similar assets or liabilities, and the entity has determined that the transaction price or quoted price does not represent fair value).

8.39.8 Disclosure

An entity shall disclose information that helps users of its financial statements assess both of the following:

(a) for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the balance sheet after initial recognition, the valuation techniques and inputs used to develop those measurements.

(b) for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

8.39.9 Major Change in Ind AS 113 *vis-à-vis* IFRS 13 Not Resulting in Carve Out

Paragraph 7(b) of IFRS 13: Paragraph 7(b) of IFRS 13 refers to IAS 26 '*Accounting and Reporting by Retirement Benefit Plans*', which is not relevant for the companies. Hence the paragraph is deleted in Ind AS 113.

8.40 Ind AS 114 : Regulatory Deferral Accounts

8.40.1 Objective

The objective of this Standard is to specify the financial reporting requirements for regulatory deferral account balances that arise when an entity provides goods or services to customers at a ***price or rate that is subject to rate regulation.***

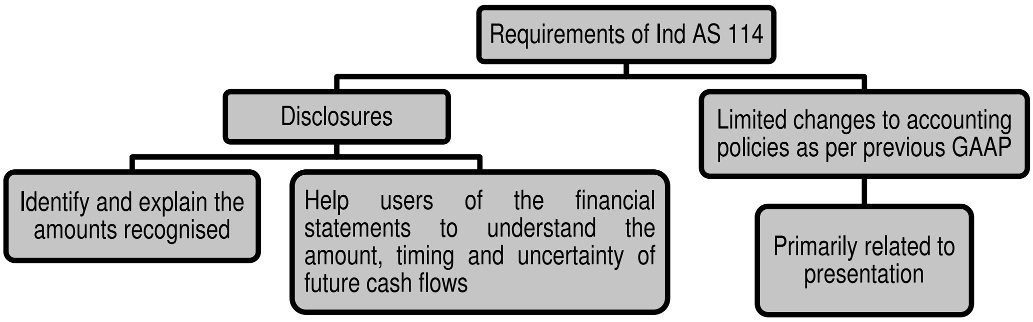
In meeting this objective, the Standard requires:

(a) limited changes to the accounting policies that were applied in accordance with previous generally accepted accounting principles (previous GAAP) for regulatory deferral account balances, which are primarily related to the presentation of these accounts; and

(b) disclosures that:

(i) identify and explain the amounts recognised in the entity's financial statements that arise from rate regulation; and

(ii) help users of the financial statements to understand the amount, timing and uncertainty of future cash flows from any regulatory deferral account balances that are recognised.

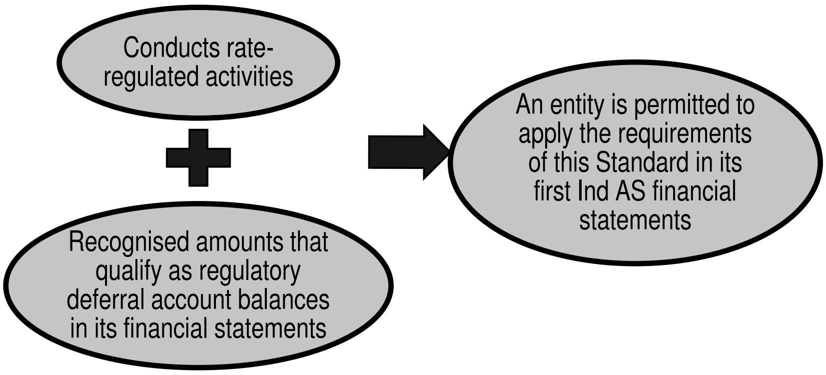


8.40.2 Scope

An entity is permitted to apply the requirements of this Standard in its first Ind AS financial statements if and only if it:

(a) conducts rate-regulated activities; and

(b) recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP.



1. An entity shall apply the requirements of this Standard in its financial statements for subsequent periods if and only if, in its first Ind AS financial statements, it recognised regulatory deferral account balances by electing to apply the requirements of this Standard.
2. This Standard does not address other aspects of accounting by entities that are engaged in rate-regulated activities.
3. An entity that is within the scope of, and that elects to apply, this Standard shall apply all of its requirements to all regulatory deferral account balances that arise from all of the entity's rate-regulated activities.

Regulatory Deferral Account Balance: A 'Regulatory Asset' or a 'Regulatory Liability' as defined in the *Guidance Note on Accounting for Rate Regulated Activities*.

Rate-Regulated Activities: An entity's activities that are subject to rate regulation.

Rate Regulation: 'Cost of Service Regulation' as defined in the Guidance Note on Accounting for Rate Regulated Activities.

8.40.3 Recognition, Measurement, Impairment and Derecognition

Temporary Exemption from paragraph 11 of Ind AS 8 '*Accounting Policies, Changes in Accounting Estimates and Errors'*

An entity that has rate-regulated activities and that is within the scope of, and elects to apply, this Standard shall apply paragraphs 10 and 12 of Ind AS 8 when developing its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances.

8.40.3.1 Continuation of Existing Accounting Policies: On initial application of this Standard, an entity shall continue to apply previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances, except for any changes permitted by paragraphs 13–15. However, the presentation of such amounts shall comply with the presentation requirements of this Standard, which may require changes to the entity's previous GAAP presentation policies.

8.40.3.2 Changes in Accounting Policies: An entity shall not change its accounting policies in order to start to recognise regulatory deferral account balances. An entity may only change its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in paragraph 10 of Ind AS 8.

8.40.3.3 Interaction with Other Standards: Any specific exception, exemption or additional requirements related to the interaction of this Standard with other Standards are contained within this Standard. In the absence of any such exception, exemption or additional requirements, other Standards shall apply to regulatory deferral account balances in the same way as they apply to assets, liabilities, income and expenses that are recognised in accordance with other Standards.

8.40.4 Presentation

8.40.4.1 Classification of Regulatory Deferral Account Balances: An entity shall present separate line items in the balance sheet for:

(a) the total of all regulatory deferral account debit balances; and

(b) the total of all regulatory deferral account credit balances.

When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its balance sheet, it shall not classify the totals of regulatory deferral account balances as current or non-current. Instead, the separate line items shall be distinguished from the assets and liabilities that are presented in accordance with other Standards by the use of sub-totals, which are drawn before the regulatory deferral account balances are presented.

8.40.4.2 Classification of Movements in Regulatory Deferral Account Balances: An entity shall present, in the other comprehensive income section of the statement of profit and loss, the net movement in all regulatory deferral account balances for the reporting period that relate to items recognised in other comprehensive income. Separate line items shall be used for the net movement related to items that, in accordance with other Standards:

(a) will not be reclassified subsequently to profit or loss; and

(b) will be reclassified subsequently to profit or loss when specific conditions are met.

An entity shall present a separate line item in the profit or loss section of the statement of profit and loss, for the remaining net movement in all regulatory deferral account balances for the reporting period, excluding movements that are not reflected in profit or loss, such as amounts acquired. This separate line item shall be distinguished from the income and expenses that are presented in accordance with other Standards by the use of a sub-total, which is drawn before the net movement in regulatory deferral account balances.

8.40.5 Disclosures

An entity that elects to apply this Standard shall disclose information that enables users to assess:

(a) the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and

(b) the effects of that rate regulation on its financial position, financial performance and cash flows.

8.40.6 Major Changes in Ind AS 114 *vis-à-vis* IFRS 14 Not Resulting in Carve Outs

1. ***Definition of previous GAAP:*** Appendix A 'Defined terms' of Ind AS 114 have been modified to clarify that *Guidance Note of Accounting for Rate Regulated Activities* would be considered as the previous GAAP for the purpose of Ind AS 114.
2. ***Application of requirements of previous GAAP:*** Under paragraph 6 of Ind AS 114, a footnote has been added to clarify the application of requirements of previous GAAP in the case of an entity subject to rate regulation coming into existence after Ind AS coming into force or an entity whose activities become subject to rate regulation as defined in this Ind AS subsequent to preparation and presentation of its first Ind AS financial statements.

3

Corporate Financial Reporting

1. Introduction

An understanding of the conceptual bases of the corporate financing reporting system and preparation of financial statements are essential prerequisites to be a good accountant or a financial analyst. This Chapter intends to explain the corporate financial reporting system and issues involved. Regulatory framework of corporate financial reporting in India and practices of Indian Companies are also covered. In the last section reporting issues relating to matters that are reported outside the general purpose financial statements are considered.

2. Corporate Financial Reporting System

This chapter discusses the conceptual issues of corporate financial reporting.

2.1 Concept of Corporate Financial Reporting

Financial reporting is the communication of financial information of an enterprise to the external world. Bedford conceptualizes the financial reporting process as consisting of four procedural steps:

1. Perception of the significant activity of the accounting entity or in the environment in which the entity performs. Implicit in the traditional perception is the belief that financial transactions represent the significant activities.
2. Symbolizing the perceived activities in such fashion that a database of the activities is available that can then be analyzed to grasp an understanding of the interrelationship of the mass of perceived activities. Conventionally, this symbolization has taken the form of recordings in accounts, journals, and ledgers using well-established bookkeeping and measurement procedures.
3. Analysis of the model of activities in order to summarize the interrelationships among activities and to provide a status picture or map of the entity. Traditionally, this analysis process has been viewed as one of developing accounting reports to provide insights into the nature or entity activities.
4. Communication (transmission) of the analysis to users of the accounting products to guide decision makers in directing future activities of the entity or in changing their relationship with the entity.

First two steps constitute the process of accounting **measurement,** the quantification of an entity's past, and present, or future economic phenomena on the basis of observations and rules. Implicit in this conception are the requirements that (a) there exist some attribute or feature of a business-related objects or event (e.g.; the value of an asset) worthy of measurement and (b) there exist a means of making the measurements (e.g., the use of exchange prices to value enterprise assets). Step 3 and 4 of the financial reporting process constitute **disclosure.** Hence, measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Corporate financial reporting is a series of activities that allows companies to record operating data and report accurate accounting statements at the end of each month, quarter and year. Bookkeepers record operating data by debiting and crediting financial accounts. Accountants prepare financial statements in accordance with corporate policies, industry practices and regulatory guidelines.

As per Section 2(40) of the Companies Act, 2013, the Financial statements of the company include:

1. a balance sheet at the end of the financial year;
2. a profit and Loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
3. cash flow statement for the financial year;
4. a statement of change in equity, if applicable; and
5. any explanatory note annexed to, or forming part of, any document referred to in sub-clause(i) to sub-clause (iv).

Provided that the financial statements, with respect to One Person Company, small company or dormant company, may not include the cash flow statement.

The financial statements, augmented by footnotes and supplementary data (often referred to as 'Notes to the Accounts') are intended to provide relevant, reliable and timely information essential for making investment, credit and similar decision. Such financial statements are called *general purpose financial statements*.

It may be mentioned that the term financial reporting is not restricted to information communicated through financial statements. Financial reporting includes other means of communicating information that relates, directly or indirectly to the information generated through accounting process. Information provided by means of financial reporting other than financial statements may take various forms and relate to various matters. Communication by means of financial reporting other than a formal financial statement is made due to regulatory requirements or customs. In a few occasions, management may communicate any matter voluntarily when it considers such communication is useful to the stakeholders outside the enterprise. Publication of unaudited financial results, news releases, management forecasts and description of future plans are examples of reports that are provided outside the general purpose financial statements.

2.2 Users of Financial Statements

Different classes of users use financial information for different purposes. Identification of the users and their classes is necessary in order to determine the purposes for which they use information. Identification of users helps in defining user group characteristics which influence both the specific type of information to be presented and the manner of presentation.

According to the Framework for the Preparation and Presentation of Financial Statements issued by the ICAI in 2000 (hereinafter referred to as 'ICAI Conceptual Framework') the users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

The common characteristic of external users is their general lack of authority to prescribe the information they want from a company. It is also observed that some users have more resource and influence than others so that they can obtain more information about an enterprise than is generally available to others. These privileged users include managers, large scale equity investors etc. These different user groups have different objectives and diverse information needs. But, general purpose financial statements are prepared to meet the common needs of all types of users. However, all of the information needs of these users cannot be met by such a report. Multiplicity and conflicts of objectives of a wide variety of potential users for general purpose reports make it difficult to design a single set of published statements that can simultaneously provide all necessary information to all possible users.

Traditionally, investors (both existing and potential) are singled out as the dominant user-group of published financial statements. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The ICAI Conceptual Framework states that the provision of financial statements, which meet the investors' needs, will also meet most of the needs of other users. Also in practice, top priority is given to the information needs of the investors while deciding what items of information should be disclosed in general purpose financial statements.

2.3 Objectives of Corporate Financial Reporting

Corporate financing reporting is not an end in itself but is a means to certain objectives. There are debates regarding objective of financial reporting. However, some consensus has been developed on the objectives of financial reporting through the issuance of the conceptual framework. The conceptual framework provides the conceptual basis for generally accepted accounting principles (GAAP). It outlines the characteristics accounting information must possess to be useful in investment and other economic decisions. Like other standard setting bodies, paragraph 22 of the Framework states that the objective of financial statements is to provide information about financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions. The Framework specifies present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public as the users of financial statements.

In USA, the FASB has identified the following major objectives of financial reporting:

(i) Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

(ii) Financial reporting should provide information to help investors, creditors, and others to assess the amount, timing and uncertainly of prospective net cash inflows to the related enterprise.

(iii) Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.

(iv) Financial reporting should provide information about an enterprise's financial performance during a period.

(v) The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.

(vi) Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

(vii) Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.

(viii) Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners.

Apart from investment decision making another objective of financial reporting is to provide information on management accountability. Management accountability is a broad concept that encompasses stewardship. The accountability relationship may be created by a constitution, a law, a contract an organization make, a custom or even by informal moral obligation. It is considered that management of an enterprise is periodically accountable to the owners not only for safekeeping of resources but also for their efficient and profitable use. Management accountability objective mainly emphasizes reliability aspect of accounting information. Accordingly, compared to relevance, verifiability through adequate documents, records and system is considered dominant consideration for inclusion of any piece of information in the financial statement.

Corporate financial reporting being user oriented and users' need of information being not same, the role of accounting and financial reporting may vary from country to country. But, financial reporting is central to the process of allocating financial resources in capital markets. Hence, primary purpose of providing useful information to all users, which help them in decision making, is common in all countries.

2.4 Capital Market and Non-Financial Influences on Corporate Financial Reporting

Till the quarter of the twentieth century, financial reporting was confined to the stewardship reporting, i.e., reporting of the wealth and income earned by the owners. With the growth in size, companies need large sums of money to finance extensive productions and distribution activities. Due to internal financial constraints, companies depend heavily on external capital markets to finance the capital needs. However, investors are seldom in a position to observe on a day-to-day basis, whether saving entrusted to the companies are utilized efficiently and effectively. Hence, investors expect and are provided with an accounting for the stewardship of monies entrusted to the company. Stewardship traditionally refers to the safe keeping of resources and the execution of plans for conserving and utilizing them. Modern concept of accountability of management extends beyond the element of stewardship and covers performance based issues. The managers of the companies accept the accountability phase of their stewardship, or at least recognize in self-interest that disclosure through financial reporting process delegates part of the responsibility for assessing the financial status of the company and its performance to the users of financial reporting but, with the growth of the capital market, the central focus of financial reporting has been shifted from stewardship reporting to decision-oriented financial reporting.

Further, the competition among the companies to obtain external financing at a relatively cheaper rate has impact on corporate disclosure. Companies are now making expanded disclosure to attract capital in domestic capital market and/or in international market and to reduce the firm's cost of capital. There are various research studies that establish that increased firm disclosure has definite impact a firm's overall cost of capital. Such reduction of cost of capital through expanded disclosure has linkage with the theory of behaviour of investors who take investment decision under uncertainty. Increased disclosure in financial reports improves the subjective probability distributions of a security's expected returns in the mind of an investor by reducing the uncertainty associated with that return stream.

Thus, capital market influences are having a major role in sharing the nature of corporate financing reporting that is now driven by the consideration of decision usefulness. The objective of decisional usefulness has formally been incorporated into the conceptual frameworks for the preparation and presentation of financial statements set out by the standard setting bodies of different countries as well as by the International Accounting Standards Committee.

Apart from accountability to shareholders, there is a growing worldwide trend of holding companies accountable to the public at large. Such a trend is responsible for changing the disclosure practice of companies to a considerable extent. Such a movement is creating companies aware about the disclosure needs of "non-financial shareholders" such as trade unions (interested in terms of employment), government (interested in the macroeconomic impact of operations of corporate sector) and general public (interested in social and environmental impact of corporate actions). Voluntary reporting of employee information, environmental information and other corporate social responsibility reports (e.g. social balance sheet) are example of disclosure arising from non-financial influences. Corporate response to such expanded disclosure requirements are mixed. However, it is desirable that financial reporting should cater needs of all type of users.

2.5 Qualitative Characteristics of Information in Financial Report

Qualitative characteristics are the attributes that make the information provided in the financial statement useful to the users. ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic. A piece of information is considered to be material when its disclosure or non-disclosure would affect decision or would make a difference in the valuation of the firm. But, in the ICAI Conceptual Framework, materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

2.5.1 Understandability

Information in annual reports should be presented in such a way that it is readily understandable by users. ICAI Conceptual Framework states that the criterion of understandability requires that the users have a reasonable knowledge of business and economic activities, accounting, and a willingness to study the information with reasonable diligence. It has also suggested that information, which is relevant to the economic decision-making needs of some of the users should not be excluded merely on the ground that it may be difficult to understand by others.

2.5.2 Relevance

The concept of relevance is directly related to the decision making needs of users. Information is said to be relevant if it can influence 'the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluation. It is suggested that all those items of information, which may aid the users in making predictions or decisions, should be reported. Information, which does not assist users in making decisions is irrelevant and hence, should be omitted. Thus, relevance is the dominant criterion of taking decisions regarding information disclosure. *Timeliness* is an important aspect of relevance. Information loses value rapidly in the financial world. As time passes and the future becomes the present, past information became increasingly irrelevant.

2.5.3 Reliability

Information is reliable if it is free from material error and bias, and faithfully represents what it purports to represent. Information is reliable to the extent a user can depend upon it to represent the economic conditions or events that it aims to represent. Being free from bias implies impartial measurement and reporting by enterprise of its events and transactions.

2.5.4 Comparability

The ICAI Conceptual Framework emphasizes that users must be able to compare financial statements, of an enterprise through time in order to identify trends in its financial position, performance and cash flows, and of different enterprises in order to evaluate their relative financial position, performance and cash flows. For this purpose, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way. The Framework indicates that the important implication of comparability is that users should be informed of the accounting policies employed in the preparation of financial statements, any changes of those policies and the effects of such changes. For achieving comparability, the Framework (paragraph 40) suggests compliance with relevant accounting standards including the disclosure of accounting policies used by the enterprise.

2.6 Theories of Disclosure

2.6.1 Concept of Disclosure

The concept of disclosure is of great significance to the accomplishment of the objectives of financial reporting. Financial reporting is the communication of financial information of an enterprise to the external world.

The theory is that a fully informed consumer would more likely make better choices. Knowing the true cost of everything would force consumers to be better educated and more informed.

Available disclosure literature suggests that disclosure is not only fundamental to financial reporting but is, at the same time, its most qualitative aspect and the nature and extent of disclosure needed in individual reporting situations is determinable only by expert professional judgment. Disclosure standards and practices are influenced by legal systems, source of finance, political and economic environments, education level and culture.

2.6.2 Motives behind Disclosure

It is argued that competition for capital is the major motivating force to disclose decision-oriented information to different user groups. Hence, market forces would ultimately shape the nature of corporate disclosure. Corporations not only compete among each other in the capital markets but also attempt to obtain capital at a lower cost. It is indicated by many researchers that there is relationship between a firm's capital cost and its level of disclosure in its annual report. Due to such linkage and decision usefulness of published financial statement, corporate financial reporting is perceived as a pre-requisite for the growth of capital markets. Apart from stock market considerations, there are varieties of considerations that may motivate management of a company to disclose information voluntarily and not wait for mandatory requirements. Some of these important considerations are:

- Political costs consideration
- Users' needs consideration, and
- Ideological goal consideration.

Political costs consideration: Fines, penalties, potential public hostility toward the company are the examples of political costs. It is now recognized that political costs may play an important role in decisions relating to additional disclosure in the form of social and environmental information. Disclosure of environmental information can be considered to reassure the public or the regulating agencies that companies were concerned about the environment and were doing everything possible to reduce the negative impact of their activities on the environment.

Users' needs consideration: Guthrie and Parker have argued that companies may disclose social information to meet the stakeholders' demand for such information. The argument is based on Users' Utility Model. Disclosure of additional information on a voluntary basis depends on the users' needs, and how these needs are perceived by management of companies.

Ideological goal consideration: It has been argued that companies would be motivated to disclose voluntarily additional information to serve their own political and ideological goals. Such disclosure would be guided by companies' agenda, ideologies and goals which are likely to be different for different companies even within the same industry. Consequently, disclosure of such information will vary from company to company.

2.6.3 Basic Problems of Disclosure

In disclosing information, business enterprises, particularly corporate entities, are confronted with certain basic problems, the solutions of which need answers to the following questions:

(i) Who are the users of information or for whom information should be disclosed?

(ii) What information should be disclosed?

(iii) How much information should be disclosed?

(iv) How should information be disclosed?

(v) When should information be disclosed?

The first question requires identification of users of information. The second question needs the identification of the purposes for which information will be used. The third question relates to the problem of determining quantum of information. The fourth and fifth questions concern the problems of deciding about the mode and timing of disclosure respectively.

Disclosure being the transmission of accounting measurement to the users group, corporate entities views it as a major policy issue. As the disclosure of accounting information is not costless, preparers of financial statement have to make judgments on the allocation of accounting information among various user groups.

From regulator's standpoints, leaving the decision about disclosure in the hand corporate management or market forces, has not been viewed favourably. It is possible for management to disclose information that is considered helpful to facilitate its external relations programmes and still withhold certain pieces of vital information that is useful for decision making by the users. Hence, greater control over corporate reporting is imposed whenever it is perceived that there is failure to adequately respond to express information needs of different stakeholders.

Thus, the scope of negative sanctions of regulatory controls over corporate disclosure increases when user groups perceive that there are deficiencies on the part of companies in providing adequate disclosure.

2.7 Role of Auditors

The audit of financial statements is a legal requirement. The audit provides an external and objective check on the measurement and disclosure aspects of corporate financial reporting. An auditor is appointed by the shareholders, but effectually his appointment is subject to will of management or promoter group. Nevertheless, the auditor is supposed to be independent of management and to serve the shareholders and other users of financial statements. Although, Management is responsible for the preparation of financial statement including the notes, the auditor through the auditor's report states whether financial statements presents fairly, in all material respects the financial position, the results of operations and the cash flows for the accounting period. The auditor is responsible for seeing that the financial statements issued conform with generally accepted accounting principles. Thus, the auditor must agree that accounting policies adopted by the management is appropriate and all estimates are reasonable. Any departure from generally accepted accounting principles (including non-compliance with the measurement and disclosure requirements of the accounting standards) would result in a qualified opinion. Auditor's report is an important accompaniment of financial statements. Because of boilerplate nature (ie. standard language) of these reports, there is tendency to skip over them while analyzing financial statements. However, such failure to give attention to the auditor's report may cause the user to miss significant information.

2.8 Quality of Financial Reporting

Ideally, financial statements should reflect an accurate picture of a company, its financial condition and performance. If the financial statements distort economic reality, capital will be deployed sub-optimally; resources will be misallocated; investors will pay a huge opportunity cost by investing in companies with unrealistic, inflated values and better investment opportunities may get bypassed. Regulations on financial reporting generally provides for penalties and other measures to deter accounting frauds. However, it may be pointed out that management has considerable discretion within the overall framework of generally accepted accounting principles. As results, there are scopes for management to "manipulate" the accounts. Such manipulations mainly relate to management of bottom line (profit or loss) and commonly referred to an earnings management. For an investor or a security analyst it is important to recognize that many opportunities exist for management to affect the quality of financial statements. Hence, reported earnings may not best represent economic reality or the future operating potential of a firm.

2.9 Mode of Financial Reporting

A number of documents and avenues of communication are available through which companies provide information about its state of affairs to the external users of such information, for example, annual report, interim report, employee report, environmental report, communications with analysts, letters to shareholders and debt holders, question and answer sessions held at annual general meeting, telephone conversations, speeches made by company officials at stock exchanges and so on.

Despite the existence of different sources of information, the annual report is regarded as the most important source of information about a company's affairs.

A typical corporate annual report usually contains a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report. Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements. Annual reports often contain useful supplementary financial and statistical data as well as management comments. Many companies in India now include Management Discussion and Analysis (MD & A) report, corporate governance report, chairman's statement, historical summary, operating positions, highlights of important data etc.

3. Indian Financial Reporting System

India is a federal state with unitary bias. This is perhaps why, unlike in the USA, there is no separate company law for any state in India. Apart from professional regulation, corporate financial reporting in India is governed primarily by the Companies Act, 2013. Another body that has a major influence in reshaping Indian financial reporting is the Securities and Exchange Board of India (SEBI). The Companies Act, 2013 prescribes the financial reporting requirements for all the companies registered under it. The reporting requirements that are imposed by the SEBI through its Guidelines and through the Listing Agreement are in addition to those prescribed under the Companies Act. SEBI requirements are to be followed by the companies listed on the Indian stock exchanges. The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India.

Role of the SEBI: The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 provides for establishment of Securities and Exchange Board of India (SEBI) with statutory powers for

(a) protecting the interests of investors in securities

(b) promoting the development of the securities market and

(c) regulating the securities market.

Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI has been obligated to perform the aforesaid functions by such measures as it thinks fit. In particular, it has powers for

- Regulating the business in stock exchanges and any other securities markets
- Registering and regulating the working of stock brokers, sub-brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices

- Calling for information, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self - regulatory organizations, mutual funds and other persons associated with the securities market.

SEBI has used its power to order changes in listing agreement and such changes are instrumental to bring about improvement in disclosure practices of listed companies in their annual reports. Listing agreement is the standard agreement between a company seeking listing of its securities and the stock exchange where listing is sought. Any stock exchange has power to alter the clauses of listing agreement unilaterally, and companies listed with that exchange are bound to accept such changes to enjoy the facility of listing. Thus, whenever the SEBI suggests any change, it is incumbent on the listed companies to follow such a change. In effect, the SEBI has power to direct the listed companies to follow any changed disclosure requirements.

SEBI has imposed a number of disclosures and other requirements through this route. Some important requirements are as follows:

- ♦ Dispatch of a copy of the complete & full annual report to the shareholders.
- ♦ Disclosure on the Y2K preparedness level.
- ♦ Disclosure of Cash Flow Statement.
- ♦ Disclosure of material developments and price sensitive information.
- ♦ Compliance with Takeover Code.
- ♦ Disclosure of interim unaudited financial result
- ♦ Disclosure regarding listing fee payment status and the name and address of each stock exchange where the company's securities are listed.
- ♦ Corporate governance report.
- ♦ Compliance with Accounting Standards issued by the ICAI.

The initiative to introduce the Cash Flow Statements (as a principal financial statement) in India was taken by the SEBI and it has used its power under section 11 of the SEBI Act, 1992 to direct all recognized stock exchange for a requirement of appending an audited Cash Flow Statement (CFS) (prepared only as per Indirect method as prescribed in AS 3 or Ind AS 7) as a part of annual accounts. As per the SEBI mandate, the requirement of providing a CFS is mandatory for listed companies from the financial year 1994-95 i.e., year ended 31st March 1995. When the SEBI mandate was issued, there was no accounting standard issued by the ICAI as regard preparation and presentation of a CFS. The ICAI issued a revised accounting standard (AS 3) on the subject by replacing its standard on Fund Flow Statement in March 1997. After introduction of ICAI standard the SEBI has directed a change in the Listing Agreement to provide that CFS shall be prepared in accordance with the ICAI standard. Earlier in the Companies Act, 1956, there was no requirement for preparing the cash flow statement. However, the new Companies Act, 2013 has mandated the Level I entities to prepare the Cash flow statement as one of the main part of its Financial Statements.

The process of the SEBI has resulted in a changed regime for imposition of financial disclosure requirements that is quick and does not require lengthy process of legislative changes. By virtue of the provisions contained in the Listing Agreement, listed companies are now under legal compulsion to comply with all the accounting standards issued by the ICAI.

The Companies Act, 2013: The Companies Act, 2013 lays down the detailed provisions regarding the maintenance of books of accounts and the preparation and presentation of annual accounts. The Act also prescribes the mechanism for issuance of accounting standards by National Financial Reporting Authority (NFRA)**. It specifies the roles and responsibilities of directors and also the matters to be reported upon by them in the annual reports of the companies. Under the provisions of the Act, audit of annual accounts is compulsory for all companies registered under it. The Act extensively deals with the qualification, appointment, removal, rights, duties and liabilities of auditors and provides contents of auditors' report. In case of delinquency/ default by the management or auditor, penal provisions are prescribed. However, despite providing for detailed requirements in respect of maintenance of books of account, preparation and presentation of financial statements and audit of annual accounts, the main thrust under the Companies Act is upon the presentation of a 'true and fair view' of the state of affairs and operating results of the reporting companies.

As the preparation of financial statements contained in annual reports presupposes the existence of a recording procedure of transactions of the reporting entities, the requirements as to the maintenance of books of accounts are also mentioned. As per Section 129 of the Companies Act, 2013, at the annual general meeting of a company, the Board of Directors of the company shall lay financial statements before the company:

Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year;

(iv) a statement of changes in equity, if applicable; and

(v) any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

** *Constitution of NFRA is prescribed under Section 132 of the Companies Act, 2013. However, this section has not been notified till 30th November, 2016.*

Requisites of Financial Statements

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provisions Applicable

(1) Specific Act is Applicable

For instance any

(a) insurance company

(b) banking company or

(c) any company engaged in generation or supply of electricity* or

(d) any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company

(2) In case of all other companies

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III.

Points to be kept in mind while preparing financial statements:

- Requirements of Schedule III to the Companies Act;
- Other statutory requirements;
- Accounting Standards issued by the Institute of Chartered Accountants of India on different accounting matters and notified by the Central Government (AS 1 to AS 32);
- Statements and Guidance Notes issued by the Institute of Chartered Accountants of India; which are necessary for understanding the accounting treatment / valuation / disclosure suggested by the ICAI.

Compliance with Accounting Standards

As per section 133 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

Schedule III to the Companies Act, 2013

As per section 129 of the Companies Act, 2013, financial statements shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III under the Act.

The MCA on 6th April 2016, amended Schedule III to include general instructions for preparation of financial statements of a company whose financial statements are required to comply with Ind AS. The amendment divides Schedule III into two parts i.e. Division I and II:

** The Electricity Act, 2003 does not specify any format for presentation of Financial Statements. Therefore, Schedule III of the Companies Act, 2013 is followed by Electricity Companies in preparation of their financial statements.*

- Division I is applicable to a company whose financial statements are required to comply with the current accounting standards.
- Division II is applicable to a company whose financial statements are drawn up in compliance with Ind AS.

Schedule III to the Companies Act, 2013 has been given as Appendix at the end of the Module I of the Study Material. For full details, students are advised to refer the same.

The Financial Statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the companies Act, 2013 and shall be in the form of or forms as may be prescribed for different class or classes of companies in Schedule III. As per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Section 135 of the Companies Act, 2013 deals with Corporate Social Responsibility obligations for the companies. As per provisions of this section, every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director. The Board of every company shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy:

Provided that the company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities:

The Corporate Social Responsibility Committee shall,

(a) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;

(b) recommend the amount of expenditure to be incurred on the activities referred to in clause (a); and

(c) monitor the Corporate Social Responsibility Policy of the company from time to time.

Provided further that if the company fails to spend such amount, the Board shall, in its report, specify the reasons for not spending the amount.

All companies covered u/s 135 of the Companies Act, 2013 are required to disclose amount of expenditure incurred on corporate social responsibility activities as note under heading 5 (k) in statement of profit and loss as per requirements of Schedule III.

Balance Sheet: The Companies Act requires that every Balance Sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year. It shall be in the form set out in Part I of the Schedule III under the Companies Act, 2013). In preparing the Balance Sheet, the preparers should follow the general instruction for preparations of Balance Sheet under the heading 'Notes' at the end of the aforesaid Part of the Schedule.

Statement of Profit and Loss: Like Balance Sheet, every Profit and Loss Account of a company is required to exhibit a true and fair view of the profit or loss of the company for the financial year. The Profit and Loss Account is required to be prepared as per the requirements of Part II of the Schedule III under the Companies Act, 2013). Like Balance Sheet, Profit or loss is also prepared in the vertical form (in which items of income are shown first and items of expenses are reported as a deduction their form) as prescribed in Part II of the Schedule III. The main advantage of the vertical form of presentation is that it makes the Balance Sheet and Profit and Loss Account easily understandable to the users who may not have a basic knowledge of accounts.

The Profit and Loss Account has to disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature. Accounting Standard 5 on *Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies* states that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence *that* their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Schedule III also requires earnings per share to be given at the end of the Statement of Profit and Loss.

NOTE: For details, students are advised to refer Schedule III to the Companies Act, 2013 given at the end of Module I of the Study Material.

Narrative Disclosures: The narrative disclosures that are contained in published company accounts embrace both qualitative and quantitative information. In most cases narrative disclosures are presented in textual form wherein more emphasis is laid on words than on figures. Although most of the narratives disclosed in published company accounts relate to the items of basic financial statements, there are certain narrative disclosures, which focus on things that are not related to financial statement items.

In India requirements as to narrative disclosures stem from the provisions of the Companies Act and that of the accounting standards. These requirements are discussed under the following two broad heads:

A. Accounting Policies

B. Notes on Accounts

A. Accounting Policies: Accounting policies often contain a large volume of narratives that have a significant bearing on the financial health and performance of the company. Accounting Standard 1 on *Disclosure of Accounting Policies* issued by the ICAI deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements. The purpose of this standard is to promote better understanding of financial statements by ensuring the disclosure of significant accounting policies in the financial statements in an orderly manner. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

B. Notes on Accounts: The section titled "Notes to the Accounts" or "Notes on Accounts" contains sizeable data. Notes on Accounts are integral part of the financial statements. Some of the disclosures made under Notes on Accounts are in fact the extensions of the items of the basic financial statements; while other notes may provide additional information. Disclosure through notes is done either to comply with statutory requirements or the company may voluntarily choose to provide details on certain items. Such notes provide information about the accounting methods, assumptions and estimates used by management to develop the data reported in the financial statement.

Cash Flow Statement: In a cash flow statement, cash flows are required to be classified in terms of the activities generating them. AS 3 prescribes three types of activities that generate cash flows for an enterprise. These are:

(i) cash flows generated by operating activities;

(ii) cash flows generated by investing activities; and

(iii) cash flows generated by financing activities.

Disclosure by Listed Companies

1. Balance Sheet, Profit and Loss Account and Directors' Report: Please, refer para given above.

2. Cash Flow Statement: Cash flow statements are prepared as per AS 3. Students are advised to refer AS 3 for details.

3. Related Party Disclosure: Transactions between related parties may not be at arm's length. Hence, companies are required to make appropriate disclosures in respect of such transactions so that users of financial statements can make their own assessment. Such disclosures have to be made in annual reports in compliance with the accounting standard on Related Party Disclosure (AS 18) issued by the ICAI.

4. Disclosure to be made by Holding Companies and Subsidiary Companies in respect of Loans, Advances and Investments: Disclosures are required as per section 129(3) of the Companies Act, 2013.

5. Management Discussion and Analysis Report: Management Discussion and Analysis (MD & A) report is a very important document through which management of a company can express its views and opinions on various aspects of a company like performance, success or failure, future plan of the company, forward looking information, etc.

The MD&A complements and supplements the financial statements, but does not form part of the financial statements. The objective in preparing the MD&A should be to improve the reporting company's overall financial disclosure by providing a balanced discussion of the results of operations and financial conditions. Although originally devised as a regulatory document to supplement financial statements, the MD&A report has the potential to be a foundational and integrative business reporting document that provides 'forward-looking information'.

The MD&A serves the laudable purpose of giving investors important disclosures about a company's operations. Although this section contains useful information, investors must heed caution, as the section is unaudited.

By virtue of the provisions contained in the Listing Agreement, the company has to provide a MD & A report to the shareholders. This report may be presented *as part of the directors' report* or *as an addition thereto*. It should include discussion on the following matters within the limits set by the company's competitive position:

(i) Industry structure and developments.

(ii) Opportunities and threats.

(iii) Segment-wise or product-wise performance.

(iv) Outlook.

(v) Risks and concerns.

(vi) Internal control systems and their adequacy.

(vii) Discussion on financial performance with respect to operational performance.

(viii) Material developments in Human Resources/ Industrial Relations front, including number of people employed.

6. Corporate Governance: In India the first attempt was made by the Confederation of Indian Industries (CII) to codify Corporate Governance. But the genesis of the provisions on Corporate Governance contained in the Listing Agreement is the Report of Kumar Mangalam Birla Committee. On 7th May 1999, the SEBI had set up a committee under the chairmanship of Sri Kumar Mangalam Birla to formulate the code of Corporate Governance. The SEBI in its meeting held on 25th January, 2000 accepted the recommendations made by the committee and suggested incorporation of certain matters in the Listing Agreement.

The following disclosures shall be made in the section on the corporate governance of the annual report.

(1) A brief statement on listed entity's philosophy on code of governance.

(2) Board of directors:

(3) Audit committee:

(4) Nomination and Remuneration Committee:

(5) Remuneration of Directors:

(6) Stakeholders' grievance committee:

(7) General body meetings

(8) Means of communication

(9) General shareholder information

(10) Other Disclosures:

4. Corporate Reporting Practices in India

There are few studies that deal with Indian practices of corporate financial reporting. The Institute of Chartered Accountants of India has made survey of corporate reporting practices in India from time to time. Other notable studies on financial reporting in India are Dasgupta Lal, Chakraborty and Banerjee. An analysis of the findings of these studies reveals that Indian corporate reporting practices are coping with changing needs of the economy and the society. Furthermore, the compliance with statutory disclosure requirement is a general phenomenon. However, in a recent study by Das reveals that there are cases of non-compliance with mandatory disclosure requirements. Thus, there is scope of improvement in the area of reporting of even mandatory disclosure items and role of management is important since the ultimate responsibility of providing information to the user rests on management. It may also be noted that there is a great amount of diversity in corporate reporting. The quality of information provided by the big companies has improved considerably and reports of some Indian companies are internationally competitive. With this brief introduction, we discuss in the following section the current reporting practices of Indian companies.

4.1 Published Financial Statements

Annual report is major vehicle through which Indian companies are publishing their financial statements. Like companies of any developed countries, Indian annual reports now include much more than the legal minimum requirements. Regarding elements of annual reports, the following are most common:

- Notice of annual general meeting
- Director's report
- Management discussion & analysis
- Risk Management Report
- Audited Standalone financial statements
- Audited Consolidated financial statements
- Corporate governance report
- Shareholders Information
- Auditor's report on financial statements
- C & AG's Comments on Accounts (in case of Government Companies)
- Business Responsibility Report*

- Information on human resources*
- Value added statement*
- Corporate social responsibility policy/report
- Environmental report*
- Information on Brand/ Intangibles*
- EVA report*

The marked elements are provided voluntarily. Regarding last few items disclosure is limited to large companies only. However, financial statements with respect to One Person Company, Small Company and Dormant Company may not include the cash flow statement.

4.2 Business Responsibility Report

SEBI recently mandated that the top 100 listed entities based on market capitalization of BSE and NSE should include 'business responsibility' reports in their annual report. Other listed entities may voluntarily disclose business responsibility reports. According to a SEBI circular, an entity's business responsibility performance will be assessed based on nine principles, business responsibility reporting is a step in the right direction, as it is expected to align Indian reporting requirements with global standards. Business responsibility reports can help entities demonstrate to key stakeholders – including investors, employees, the government and consumers – that their businesses are not detrimental to the environment, society or employees. This will positively impact brand reputation, attract, motivate and retain employees, provide access to global markets and attract foreign capital. To comply with the new reporting requirements, entities would need appropriate systems, mechanism and processes.

4.3 Corporate Social Responsibility Reporting

Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board. The Board's report under sub-section (3) of section 134 shall disclose the composition of the Corporate Social Responsibility Committee and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company. If the company fails to spend the prescribed amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134, specify the reasons for not spending the amount.

5. Other Reports

Disclosure of Financial Information in Prospectus: Prospectus is an important offer document that is issued by a company for making public issue of securities. SEBI (Disclosure & Investor Protection) Guidelines provide contents of the prospectus. There are requirements to disclosure certain important pieces of financial information relating to the issuer company and group companies. The major aspect of disclosure of financial information relates to reporting of audited profits and losses and assets and liabilities of the issuer company for each of the five financial year immediately preceding the issue of the prospectus. The requirements of the SEBI Guidelines on audited financial statements are similar to that of Section 26 of the Companies Act, 2013. Requirements of Indian Companies Act are elaborated separately. Other financial information that is to be provided in the prospectus includes.

1. Capital structure of the company
2. Utilization of Issue Proceeds
3. Financial Information of group companies
4. Promise vis-à-vis performance
5. Accounting and other ratios to justify the basis of issue price. (Such ratios shall be based on the financial statements prepared on the basis of Indian Accounting Standards)

It may be noted that abovementioned items are disclosed without any audit / review by independent accountant.

SEBI Guidelines, now allow an issuer company, if it so desires, to include in the offer document, the financial statements prepared on the basis of more than one set of accounting standards (e.g. Indian standards and US GAAPs) subject to disclosure of the material differences arising because of differences in the accounting policies of two different accounting standards.

Requirements of the Indian Companies Act regarding disclosure of financial information in prospectus are discussed under two heads: Auditor's report in prospectus and Accountant's report in prospectus.

Unaudited Quarterly Results: All listed companies are now required to furnish unaudited quarterly results in the prescribed proforma within one month from the end of the quarter to the stock exchanges on which it is listed and publish the same within 48 hours of the conclusion of the board meeting in atleast one national newspaper and one regional language newspaper. The quarterly results are to be prepared on the basis of accrual accounting policy and in accordance with uniform accounting practices for all periods on quarterly basis. It incorporates a statement of segmentwise revenue; results and capital employed prepared as per AS 17 on Segment Reporting and also comply with AS 22 on Accounting for Taxes on Income as regards measurement of the requirements of deferred taxes.

6. Best Presented Accounts

For many years the ICAI has been awarding shields and plaques for best presented accounts. The aim is to encourage companies in presenting accounting information in the financial statements convincingly to serve the information needs of the users in the best possible manner.

6.1 Conditions for Entry to the Annual Competition for the Best Presented Accounts

I. From 2004-2005 onwards, ICAI started presenting the awards for Excellence in Financial Reporting in following seven categories:

Category I: Manufacturing and Trading enterprises (including processing, mining, plantation, oil and gas enterprises).

Category II: Finance sector (including NBFCs, mutual funds, investment bankers, HFCs etc.).

Category III: Service sector (including hotels consultancy, transport, stock exchanges, R & D, private hospitals).

Category IV: Banking, Insurance and Financial Institutions.

Category V: Information Technology, Communication and Entertainment enterprises.

Category VI: Infrastructure and Construction sector (including power generation and supply, port trusts, roads).

Category VII: Others (Section 8 companies, educational institutions, NGOs, charitable hospitals and other organisations).

Gold Shields and Silver Shields are presented, in all the seven categories, to the award winners for 'Excellence in Financial Reporting'.

II The accounts for entry to the competition should relate to the financial year ending on any day between 1st April and 31st March of next year.

III Six copies of the following documents (or such other similar documents as are prepared by the Organisation concerned) should be sent to the Secretary, Research Committee, the Institute of Chartered Accountants of India, Indraprastha Marg, New Delhi-110002, so as to reach him before the specified date.

(a) Balance Sheet

(b) Profit and Loss Account

(c) Directors' Report

(d) Chairman's statement or speech at the Annual General Meeting.

IV. No form has to be filled up and no fee is payable.

V. Cyclostyled copies of the Annual Report and Accounts are not accepted. This condition, however, does not apply to entities covered by Category IV.

VI In all matters concerning the competition, the decision of the panel of judges appointed by the Institute will be final.

6.2 Some Important Factors Generally Considered for the Award of Gold/ Silver Shields and Plaques for the Best Presented Accounts

1. Compliance with the legal requirements in the preparation and presentation of financial statements as specified by the relevant statute, e.g., the Companies Act, 2013, in case of companies.
2. Basic quality of accounts as judged from the qualifications in the auditor's report, notes to the accounts and compliance with the generally accepted accounting principles such as those enunciated in the Accounting Standards, Statements, Guidance Notes, etc., issued by the Council of the Institute of Chartered Accountants of India and its various Committees.
3. The nature and quality of information presented in the accounts to make the disclosure meaningful. For example:
   (i) Sufficient details of revenues/expenses for financial analysis, e.g., distinction between manufacturing cost, selling cost, administrative cost.
   (ii) Use of vertical form as against the conventional "T" form; judicious use of schedules; use of sub-totals; manner of showing comparative figures; ease of getting at figures.
   (iii) Extent to which additional financial information is provided to the readers through charts and graphs.
   (iv) Extent of clarity, lucidity and comprehensiveness of the information contained in the financial statements, in the context of a layman.
   (v) Financial highlights and ratios.
   (vi) Inclusion of one or more of the information like value added statement, break-up of operations, organisation chart, location of factories/branches, human resource accounting, inflation adjusted accounts, social accounts, etc.
4. The extent to which the (i) Reports of the Governing Body such as Board of Directors Report and/or (ii) Chairman's Statement, if any, are informative. The following aspects are generally considered relevant in this regard:
   (i) Availability of information regarding different segments and units of the entity, i.e., whether details about each product/service and units, and whether located in the same area or spread in different geographical locations, are given.
   (ii) Information regarding financial operations, capital raised during the year, financial requirements, borrowings, etc. In respect of multi-product/multi-unit organisations, whether details as per (i) above have been given for financial operations.
   (iii) Employee relations.

(iv) Industry problems and problems peculiar to the enterprise.

(v) Information regarding social concerns (e.g., contribution to conservation and development of environment and ecology).

(vi) Information on contribution to community development projects, (e.g., medical institutions, educational institutions, provision of sanitary and drinking water, etc.), particularly in areas around location of entity.

(vii) Post-balance sheet events not requiring adjustment in accounts but material enough to warrant disclosure and future plans, programmes, market conditions, profitability forecast, environment friendliness, etc.

(viii) Manner of review of performance, plans and prospects by the company.

(ix) Compliance report on the Corporate Governance, clearly indicating non-compliance with any of the mandatory requirements with the reasons therefor.

(x) Directors' Responsibility Statement required under section 134 of the Companies Act, 2013.

5. Layout of contents, general appearance, presentation and quality of printing.

6. Timeliness in presenting accounts based on the date of the notice of the Annual General Meeting in respect of which the Annual Report is circulated to the shareholders.

4

Accounting for Corporate Restructuring

1. Introduction

The dictionary meaning of the term 'restructuring' is 'give new structure to; rebuild, rearrange' (the Concise Oxford Dictionary).

Restructuring is the corporate management term for the act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, or better organized for its present needs. Alternate reasons for restructuring include a change of ownership or ownership structure, demerger, or a response to a crisis or major change in the business such as bankruptcy, repositioning, or buyout. Restructuring may also be described as corporate restructuring, debt restructuring and financial restructuring.

The continuing corporate restructuring wave that began in the 80s has been mainly triggered off by a renewed commitment to deliver shareholder value. To that extent both shareholder value management and corporate restructuring are inseparable as the end and the important means to that end. In India, the process of economic liberalisation and globalisation has created its own impetus, due to which, business environment has become highly competitive. Corporates are now restructuring and repositioning their folios to meet the challenges and seize opportunities thrown open by the multilateral trade agenda and emergence of the World Trade Organisation (WTO).

Most of the diversified multi-product companies are restructuring their corporate operations into more homogenous units to achieve synergy in operations. This entails transfer of business units from one company to the other or breaking up of a large group into smaller ones. On the other hand, smaller companies are forming alliances and joint ventures for their survival and growth. The exercise involves strategic planning to cope with the complex changes in the ownership and control and comply with a variety of business laws.

The underlying object of corporate restructuring is efficient and competitive business operations by increasing the market share, brand power and synergies. In the emerging scenario, joint ventures, alliances, mergers, amalgamations and takeovers are becoming the easiest and quickest way to expand capacities and acquire dominance over the market.

While asset and capital restructuring can be termed as external, organisational restructuring may be referred to as internal; this is based on the significance and impact of the restructuring process on a company's internal or external stakeholders.

2. Methods

The different methods of restructuring and their implications are as under:

(1) External Restructuring

(a) Asset-based (portfolio) restructuring

(b) Financial or capital restructuring

(2) Internal Restructuring

(a) Portfolio restructuring (Cost reduction through closure of units, redundancy programmes etc.)

(b) Organisational restructuring (Management or organisational restructuring involving decentralisation, delayering, product-market based divisionalisation, matrix structure etc.)

(3) Amalgamation, absorption or external reconstruction.

3. Asset-based Restructuring

(i) Mergers and Acquisitions (M & A): Acquisition of companies/business units or merger with other companies has been one of the most common ways of carrying out restructuring. While acquisition of companies can be “friendly” or “hostile”, merger invariably involves friendly pooling of interest, undertaken by managements of companies of roughly comparable sizes. However, in the Indian context the term merger is used to denote consolidation of separate legal entities, not necessarily of similar sizes, into one through a statutory process of amalgamation. Since the motives of merger or acquisition are the same and both involve transfer of ownership and control of assets and the right to manage corporate cash flows and the difference between the two is very often only a matter of technical detail, the term mergers and acquisitions (M & A) is often used interchangeably.

Amalgamation has been dealt with in detail in separate chapter.

(ii) Sell-Off: A sell-off, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership.

(iii) Demergers or Spin-offs: A spinoff occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance growth or deals. Like the carve-out, the subsidiary becomes a separate legal entity with a distinct management and board.

In most cases, spinoffs unlock hidden shareholder value. For the parent company, it sharpens management focus. For the spinoff company, management doesn't have to compete for the parent's attention and capital. Once they are set free, managers can explore new opportunities.

Unlike in a divestiture, the "parent" company or group does not receive any proceeds from a demerger as the demerged company's shares are directly distributed to the "parent" company's shareholders.

The word Demerger has received statutory recognition in the Income-Tax Act, 1961 by the insertion of clause (*19AA*) in section 2 by the Finance Act, 1999, w.e.f. 1-4-2000. Section 2(19AA) says that "demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956 (1 of 1956)*, by a demerged company of its one or more undertakings to any resulting company in such a manner that—

(i) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(ii) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

(iii) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

(iv) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged

(v) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(vi) the transfer of the undertaking is on a going concern basis;

(vii) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A of the Income Tax Act in this regard.

***Explanation 1.*—**For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

***Explanation 2.*—**For the purposes of this clause, the liabilities referred to in sub-clause (*ii*), shall include—

(*a*) the liabilities which arise out of the activities or operations of the undertaking;

**Section 230 to 239 of the Companies Act, 2013 deal with the provisions related to restructuring of companies. It may be noted that these sections have not been notified till 31st December, 2016.*

(*b*) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and

(*c*) in cases, other than those referred to in clause (*a*) or clause (*b*), so much of the amounts of general or multipurpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

Explanation 3.—For determining the value of the property referred to in sub-clause (*iii*), any change in the value of assets consequent to their revaluation shall be ignored.

Explanation 4.—The splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act, or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger if such split up or reconstruction fulfils such conditions as may be notified in the Official Gazette, by the Central Government**;**

Explanation 5.— For the purposes of this clause, the reconstruction or splitting up of a company, which ceased to be a public sector company as a result of transfer of its shares by the Central Government, into separate companies, shall be deemed to be a demerger, if such reconstruction or splitting up has been made to give effect to any condition attached to the said transfer of shares and other prescribed conditions.

As per section 2(*19AAA*) "demerged company" means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company;

At the same time, the process of demerger is achieved only through the provisions of Sections 391 – 394 of the Companies Act 1956*, which deals with the subject of – "Compromise, Arrangements Reconstructions". In other words, every scheme of demerger as defined under the Income-Tax Act should necessarily be drawn through a scheme of arrangement which is subject to the approval of the National Company Law Tribunal constituted under Section 408 of the Companies Act, 2013. Briefly stated, in a demerger, ownership rights of shareholder are recognised vis-a-vis the assets of the company in such a way that the shareholder becomes, after the approval of the Tribunal is obtained, the owner of shares in certain new companies which are created for the purpose and transferring segregated business by telescoping them into these companies and allotting shares to the shareholders in a proportionate manner. To put it in nutshell, if X is a shareholder of A Limited, a company having two lines of businesses, it can split its two businesses into two companies, viz. A Limited and B Limited and allot to the same shareholders shares in both the companies in lieu of the shares in the original company.

4. Capital and Financial Restructuring

Needless to state that the distinction between, asset-based and purely financial-side restructuring is often blurred as acquisitions or divestiture has strong financial or capital structure consequences. Nonetheless, the distinction is made on the basis of the dominant

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** Section 230 to 239 of the Companies Act, 2013 deal with the provisions related to restructuring of companies. It may be noted that these sections have not been notified till 31st December, 2016.*

motives behind a given restructuring transaction. This type of restructuring includes buy back of shares, debt to equity conversions etc. Sections 68 to 70 of the Companies Act, 2013 deals with buy back of securities. These sections have already been discussed in Chapter 4, Unit 1, Para 1.2 of Paper 5 'Advanced Accounting' Study Material at IIPC level

Illustration 1

The following is the draft Balance Sheet of Diverse Ltd. having an authorised capital of ₹ 1,000 crores as on 31st March, 2017:

		(₹ in crores)
I Equity and Liabilities		
*1 **Shareholders' funds:***		
a. Share capital		
Equity shares of 10 each fully paid up	*250*	
b. Reserves and surplus (Revenue)	*750*	*1,000*
*2. **Non-current Liabilities***		
Long term borrowings		
Secured against: (a) Fixed assets ₹ 300 Cr.		
(b) Working capital ₹ 100 Cr.	*400*	
Unsecured:	*600*	*1,000*
*3. **Current Liabilities***		*2,000*
		4,000
II. Assets		
*1. **Non –Current Assets***		
(a) Fixed assets:		
(i) Tangible Assets		
Gross block	*800*	
Less: Depreciation	*(200)*	*600*
(b) Investments at cost (Market value ₹ 1,000 Cr.)		*400*
*2. **Current assets***		*3,000*
		4,000

Capital commitments: ₹ 700 crores.

The company consists of 2 divisions:

(i) Established division whose gross block was ₹ 200 crores and net block was ₹ 30 crores; current assets were ₹ 1,500 crores and working capital was ₹ 1,200 crores; the entire amount being financed by shareholders' funds.

(ii) New project division to which the remaining fixed assets, current assets and current liabilities related.

The following scheme of reconstruction was agreed upon:

(a) Two new companies Sunrise Ltd. and Khajana Ltd. are to be formed. The authorised capital of Sunrise Ltd. is to be ₹ 1,000 crores. The authorised capital of Khajana Ltd. is to be ₹ 500 crores.

(b) Khajana Ltd. is to take over investments at ₹ 800 crores and unsecured loans at balance sheet value. It is to allot equity shares of ₹ 10 each at par to the members of Diverse Ltd. in satisfaction of the amount due under the arrangement.

(c) Sunrise Ltd. is to take over the fixed assets and net working capital of the new project division along with the secured loans and obligation for capital commitments for which Diverse Ltd. is to continue to stand guarantee at book values. It is to allot one crore equity shares of ₹ 10 each as consideration to Diverse Ltd. Sunrise Ltd. made an issue of unsecured convertible debentures of ₹ 500 crores carrying interest at 15% per annum and having a right to convert into equity shares of ₹ 10 each at par on 31.3.2019. This issue was made to the members of Sunrise Ltd. as a right who grabbed the opportunity and subscribed in full.

(d) Diverse Ltd. is to guarantee all liabilities transferred to the 2 companies.

(e) Diverse Ltd. is to make a bonus issue of equity shares in the ratio of one equity share for every equity share held by making use of the revenue reserves.

Assume that the above scheme was duly approved by the Honourable High Court and that there are no other transactions. Ignore taxation.

You are asked to:

(i) Pass journal entries in the books of Diverse Ltd., and

(ii) Prepare the balance sheets of the three companies after the scheme of arrangement.

Solution

Journal of Diverse Ltd.

Transactions with Khajana Ltd. *(₹ in crores)*

1	Khajana Ltd. A/c	Dr.	200	
	Unsecured loans A/c	Dr.	600	
	To Investments A/c			400
	To Members A/c			400
	(Being transfer of investments at agreed value of ₹ 800 crores, unsecured loans ₹ 600 crores) – WN 1			
2	Members A/c	Dr.	200	
	To Khajana Ltd			200
	Consideration received from Khajana Ltd			
3	Members A/c	Dr	200	
	To Capital Reserve			200
	(Being balance in the member's account transferred)			

Transactions with Sunrise Ltd.

			(₹ in crores)	(₹ in crores)
1.	Sunrise Ltd. A/c (1cr equity shares X ₹ 10)	Dr.	10	
	Provision for depreciation A/c (WN 2)	Dr.	30	
	Secured loans against fixed assets A/c	Dr.	300	
	Secured loans against working capital A/c	Dr.	100	
	Current liabilities A/c (WN 2)	Dr.	1,700	
	To Fixed assets A/c (WN 2)			600
	To Current assets A/c (WN 2)			1,500
	To Capital reserve A/c			40
	(Being assets and liabilities of new project division transferred to Sunrise Ltd. along with capital commitments of ₹ 700 crores, the difference between consideration and the book values at which transferred assets and liabilities appeared being credited to capital reserve)			
2.	Equity shares of Sunrise Ltd.	Dr.	10	
	To Sunrise Ltd.			10
	(Being the receipt of one crore equity shares of ₹ 10 each from Sunrise Ltd. in full discharge of consideration on transfer of assets and liabilities of the new project division)			
3.	Investment in debentures A/c	Dr.	500	
	To Bank A/c			500
	(Being issue of unsecured convertible debentures by Sunrise Ltd., subscribed in full)			
4.	Revenue reserves A/c	Dr.	250	
	To Equity share capital A/c			250
	(Being allotment of 25 crores equity shares of ₹ 10 each as fully paid bonus shares to the members of the company by using revenue reserves in the ratio of one equity share for every equity share held)			

Diverse Ltd.
Balance Sheet after the scheme of arrangement

		Note No.		(₹ in crores)
I	**Equity and liabilities**			
	(1) **Shareholders' funds**:			
	(a) Share Capital	1	500	

	(b) Reserves and surplus	2	740	1,240
	(2) **Current liabilities**			300
	Total			1,540
II	**Assets**			
	(1) **Non-current Assets**			
	(a) Fixed assets:	3		30
	(b) Non-current investments	4		510
	(2) **Current assets(1,500 – 500)**			1,000
	Total			1,540
	1. Capital commitments			Nil
	2. Contingent Liability			
	Guarantee given in respect of:			
	Capital commitments by Sunrise Ltd.		700	
	Liabilities transferred to Sunrise Ltd.		2100	
	Liabilities transferred to Khajana Ltd.		600	

Notes to Accounts

(₹ in crores)

1	**Share capital:**		
	Authorised capital: 100 crores Equity Shares of ₹ 10 each	1,000	
	Issued, subscribed and paid up capital		500
	50 crores Equity Shares of ₹ 10 each fully paid-up		
	Of the above shares, 25 crores fully paid Equity Shares of ₹ 10 each have been issued as bonus shares by capitalization of revenue reserves.		
2	**Reserves and Surplus:**		
	1. Capital Reserve on transfer of:		
	Investments to Khajana Ltd.	200	
	Business of new project division to Sunrise Ltd.	40	240
	2. Surpluses (profit and loss Account):		
	As per last balance sheet	750	
	Less: Used for issue of fully paid bonus shares	250	500
			740
3	**Fixed assets:**		
	Gross block:		
	As per last balance sheet	800	

	Less: Transfer to Sunrise Ltd.	(600)	200
	Provision for depreciation:		
	As per last balance sheet	200	
	Less: In respect of assets transferred to Sunrise Ltd.	(30)	(170)
			30
4	**Investments (at cost):**		
	Investment in Equity Instruments		
	In wholly owned subsidiary Sunrise Ltd.		
	1 crore equity shares of ₹10 each		10
	Investment in Debentures and bonds		
	15% unsecured convertible debentures		500
			510

Balance Sheet of Sunrise Ltd. after the scheme of arrangement

		Note No.		*(₹ in crores)*
I	**Equity and liabilities**			
	(1) **Shareholders' funds**:			
	(a) Share Capital	1		10
	(2) **Non-current liabilities**:			
	(a) Long term borrowings			
	Secured loans	2	400	
	Unsecured loans	3	500	900
	(3) **Current liabilities**			1700
	Total			2,610
II	**Assets**			
	1. **Non-current assets**			
	(a) Fixed assets			
	(i) Tangible assets		570	
	(ii) Intangible assets (Goodwill)		40	610
	(2) **Current assets**			
	(a) Cash and Cash equivalents		500	
	(b) Other current Asset		1,500	2,000
	Total			2,610
	1. Capital commitments			
	2. Guarantee given by Diverse Ltd. in			

	respect of:			
	Capital commitments		700	
	Liabilities		2,100	2,800

Notes to Accounts

(₹ in crores)

1	**Share Capital**	
	Authorised Capital	
	100 crores Equity Shares of ₹ 10 each	1,000
	Issued, Subscribed and Paid-up capital 1 crore	
	Equity Shares of ₹ 10 each fully paid-up	10
	(All the above shares have been issued for consideration other than cash, on takeover of new project division from Diverse Ltd.	
	All the above shares are held by the holding company Diverse Ltd.)	
2	**Secured Loans**	
	(a) Against fixed assets	300
	(b) Against working capital	100
		400
3	**Unsecured Loans**	
	15% Unsecured convertible Debentures	500
	- Convertible into equity shares of ₹ 10 each at par on 31.3.2019	

Balance Sheet of Khajana Ltd. after the scheme of arrangement

(₹ in crores)

	Note No.	
I. Equity and liabilities		
(1) **Shareholders' funds:**		
(a) Share Capital	1	200
(2) **Non-current liabilities**:		
(a) Long term borrowings		
Unsecured loans		600
Total		800
II. Assets		
Non-current investments		800
Total		800
Guarantee given by Diverse Ltd. in respect of unsecured loans		

Notes to Accounts

		(₹ in crores)
1	**Share Capital**	
	Authorised	
	50 crores Equity Shares of ₹ 10 each	500
	Issued, Subscribed and Paid-up	
	20 crores Equity Shares of ₹ 10 each fully paid-up	200
	(All the above shares have been issued to members of Diverse Ltd. for consideration other than cash, on acquisition of investments and taking over of liability for unsecured loans from Diverse Ltd.)	

Working Notes:

1. Amount Due from Khajana Ltd.

Investments	800
Less : Unsecured Loans	(600)
Net Consideration	200

2. Segregation of Assets & Liabilities between Established and New Division

As per information in point (i)

	Particulars	*Total (A)*	*Established Division (B)*	*New Project Division (A-B)*
1	Gross Block	800(Given)	200(Given)	600(A-B)
	Net Block	600(Given)	30(Given)	570(A-B)
	Provision for Depreciation	200	170	30
2	Current Assets	3,000(Given)	1,500(Given)	1,500(A-B)
	Working Capital	1,000(Given)	1,200(Given)	(200)(A-B)
	Current Liabilities	2,000	300	1,700

(₹ in crores)

		Established division	*New Project division*	*Total*
1.	Fixed assets:			
	Gross block	200	600	800
	Less: Depreciation	(170)	(30)	(200)
		30	570	600
	Current assets	1,500	1,500	3,000

	Less: Current liabilities	(300)	(1,700)	(2,000)
	Employment of funds	1,200	(200)	1,000
2.	Guarantee by Diverse Ltd. against:			
	(a) (i) Capital commitments			700
	(ii) Liabilities transferred to Sunrise Ltd.			
	Secured loans against fixed assets		300	
	Secured loans against working capital		100	
	Current liabilities		1,700	2,100
	(b) Liabilities transferred to Khajana Ltd.			600

Illustration 2

Enterprise Ltd. has 2 divisions Laptops and Mobiles. Division Laptops has been making constant profits while division Mobiles has been invariably suffering losses.

On 31st March, 2017, the division-wise draft Balance Sheet was:

(₹ in crores)

		Laptops	*Mobiles*	*Total*
Fixed assets cost		*250*	*500*	*750*
Depreciation		*(225)*	*(400)*	*(625)*
Net Assets	*(A)*	*25*	*100*	*125*
Current assets:		*200*	*500*	*700*
Less: Current liabilities		*(25)*	*(400)*	*(425)*
	(B)	*175*	*100*	*275*
Total (A+B)		*200*	*200*	*400*
Financed by:				
Loan funds		*-*	*300*	*300*
Capital : Equity ₹ 10 each		*25*	*-*	*25*
Surplus		*175*	*(100)*	*75*
		200	*200*	*400*

Division Mobiles along with its assets and liabilities was sold for ₹ 25 crores to Turnaround Ltd. a new company, who allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share to the members of Enterprise Ltd. in full settlement of the consideration, in proportion to their shareholding in the company.

Assuming that there are no other transactions, you are asked to:

(i) Pass journal entries in the books of Enterprise Ltd.

(ii) Prepare the Balance Sheet of Enterprise Ltd. after the entries in (i).

(iii) Prepare the Balance Sheet of Turnaround Ltd.

Solution

Journal of Enterprise Ltd.

(₹ in crores)

			Dr. ₹	Cr. ₹
(1)	Turnaround Ltd.	Dr.	25	
	Loan Funds	Dr.	300	
	Current Liabilities	Dr.	400	
	Provision for Depreciation	Dr.	400	
	To Fixed Assets			500
	To Current Assets			500
	To Capital Reserve			125
	(Being division Mobiles along with its assets and liabilities sold to Turnaround Ltd. for ₹ 25 crores)			
(2)	Capital Reserve	Dr.	25	
	To Turnaround Ltd.			25
	(Being allotment of 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share to the members of Enterprise Ltd. in full settlement of the consideration)			

Notes :

(1) Any other alternative set of entries, with the same net effect on various accounts, may be given by the students.

(2) Profit on sale of division may, alternatively, be credited to Profit and Loss Account instead of Capital Reserve, in accordance with the requirements of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies.

Enterprise Ltd.
Balance Sheet after reconstruction

(₹ in crores)

		Note No.		
I.	**Equity and liabilities**			
	(1) Shareholders' funds			
	(a) Share Capital		25	
	(b) Reserves and surplus	1	175	200
	(2) Current Liabilities			25
	Total			225

II.	**Assets**			
	(1) Non-current assets			
	(a) Fixed assets			25
	(2) Current assets			200
	Total			225

Notes to Accounts

		(₹ *in crores)*
1.	**Reserves and Surplus**	75
	Add: Capital Reserve on reconstruction	100
		175

Note to Accounts: Consequent on transfer of Division Mobiles to newly incorporated company Turnaround Ltd., the members of the company have been allotted 1 crore equity shares of ₹ 10 each at a premium of ₹ 15 per share of Turnaround Ltd., in full settlement of the consideration in proportion to their shareholding in the company.

Balance Sheet of Turnaround Ltd.

(₹ *in crores)*

		Note No.		
I.	**Equity and liabilities**			
	(1) **Shareholders' funds**			
	(a) Share Capital	1	10	
	(b) Reserves and surplus: Securities Premium		15	25
	(2) **Non-current liabilities**			
	Long term borrowings			300
	(3) **Current liabilities**			400
	Total			725
II.	**Assets**			
	(1) **Non-current assets**			
	Fixed assets			
	(i) Tangible assets		100	
	(ii) Intangible assets	2	125	225
	(2) **Current assets**			500
	Total			725

Notes to Accounts

		(₹ in crores)
1.	**Share Capital:**	
	Issued and Paid-up capital	
	1 crore Equity shares of ₹ 10 each fully paid up	10
	(All the above shares have been issued for consideration other than cash, to the members of Enterprise Ltd. on takeover of Division Mobiles from Enterprise Ltd.)	
2.	**Intangibles Assets:**	
	Goodwill (WN 1)	125

Working Note

1. Calculation of Goodwill/Capital Reserve for Turnaround Ltd.

Assets taken over

Non-Current Assets	100
Current Assets	500
Total Assets (A)	600
Loan Funds	300
Current Liabilities	400
Total Liabilities (B)	700
Net Assets C= (A-B)	(100)
Purchase Consideration (given) (D)	25
Goodwill (D-C)	125

Illustration 3

Kuber Ltd. a non-listed company, furnishes you with the following draft Balance Sheet as at 31st March, 2017:

	(₹ in crores)	
Equity and liabilities		
(1) Share holders' funds		
(a) Share Capital:		
Authorised capital	*100*	
Issued, subscribed and paid up capital		
12% Redeemable preference shares of ₹ 100 each fully paid	*75*	
Equity shares of ₹ 10 each fully paid	*25*	*100*
(b) Reserves and surplus:		
Capital reserve	*15*	

Securities premium	*25*	
Surplus (profit and loss account)	*260*	*300*
(2) Current liabilities		*40*
		440
Assets		
1. Non-current assets		
Fixed assets: Cost	*100*	
Less: Provision for depreciation	*(100)*	*Nil*
2. Non-current Investments at cost (market value ₹ 400 Cr.)		*100*
3. Current assets		*340*
		440

The company redeemed preference shares on 1st April, 2017. It also bought back 50 lakh equity shares of ₹ 10 each at ₹ 50 per share. The payments for the above were made out of the huge bank balances, which appeared as part of current assets.

You are asked to :

(i) Pass journal entries to record the above

(ii) Prepare balance sheet

(iii) Value equity share on net asset basis.

Solution

Journal of Kuber Ltd.

(₹ in crores)

		Dr. ₹	Cr. ₹
Redeemable preference share capital Account	Dr.	75	
To Bank Account			75
(Being redemption of 12% preference shares pursuant to capital re-organisation)			
Revenue reserves Account	Dr.	75	
To Capital redemption reserve Account			75
(Being amount equal to par value of preference shares redeemed out of profits transferred to capital redemption reserve)			
Equity share capital Account	Dr.	5	
Securities Premium Account	Dr.	20	
To Bank Account			25

(Being buy-back of 50 lakh equity shares* of ₹ 10 each from the members at a price of ₹ 50 per share, premium paid transferred to Securities Premium Account –Refer Section 52(2)(e) of the Companies Act, 2013)			
Revenue reserves	Dr.	5	
To Capital redemption reserve			5
(Being transfer to capital redemption reserve, on buy-back out of reserves)			

Kuber Ltd.
Balance Sheet (after reconstruction)

		Note No.	*(₹ in crores)*	
I.	**Equity and liabilities**			
	(1) **Shareholders' funds**			
	(a) Share Capital	1.	20	
	(b) Reserves and Surplus	2.	280	300
	(2) **Current liabilities**			40
	Total			340
II.	**Assets**			
	(1) **Non-current Assets**			
	(a) Fixed Assets (100 -100)		–	-
	(b) Non-current investments (market value: ₹ 400 crores)			100
	(2) **Current assets**			240
	Total			340

Notes to Accounts

		(₹ in crores)	
1.	**Share Capital**		
	1. Authorised Capital		100
	2. Issued, Subscribed and Paid-up		
	200 lakhs Equity Shares of ₹ 10 each fully paid up		20
	(50 lakhs Equity Shares of ₹ 10 each have been bought back out of Securities Premium account at ₹ 50 per share and 12% 75 lakhs Redeemable Preference Shares of ₹ 100 each fully paid up, have been redeemed on 1st April, 2017)		
2.	**Reserves and Surplus**		
	(1) Capital Reserve		15

* *It may be noted that according to Securities and Exchange Board of India (Buy-back of Securities Amendment) Regulations, 2013, no offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market by a listed company.*

	(2)	Capital Redemption Reserve		
		As per last account	–	
		Add: Transfer from Revenue Reserves (75 + 5)		80
	(3)	Securities Premium Reserve (25 - 20)		5
	(4)	Surplus (Profit and Loss A/c)		
		As per last account	260	
		Less: Transfer to Capital Redemption Reserve (75 + 5)	(80)	180
				280

Net asset value of an equity share

	(₹ in crores)
Investments (at market value)	400
Net current assets	200
Net assets available to equity shareholders	600
No. of equity shares : 2 crores	
Value of an equity share = $\frac{600 \text{ crores}}{2 \text{ crores}}$ = ₹ 300	

Note: As regards treatment of loss (profit) on buy-back, there is no authoritative pronouncement as to whether the difference between the nominal value and the amount paid should be treated as capital or revenue in nature. In the given case, the debit has been given to Securities premium account. Also, in the absence of any other information, it may be assumed that shares have been bought back out of free reserves. However, the securities premium account has restrictive use. Therefore, the companies may opt to utilize the securities premium account for buy back, if available, rather to use the free reserves which can be used for other purposes in future.

Further as per Section 52 of the Companies Act, 2013, Securities Premium account may be used for purchase of its own shares as per Section 68.

Illustration 4

Maxi Mini Ltd. has 2 divisions - Maxi and Mini. The draft Balance Sheet as at 31st October, 2017 was as under:

	Maxi division ₹	*Mini division ₹*	*Total (in crores) ₹*
Fixed assets:			
Cost	*600*	*300*	*900*
Depreciation	*(500)*	*(100)*	*(600)*
W.D.V. (A)	*100*	*200*	*300*
Net current assets:			

Current assets	*400*	*300*	*700*
Less: Current liabilities	*(100)*	*(100)*	*(200)*
(B)	*300*	*200*	*500*
Total (A+B)	*400*	*400*	*800*
Financed by :			
Loan funds (A)	*–*	*100*	*100*
(secured by a charge on fixed assets)			
Own funds:			
Equity capital			*50*
(fully paid up ₹ 10 shares)			
Reserves and surplus			*650*
(B)	*?*	*?*	*700*
Total (A+B)	*400*	*400*	*800*

It is decided to form a new company Mini Ltd. to take over the assets and liabilities of Mini division.

Accordingly Mini Ltd. was incorporated to take over at Balance Sheet figures the assets and liabilities of that division. Mini Ltd. is to allot 5 crores equity shares of ₹ 10 each in the company to the members of Maxi Mini Ltd. in full settlement of the consideration. The members of Maxi Mini Ltd. are therefore to become members of Mini Ltd. as well without having to make any further investment.

(a) You are asked to pass journal entries in relation to the above in the books of Maxi Mini Ltd. and Mini Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 2017, showing corresponding previous year's figures.

(b) The directors of the 2 companies ask you to find out the net asset value of equity shares pre and post demerger.

(c) Comment on the impact of demerger on "shareholders wealth".

Solution

Demerged Company: Mini Division of "Maxi Mini Ltd"

Resulting Company: "Mini Ltd."

(a) Journal of Maxi Mini Ltd. (Demerged Company)

		(₹ in crores)	
		Dr. ₹	*Cr.* ₹
Current liabilities A/c	Dr.	100	
Loan fund (secured) A/c	Dr.	100	
Provision for depreciation A/c	Dr.	100	
Loss on reconstruction (Balancing figure)	Dr.	300	
To Fixed assets A/c			300

To Current assets A/c		300
(Being the assets and liabilities of Mini division taken out of the books on transfer of the division to Mini Ltd., the consideration being allotment to the members of the company of one equity share of ₹ 10 each of that company at par for every share held in the company vide scheme of reorganisation)		

Note : Any other alternatives set of entries, with the same net effect on various accounts, may be given by the students.

Journal of Mini Ltd.

		(₹ in crores)	
		Dr. ₹	*Cr.* ₹
Fixed assets (300-100) A/c	Dr.	200	
Current assets A/c	Dr.	300	
To Current liabilities A/c			100
To Secured loan funds A/c			100
To Equity share capital A/c			50
To Capital reserve			250
(Being the assets and liabilities of Mini division of Maxi Mini Ltd. taken over and allotment of 5 crores equity shares of ₹ 10 each at part as fully paid up to the members of Maxi Mini Ltd.)			

Maxi Mini Ltd.
Balance Sheet as at 1st November, 2017

			(₹ in crores)	
		Note No	*After reconstruction*	*Before Reconstruction*
I.	**Equity and liabilities**			
	(1) **Shareholder's funds**			
	(a) Share Capital		50	50
	(b) Reserves and Surplus	1	350	650
			400	700
	(2) **Non-current liabilities**			
	Secured loan		-	100
	(3) **Current liabilities**		100	200
	Total		–	
			500	1,000

II.	**Assets**			
	(1) **Non-Current Assets**			
	Fixed assets :	2	100	300
	(2) **Current assets**		400	700
	Total		500	1,000

Notes to Accounts

		After reconstruction	*Before reconstruction*
1.	Reserves and Surplus	650	650
	Less: Loss on reconstruction	(300)	–
		350	650
2.	Fixed Assets	600	900
	Less: Depreciation	(500)	(600)
		100	300

Note to Accounts : Consequent on reconstruction of the company and transfer of Mini division to newly incorporated company Mini Ltd., the members of the company have been allotted 5 crores equity shares of ₹ 10 each at part of Mini Ltd.

Mini Ltd.
Balance Sheet as at 1 November, 2017

		Note No.	*(₹ in crores)*	
I.	**Equity and liabilities**			
	(1) **Shareholder's funds**			
	(a) Share Capital	1	50	
	(b) Reserves and Surplus		250	300
	(2) **Non-current liabilities**			
	Secured loans			100
	(3) **Current liabilities**			100
	Total			500
II.	**Assets**			
	(1) **Non-current assets**			
	(a) Fixed assets			200
	(2) **Current assets**			300
	Total			500

Notes to Account

	(₹ in crores)
1. Share Capital : Issued and paid up : 5 crores Equity shares of ₹ 10 each fully paid up (All the above shares have been issued for consideration other than cash, to the members of Maxi Mini Ltd., on takeover of Mini division from Maxi Mini Ltd.)	50

(b) Net asset value of an equity share

	Pre-demerger	*Post-demerger*
Maxi Mini Ltd. :	$\frac{₹ 700 \text{ crores}}{5 \text{ crores}} = ₹\ 140$	$\frac{₹ 400 \text{ crores}}{5 \text{ crores}} = ₹\ 80$
Mini Ltd.:		$\frac{₹ 300 \text{ crores}}{5 \text{ crores}} = ₹\ 60$

(c) Demerger into two companies has had no impact on "net asset value" of shareholding. Pre-demerger, it was ₹ 140 per share. After demerger, it is ₹ 80 plus ₹ 60 i.e. ₹ 140 per original share.

It is only yield valuation that is expected to change because of separate focusing on two distinct businesses whereby profitability is likely to improve on account of demerger.

5. Amalgamation – Legal Aspects

5.1 Provisions under the Companies Act, 1956*

Section 390 to 396A in Chapter V is a complete code in itself. It provides the law and procedure to be complied with by the companies for Compromise, arrangement and reconstruction which are all part of restructuring. Section 391 of the Companies Act 1956* provides for all matters which the company court should consider and also the condition under which it has to exercise its power. Court for the purpose of section 391 to 394 of the Act* would mean the High Court having jurisdiction over the registered office of the company.

Sec 391 provides that where a compromise or arrangement is proposed between company and its Trade payables and any class of them or member or any class of them, an application is required to be submitted to the court. On the submission of the application the court may direct to hold the meeting of Account payables or member or class of them. The scheme must be approved in the meeting by majority in number representing 3/4 in value of the Account payables or members. The scheme must disclose all the material fact, financial position and auditors report on the account of the company. The order made by the court should be filled with the ROC within 30 days unless it will not become effective. The copy of the order is also required

** Section 230 to 239 of the Companies Act, 2013 deal with amalgamation aspects of companies. It may be noted that these sections have not been notified till 30th November, 2016.*

to attach with all the copy of memorandum of the company, if there is default the person will be liable to punished.

Section 392 empowers the court to give direction and make modification in the order to operate the scheme smoothly. The court has also power to order to wind up the company if it satisfies that the scheme cannot work satisfactory with or without modification.

Section 393 says that the scheme must disclose all the relative fact as per the prescribe rules otherwise the scheme should not be approved.

Section 394 says that it is necessary to have the report from the ROC in case the scheme involves that the company is being wound up and the report of the liquidator, in case the scheme involves dissolution of a company to ensure that the affairs of the company is not being conducted in a manner prejudicial to the interest of the member or public.

Section 395 provides that if 90% or more shareholders of a company approve a scheme of arrangement, then the same may be imposed on the remaining shareholders of the company. However, the dissenting shareholders shall have the right to file their objection with the Company Law Board. Unless the Company Law Board orders otherwise, the acquirer shall be entitled to acquire the shares of the target company.

5.2 Meaning of Reconstruction and Amalgamation

The terms amalgamation and reconstruction are not defined in the Companies Act. Generally the expression reconstruction", "reorganisation" or "scheme of arrangement" is used where only one company is involved and the rights of its shareholders and/or Trade payables are varied. The term amalgamation is used where two or more companies are involved or where one is merged with another or taken over by another. Neither reconstruction nor amalgamation has a precise meaning. Amalgamation is blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company which is to carry blended undertakings. There may be amalgamation either by the transfer of two or more undertakings to an existing company. The term amalgamation contemplates not only state of things in which two companies are so joined as to form a new company but also the absorption and blending of one by the other.

5.2.1 Dissenting Shareholders

Sections 395 and 396 of the Companies Act, 1956* deal with provisions of the Dissenting shareholders. Dissenting shareholders include shareholders who have not assented to the scheme or contract and any shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract.

Where a scheme or contract involves transfer of shares or any class of shares of a transferee company to the transferor company, the transferee company has to make offer which should be approved by the holder of not less than nine-tenths in value of such shares on which transfer is involved within 4 months. After expiry of such 4 months period, and within two months' time

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** Sections 235 and 236 of the Companies Act, 2013 deal with provisions relating to Dissenting shareholders. It may be noted that these sections have not been notified till 30th November, 2016.*

thereafter, the transferee company may give notice in the prescribed manner to any dissenting shareholder that it desires to acquire their shares. When such a notice is given, the transferee company shall, excepting the case where an application has been made by the dissenting shareholders within 1 month from the date on which the notice was given to the court and the court orders otherwise, be entitled and bound to acquire those shares. If there is no court order in response to the application made by the dissenting shareholder, the transferee company must transmit a copy of the notice to the transferor company together with an instrument of transfer executed on behalf of the shareholder by any person appointed by the transferor along with the amounts or other considerations representing price payable to the dissenting shareholders. Any such sum received by the transferee company representing the price of the shares of the dissenting shareholders shall be paid into a separate bank account. The price of shares will be at such rates which have been agreed upon as per the scheme of amalgamation and payable to the other shareholders.

There have however been some instances when shareholders holding a small number of shares, have made frivolous objections against the scheme, just with the objective of deferring the implementation of the scheme. The courts have, on a number of occasions, overruled their objections. But companies had to bear the consequences in the form of time and cost over-runs.

6 Amalgamation – Accounting Aspects

6.1 Purchase Consideration

The consideration paid for the purpose of amalgamation is termed as Purchase Consideration (PC). PC includes any benefit passed on to the members of the transferee company from the transferor company in any form i.e. Equity shares, Preference shares, Debentures, Cash etc. There are no such restriction with the pricing of the securities issued, it can be at par, premium or at discount. Usually intrinsic value of share is taken into consideration for the said purpose.

Para 3 (g) of AS 14 on Accounting for Amalgamations (explained in para 14 & 15) issued by ICAI defines the term ‘consideration’ as ‘the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

As per para 14 of AS 14, consideration may be in the form of

- Securities
- Cash
- Other Assets

Determination of Value

Consideration	Valuation
Securities	Value fixed by statutory authorities
Other Assets	a. Fair value with reference to market value or b. Fair Value may be respective net book values

Examination Approach

In the problem information for PC will be available in two ways:

A. List of the various consideration paid is given

B. On the basis of valuation of assets and liabilities taken over

A. List of the various considerations paid

In this case one should take care to add only those items paid to the members of the company and not to any outsider. Please, note that debenture holders are outsiders. Following are few such examples:

A List of the various considerations paid

Case I: A Ltd. take over B Ltd. and discharges consideration for the business as follows:

(i) Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.

(ii) Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders worth ₹ 1,00,000 of B Ltd. at a premium of 10%.

(iii) It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.

In the above case, our PC will be

For Equity Shareholders (42,000 shares X ₹ 10)	₹ 4,20,000
For Preference Shareholders (₹ 1,00,000 X 110 %)	₹ 1,10,000
Total Purchase Consideration	₹ 5,30,000

Payment to debenture holders is not to be considered as they are not the shareholders of the transferor company.

B. On the basis of valuation of assets and liabilities taken over

Case II: Where net assets taken over is directly given

A Ltd. takes over B Ltd.'s net assets worth ₹ 2,00,000 at an agreed price of ₹ 2,60,000. A Ltd discharges the PC by allotment of 20,000 equity shares of ₹ 10 each at an agreed value of ₹ 12 each of A Ltd. and by the payment of the balance in cash.

Purchase Consideration = ₹ 2,60,000 i.e. the agreed price.

The payment shall be done as under

Equity shares (20,000 x ₹ 12) = ₹ 2,40,000

Cash ₹ (2,60,000 – 2,40,000) = ₹ 20,000

Case III Given below is the summarized Balance Sheet of AB Ltd. as on 31.12.2017 on which date its assets and liabilities are taken over by CD Ltd.

Equity and Liabilities	*₹ '000*	*Assets*	*₹ '000*
Shareholders' funds		Non-current assets	
Share Capital		Fixed assets	
Equity Shares of ₹ 10 each fully paid up	52,00	Plant and Machinery	26,00
General Reserve	650	Furniture	12,00
12% Debentures	13,50	Inventory	24,00
Trade payables and		Trade receivables	7,50
Other current Liabilities	7,50	Cash	10,00
	79,50		79,50

CD Ltd. agreed to issue 12% Debentures to the debenture holders of AB Ltd. at par.

(1) **Assets and liabilities taken over at book values:** If all the assets and liabilities are takenover at par then determination of purchase consideration is very simple.

	₹ '000	*₹ '000*
Gross Assets taken over as per Balance Sheet		
Plant and Machinery		26,00
Furniture		12,00
Inventory		24,00
Trade receivables		7,50
Cash		10,00
		79,50
Less: Liabilities taken over		
12% Debentures	13,50	
Trade payables and other current liabilities	7,50	(21,00)
Value of net assets taken over		58,50

Thus, purchase consideration is ₹ 58,50 thousands.

(2) **Assets and liabilities taken over at valuation:** Suppose that CD Ltd. agreed to take over the asset of AB Ltd. at current values:

Plant and Machinery	30% depreciation
Furniture	20% depreciation
Inventory	+20% revaluation
Trade receivables	10% discount

Purchase consideration is to be determined as follows:

	₹ '000
Value of assets taken over:	
Plant and Machinery	18,20
Furniture	9,60
Inventory	28,80
Trade receivables	6,75
Cash	10,00
	73,35
Less : liabilities taken over	(21,00)
Purchase Consideration	52,35

Case IV: Where Intrinsic value of shares is calculated

Step 1 : Calculate the net worth of the business taken over at revalued figures

Step 2 : Divide net worth by the nos. of shares to get intrinsic value

Intrinsic Value = Net worth / No. of shares

In the example above, intrinsic value at book value =

	Book Value	*After Revaluation*
Net worth	₹ 58,50,000	₹ 52,35,000
No. of shares	5,20,000	5,20,000
Intrinsic Value per share	₹ 11.25 per share	₹ 10.07 per share

(3) When payments are more or less than value of net assets : Often the transferee pays more or less than the value of net assets taken over. Take for example, that CD Ltd. in case issued 600 thousand equity shares of ₹ 10 each at par to the equity shareholders of the transferor company AB Ltd. Then purchase consideration is ₹ 60,00 thousand, not ₹ 58,50 thousand. The difference ₹ 150 thousand is goodwill paid by CD Ltd. It is purchased goodwill.

Also take for example that CD Ltd. issued 565 equity shares of ₹ 10 each to the equity shareholders of AB Ltd. Here purchase consideration becomes ₹ 56,50 thousand, not ₹ 60,00 thousand. The difference ₹ 200 thousand is capital reserve to CD Ltd.

Let us suppose that CD Ltd. agreed to discharge 12% Debentures @ 110 by issuing its own debentures and to issue 550 thousand equity shares to the equity shareholders at a premium of ₹ 2 per share.

	₹ '000	*₹ '000*
Value of assets taken over:		
as per Balance Sheet value		79,50

Less: Liabilities taken over		
12% Debentures	14,85	
Trade payables and other Liabilities	7,50	(22,35)
Book Value of Net Assets		57,15
Purchase Consideration :		
550 thousand equity shares ₹ 10 each at a premium of ₹ 2		66,00
Goodwill paid ('000 ₹)		8,85

As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. The payment to debenture holders is not the part of purchase consideration. It is a mode of settling the liability which the transferee company is taking over in the scheme of amalgamation. Therefore correct amount of purchase consideration is ₹ 66,00,000).

6.2 Discharge of Purchase Consideration

As discussed earlier in this unit, the purchase consideration in the case of amalgamation is payable to the shareholders, both preference and equity, of the transferor company. This may be discharged by issuing preference and/or equity shares of the transferee company and partly by cash. Often the transferee company discharges claims of the preference shareholders of the transferor company at a premium or at a discount by issuing preference shares. Similarly, claims of the equity shareholders of the transferor company may also be discharged by issuing equity shares of the transferee company either at par or at premium or at discount.

Given below is an example stating the computational procedure of determining number of shares of the transferee company to be issued in discharge of the purchase consideration.

Example 1

Summarised Balance Sheet of PX Ltd. as on 31.12.2017

Equity and Liabilities	*₹ in '000*	*Assets*	*₹ in '000*
Share Capital:		Fixed Assets	50,00
Equity shares of ₹ 10 each	50,50	Inventory	20,00
8% Preference shares	9,50	Trade receivables	10,00
12% Debentures	15,00	Cash & Bank	5,00
Trade payables & Other Liabilities	10,00		
	85,00		85,00

ZX Ltd. agreed to take over PX Ltd. by issuing requisite number of preference shares of ₹ 10 each at 5% discount to the preference shareholders of PX Ltd. and requisite number of equity shares of ₹ 10 each at par to the equity shareholders of PX Ltd. Purchase consideration is settled as per book value of the assets and the debentures will be taken over by ZX Ltd. on the agreement that such will be paid off at 10% premium after one year. Debenture-holders of PX

Ltd. will accept 12% debentures of ZX Ltd.

Purchase Consideration:		*₹ in '000*
Book Value of assets taken over		85,00
Less : Liabilities taken over:		
Debentures	15,00	
Add: Premium on redemption of debentures (1,500 × 10 %)	1,50	
	16,50	
Trade payables & Other Liabilities	10,00	(26,50)
Purchase Consideration		58,50

To be discharged by 8% preference shares and equity shares of ZX Ltd.

Computation of number of shares to be issued:

1) Preference shares to be issued: $\frac{950 \text{ thousand}}{₹\,9.5 \text{ (i.e} ₹\,10 - 5\% \text{ discount)}}$ = 100 thousand

Balance of purchase consideration: ₹ 58,50 thousand - ₹ 950 thousand = ₹ 49,00 thousand

2) Equity shares to be issued $\frac{₹\,49{,}00 \text{ thousand}}{₹\,10}$ = 490 thousand

Example 2

Given below is the summarized Balance Sheet of LMN Ltd. as on 31.12.2017 at which date the company was taken over by PQR Ltd.

Equity and Liabilities	*₹ in '000*	*Assets*	*₹ in '000*
Share Capital		Fixed assets	80,00
Equity Shares	70,00	Current assets	42,00
Preference shares	12,00		
12% Debentures	25,00		
Trade payables	15,00		
	122,00		122,00

Decided that fixed assets of LMN Ltd. will be taken over at a valuation of ₹ 102,00 thousand. 8% preference shareholders of LMN Ltd. are to be discharged by issuing 8% preference shares of the transferee company to the extent of 50% and the balance in cash. Claims of the equity shareholders to be discharged by issuing equity shares of the transferee company to the extent of 60% and the balance in cash. The transferee company will issue preference shares at par but equity shares of ₹ 10 each at a premium of 20%

Purchase Consideration:

	₹ in '000
Value of assets taken over	
Fixed assets	102,00

Current assets	42,00
	144,00
Less: Liabilities taken over:	(40,00)
Purchase Consideration	104,00
To be discharged by:	
Preference shares (12,00 x 50%)	6,00
Equity shares	55,20
Cash	42,80
	104,00

Number of shares to be issued:

Preference Share holders

Preference Shareholders of LMN Ltd.	₹ 12,00,000
50% by 8% Preference Shares of PQR Ltd.	₹ 6,00,000
Balance by Cash	₹ 6,00,000
No. of Preference Shares (₹ 10 each)	60,000 shares

Equity Shareholders

	₹
Total Purchase Consideration	1,04,00,000
Less : Preference Shareholders portion	(12,00,000)
Equity Shareholders portion	92,00,000
60% by Equity shares of PQR Ltd (₹ 10 + 20 % premium = ₹ 12 per share)	55,20,000
Balance By Cash	36,80,000
No. of equity shares 4,60,000 shares (5,520 thousand / ₹ 12)	

Example 3

Given below are summarized Balance Sheets of A Ltd. & B Ltd. as on 31st Dec. 2017 at which date the companies were amalgamated and a new company C Ltd. was formed.

Balance Sheets of A Ltd. & B Ltd.

Equity and Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd*
	(₹ in '000s)			*(₹ in '000s)*	
Equity Shares of			Fixed Assets	85,00	70,00
₹ 10 each	70,00	60,00	Current assets	20,00	30,00
Reserve	20,00	30,00			
Trade payables &					

Other current liabilities	15,00	10,00			
	105,00	100,00		105,00	100,00

Agreed that fixed assets of A Ltd. would be valued at ₹ 100,00 thousand and that of B Ltd. at ₹ 95,00 thousand. C Ltd. would issue requisite number of equity shares of ₹ 10 each at 10% premium to discharge claim of the equity shareholders of A Ltd. & B Ltd. Let us see how many shares of C Ltd. should be issued to take over the businesses of A Ltd. & B Ltd.

Purchase Consideration:

	A Ltd.	*B Ltd.*
Value of assets taken over	₹ in '000s	₹ in '000s
Fixed assets	100,00	95,00
Current assets	20,00	30,00
	120,00	125,00
Less: Liabilities taken over	(15,00)	(10,00)
Purchase Consideration	105,00	115,00

Total Purchase Consideration = 220,00 thousand (105,00 of A + 115,00 of B)
Number of equity shares to be issued by C Ltd.

$$\frac{₹\,22{,}000 \text{ thousand}}{₹\,11\ (₹\,10 + 10\%\ \text{premium})} = 2{,}000 \text{ thousand equity shares}$$

So, C Ltd. will be formed with the paid up capital of ₹ 200,00 thousand and share premium of ₹ 20,00 thousand.

6.3 Types of Amalgamation

The Institute has issued in October, 1994, AS 14 on 'Accounting for Amalgamations'. AS 14 is mandatory in nature and is applicable in respect of accounting periods commencing on or after 1/4/1995. AS 14 deals with accounting for amalgamations and the treatment of any resultant goodwill or reserve. Amalgamations fall into two broad categories.

1. Amalgamations in the nature of merger; and
2. Amalgamations in the nature of purchase

In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamated companies but also of the shareholders' interest and of the businesses of these companies. Such amalgamations are called 'amalgamations in the nature of merger'. The basic conditions of these amalgamations are:

(a) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(b) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(c) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(d) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(e) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not have a proportionate share in the equity of the combined company or the business of the company which is acquired is not intended to be continued. Such amalgamations are called 'amalgamations in the nature of purchase'. In short, those amalgamations which do not satisfy any one or more of the conditions specified in (a) through (e) above are known as amalgamations in the nature of purchase.

6.4 Methods of Accounting for Amalgamation

There are two main methods of accounting for amalgamations:

(a) The Pooling of Interests Methods and

(b) The Purchase Method.

The first method is applied in case of amalgamation in the nature of merger and the second method in case of amalgamation in the nature of purchase.

♦ **The Pooling of Interests Method:** Under this method the assets, liabilities and all reserves of the transferor company are recorded by transferee company at their existing carrying amounts unless the carrying amounts are to be adjusted to follow a uniform set of accounting policies. The effects on the financial statements of the transferee company of any changes in accounting policies are to be reported in accordance with AS 5. The balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve, if any.

  The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

  No goodwill is recognized under the pooling of interest method as there is no acquistion.

  'Transferor company' means the company which is amalgamated into another company.

'Transferee company' means the company into which a transferor company is amalgamated.

♦ **The Purchase Method :** Here the assets and liabilities of the transferor company should be incorporated in the transferee company's financial statements in either of the following two ways:

(i) at their existing carrying amounts; or

(ii) the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

The reserves of the transferor company, other than statutory reserves, should not be included in the financial statements of the transferee company. In case of statutory reserves (i.e., Development Allowance Reserve, Investment Allowance Reserve etc.) where the maintenance of such reserves for a specific period is required by statute, these should be recorded in the financial statements of the transferee company with the help of the following entry:

Amalgamation Adjustment Reserve A/c Dr.

To Statutory Reserves A/c

In the Balance Sheet, 'Amalgamation Adjustment Reserve' shall be presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements:

1. The corresponding debit is "also" to a Reserve Account
2. That Reserve account will show a negative balance
3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over"
4. So the presentation will be as follows

Reserves

Description	Amount (Current year)	Amount (Previous Year)
Statutory Reserve (taken over from transferor company)		
General Reserve		
Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	(--)	(--)

Any excess of the amount of purchase consideration over the acquired net assets of the transferor company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. On the other hand if the amount of purchase consideration falls short of the value of net assets acquired, such shortfall should be recognised as capital reserve.

6.5 Treatment of Goodwill arising on Amalgamation

Goodwill on amalgamation can arise only if 'The Purchase Method' is followed.

The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

6.6 Amalgamation after the Balance Sheet Date

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements.

Illustration 5

AX Ltd. and BX Ltd. amalgamated on and from 1st January 2017. A new Company ABX Ltd. was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-2017

Equity and Liabilities	*AX Ltd. ₹ '000*	*BX Ltd. ₹ '000*	*Assets*	*AX Ltd. ₹ '000*	*BX Ltd. ₹ '000*
Share Capital			*Fixed*		
Equity Shares of			*Assets*	*85,00*	*75,00*
₹ 10 each	*60,00*	*70,00*	*Investment*	*10,50*	*5,50*
General Reserve	*15,00*	*20,00*	*Inventory*	*12,50*	*27,50*
P & L A/c	*10,00*	*5,00*	*Trade receivables*	*18,00*	*40,00*
Investment Allowance			*Cash & Bank*	*4,50*	*4,00*
Reserve	*5,00*	*1,00*			
Export Profit Reserve	*50*	*1,00*			
12% Debentures	*30,00*	*40,00*			
Trade payables	*10,00*	*15,00*			
	130,50	*152,00*		*130,50*	*152,00*

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies.

Prepare a note showing purchase consideration and discharge thereof and draft the Balance Sheet of ABX Ltd.

Solution: (Assumption: Amalgamation is in the nature of merger)

(1) Calculation of Purchase Consideration

		AX Ltd. ₹ '000		BX Ltd. ₹ '000
Assets taken over:				
Fixed assets		85,00		75,00
Investments		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Bank		4,50		4,00
Gross Assets		130,50		152,00
Less : Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)
Net Assets taken over		90,50		97,00
Less: Reserves and Surplus:				
General Reserve	15,00		20,00	
P & L A/c	10,00		5,00	
Investment Allowance Reserve	5,00		1,00	
Export Profit Reserve	50	(30,50)	1,00	(27,00)
Purchase Consideration		60,00		70,00

Total Purchase Consideration = 130,00 (60,00 of AX Ltd. & 70,00 of BX Ltd.)

2. Discharge of Purchase Consideration

No. of shares to be issued to AX Ltd = $\frac{\text{Net Assets taken over of AX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}}$ x Purchase Consideration

No. of shares to be issued to BX Ltd = $\frac{\text{Net Assets taken over of BX Ltd.}}{\text{Net Assets taken over of AX Ltd. and BX Ltd.}}$ x Purchase Consideration

	AX Ltd. ₹'000	BX Ltd. ₹ '000
$130{,}00 \times \frac{90{,}50}{187{,}50} = 6{,}27{,}500$ * Equity shares of ₹ 10 each	62,75	

* The total purchase consideration is to be discharged by ABX Ltd. in such a way that the rights of the shareholders of AX Ltd. and BX Ltd. remain unaltered in the future profits of ABX Ltd.

$130,00 \times \frac{97,00}{187,50} = 6,72,500$ Equity shares of ₹ 10 each		67,25

Balance Sheet of ABX Ltd. as on 1.1.2017

Particulars	*Note No.*	*(₹ 000)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	130,00
(b) Reserves and Surplus	2	57,50
(2) **Non-Current Liabilities**		
Long-term borrowings	3	70,00
(3) **Current Liabilities**		
(a) Trade payables (10,00 + 15,00)		25,00
Total		282,50
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets (85,00 + 75,00)		160,00
(b) Non-current Investments (10,50+ 5,50)		16,00
(2) **Current assets**		
(a) Inventories (12,50 + 27,50)		40,00
(b) Trade Receivables (18,00 + 40,00)		58,00
(c) Cash & Cash equivalents (4,50 + 4,00)		8,50
Total		282,50

Notes to Accounts

		(₹ 000)	*(₹ 000)*
1.	**Share Capital**		
	13,00,000 Equity Shares of ₹ 10 each		130,00
2.	Reserves and surplus		
	General Reserve (15,00 + 20,00)	35,00	
	Profit & Loss (10,00 + 5,00)	15,00	
	Investment Allowance Reserve (5,00 + 1,00)	6,00	
	Export Profit Reserve (50 + 1,00)	1,50	57,50
3.	**Long Term Borrowings**		
	12% Debentures (Assumed that new debentures were issued in exchange of the old series) (30,00+40,00)		70,00

Assumption: Amalgamation is in the nature of Purchase

(1) Calculation of Purchase Consideration

		AX Ltd. *₹ '000*		***BX Ltd.*** *₹ '000*
Assets taken over:				
Fixed assets		85,00		75,00
Investments		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Bank		4,50		4,00
Gross Assets		130,50		152,00
Less : Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)
Purchase Consideration		90,50		97,00

(2) Discharge of Purchase consideration:

	AX Ltd. *₹ '000*	***BX Ltd.*** *₹ '000*
9,05,000 Equity Shares of ₹ 10 each	90,50	
9,70,000 Equity Shares of ₹ 10 each		97,00

Balance Sheet of ABX Ltd. as on 1.1.2017

Particulars	*Note No.*	*(₹ 000)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	187,50
(b) Reserves and Surplus	2	Nil
(2) **Non-Current Liabilities**		
Long-term borrowings	3	70,00
(3) **Current Liabilities**		
(a) Trade payables (10,00 + 15,00)		25,00
Total		28,250
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		

	Tangible assets (85,00 + 75,00)		160,00
	(b) Non-current Investments (10,50+ 5,50)		16,00
(2)	**Current assets**		
	(a) Inventories (12,50 + 27,50)		40,00
	(b) Trade Receivables (18,00 + 40,00)		58,00
	(c) Cash & Cash equivalents (4,50 + 4,00)		8,50
	Total		28,250

Notes to Accounts

		(₹ 000)	*(₹ 000)*
1.	**Share Capital**		
	18,75,000 Equity Shares of ₹ 10 each		187,500
2.	**Reserves and surplus**		
	Investment Allowance Reserve	6,00	
	Export Profit Reserve	1,50	
	Amalgamation Adjustment Reserve	(7,50)	Nil
3.	**Long Term Borrowings**		
	12% Debentures (Assumed that new debentures were issued in exchange of the old series)		70,00

Note :

(1) Shares are issued by ABX Ltd. on the basis of net assets acquired of AX Ltd. and BX Ltd. Hence, there is no goodwill.

(2) The statutory reserves of AX Ltd. and BX Ltd. are shown in the balance sheet of ABX Ltd. with a corresponding debit to Amalgamation Adjustment Reserve.

Illustration 6

Long Ltd. and Short Ltd. were amalgamated on and from 1st April, 2017. A new company Moderate Ltd. was formed to take over the businesses of the existing companies. The summarized balance sheets of Long Ltd. and Short Ltd. as on 31st March, 2017 are given below:

(₹ in lakhs)

Equity and Liabilities	*Long Ltd.*	*Short Ltd.*	*Assets*	*Long Ltd.*	*Short Ltd.*
Share Capital:					
Equity shares of ₹ 100 each	*850*	*725*	***Fixed Assets:***		
14% Preference Shares			*Land & Building*	*460*	*275*
of ₹ 100 each	*320*	*175*	*Plant & Machinery*	*325*	*210*
Reserves and Surplus:			***Investments***	*75*	*50*
Revaluation reserve	*125*	*80*	***Current Assets***		
Capital Reserve	*300*	*200*	*Inventory*	*325*	*269*

Investment Allowance	*50*	*30*	*Trade receivables*	*330*	*270*
Reserve			*Cash and Bank*	*385*	*251*
P & L Account	*15*	*12*			
Secured Loans:					
13% Debentures					
(₹ 100 each)	*50*	*28*			
Unsecured Loan:					
Public deposits	*25*	*—*			
Current Liabilities					
and Provisions:					
Trade payables	*165*	*75*			
	19,00	*13,25*		*19,00*	*13,25*

Other information

(i) 13% Debenture holders of Long Ltd. and Short Ltd. are discharged by Moderate Ltd. by issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.

(ii) Preference Shareholders of the two companies are issued equivalent number of 15% preference shares of Moderate Ltd. at a price of ₹ 125 per share (face value ₹ 100)

(iii) Moderate Ltd. will issue 4 equity shares for each equity share of Long Ltd. and 3 equity shares for each equity share of Short Ltd. The shares are to be issued @ ₹ 35 each, having a face value of ₹ 10 per share.

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

Prepare the balance sheet of Moderate Ltd. as on 1st April, 2017 after the amalgamation has been carried out on the basis of the following assumption:

(a) Amalgamation is in the nature of merger.

(b) Amalgamation is in the nature of purchase.

Solution

Para 3 (g) of AS 14 defines the term 'consideration' as the value of shares, other securities and any payment made in the form of cash or other assets by the transferee company to the shareholders of transferor company. Therefore, payments made to debenture holders should not be construed as part of consideration.

Computation of Purchase consideration (Payment Basis)

			(₹ in lakhs)
		Long Ltd.	***Short Ltd.***
(1)	Preference Shareholders:		
	3,20,000 shares @ ₹ 125 each	400.00	
	1,75,000 shares @ ₹ 125 each		218.75

(2)	Equity Shareholders:		
	(4 × 8,50,000) = 34,00,000 equity shares @ ₹ 35 each	1190.00	
	(3 × 7,25,000) = 21,75,000 equity shares @ ₹ 35 each		761.25
		15,90.00	9,80.00

(a) Amalgamation in the nature of merger

Balance Sheet of Moderate Ltd.
As on 1st April, 2017

Particulars	*Note No.*	*(₹ in lakhs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	1,052.50
(b) Reserves and Surplus	2	1,839.90
(2) **Non-Current Liabilities**		
Long-term borrowings	3	92.60
(3) **Current Liabilities**		
Trade payables	4	240.00
Total		3,225.00
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets	5	1,270.00
(b) Non-current Investments (75+50)		125.00
(2) **Current assets**		
(a) Inventories (325 + 269)		594.00
(b) Trade Receivables	6	600.00
(c) Cash & Cash equivalents (385 + 251)		636.00
Total		3,225.00

Notes to Accounts

		(₹ in lakhs)	*(₹ in lakhs)*
1.	**Share Capital**		
	55,75,000 Equity Shares of ₹ 10 each	5,57.50	
	4,95,000 15% Preference shares of 100 each	4,95.00	1,052.50
2.	**Reserves and surplus**		
	Capital Reserve (WN 1)	NIL	
	Revaluation Reserve (125 + 80)	2,05.00	
	Securities Premium (WN 3)	15,17.50	

	Investment Allowance Reserve (50 + 30)	80.00	
	Profit & Loss (WN 4)	37.40	1,839.90
3.	**Long Term Borrowings**		
	15% Debentures (WN 2)	67.60	
	Public Deposit (25.00 + 0.00)	25.00	92.60
4.	**Trade payables**		
	Long Ltd.	165	
	Short Ltd.	75	240.00
5.	**Tangible assets**		
	Land & Building (460 + 275)	735.00	
	Plant & Machinery (325 + 210)	535.00	1,270.00
6.	**Trade Receivables**		
	Long Ltd.	330	
	Short Ltd.	270	600.00

Working Notes:

1. **Calculation of Capital Reserve**

	(₹ in lakhs)
Preference Share Capital	
Long Ltd.	320.00
Short Ltd.	175.00
Total (A)	495.00
Equity Share Capital	
Long Ltd.	850.00
Short Ltd.	725.00
Total (B)	1,575.00
Total Share Capital of transferor (C = A + B)	2,070.00
Share Capital Issued by transferee	
Preference Share Issued including premium	618.75
Equity Share issued including premium	1951.25
Total (D)	2,570.00
Amount to be adjusted in reserves of transferee company (D – C)	500.00
Capital Reserves (Long Ltd + Short Ltd)	500.00
Net Capital Reserve	NIL

2. **Calculation of Debenture to be issued** *(₹ in lakhs)*

	Long Ltd.	Short Ltd.
13% Debentures	50.00	28.00
Interest on Debentures (a)	6.50	3.64
Moderate Ltd. Debentures rate of interest (b)	15 %	15 %
Debenture Value to earn above calculated interest (a / b)	43.33	24.27
Total Debentures to be issued (c)		67.60
Existing Liability of Long and Short Ltd (50 + 28) (d)		78.00
Profit on taking over the debenture liability (d-c)		10.40

3. Calculation of Securities Premium

A Equity Shares		
Total number of equity shares issued to		
Long Ltd.	34,00,000	
Short Ltd.	21,75,000	
Total	55,75,000	
Securities Premium per share (₹ 35 – ₹ 10)	₹ 25	
Total Securities Premium from Equity Shares		1,393.75 lakhs
B Preference Shares		
Total number of preference shares issued to		
Long Ltd.	3,20,000	
Short Ltd.	1,75,000	
Total	4,95,000	
Securities Premium per share (₹ 125 – ₹ 100)	₹ 25	
Total Securities Premium from Preference Shares		123.75 lakhs
Total Securities Premium		1,517.50 lakhs

4. **Profit and Loss Account Balance** ***(₹ in lakhs)***

P & L of Long Ltd.	15.00
P & L of Short Ltd.	12.00
Profit on taking over of debentures (WN 2)	10.40
Total	37.40

(b) Amalgamation in the nature of Purchase:

Balance Sheet of Moderate Ltd.
As on 1st April, 2017

Particulars	*Note No.*	*(₹ in lakhs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	1,052.50
(b) Reserves and Surplus	2	18,39.90
(2) **Non-Current Liabilities**		
Long-term borrowings	3	92.60
(3) **Current Liabilities**		
(a) Trade payables	4	240.00
Total		3,225.00
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets	5	1,270.00
(b) Non-current Investments (75+50)		125.00
(2) **Current assets**		
(a) Inventories (325 + 269)		594.00
(b) Trade Receivables	6	600.00
(c) Cash & Cash equivalents (385 + 251)		636.00
Total		3,225.00

Notes to Accounts

		(₹ in lakhs)	*(₹ in lakhs)*
1.	**Share Capital**		
	55,75,000 Equity Shares of ₹ 10 each	5,57.50	
	4,95,000 15% Preference shares of 100 each	4,95.00	1,052.50
2.	**Reserves and surplus**		
	Capital Reserve (WN 1)	3,22.40	
	Securities Premium	15,17.50	
	Investment Allowance Reserve (50 + 30)	80.00	
	Amalgamation Adjustment Reserve	***(80.00)***	18,39.90
3.	**Long Term Borrowings**		
	15% Debentures	67.60	
	Public Deposit	25.00	92.60

4.	**Trade payables**		
	Long Ltd.	165	
	Short Ltd.	75	240.00
5.	**Tangible assets**		
	Land & Building	735.00	
	Plant & Machinery	535.00	1,270.00
6.	**Trade Receivables**		
	Long Ltd.	330	
	Short Ltd.	270	600.00

Working Note

				(₹ in lakhs)
		Long Ltd.		*Short Ltd.*
Assets taken over:				
Land and Building		4,60		2,75
Plant and Machinery		3,25		2,10
Investments		75		50
Inventory		3,25		2,69
Trade receivables		3,30		2,70
Cash and Bank		3,85		2,51
		19,00		13,25
Less : Liabilities taken over:				
13% Debentures	43.33		24.27	
Public Deposits	25.00		—	(99.27)
Trade payables	1,65.00	(2,33.33)	75.00	
Net Assets taken over		16,66.67		12,25.73
Less : Purchase consideration		(15,90.00)		(9,80.00)
Capital Reserves		76.67		245.73

Illustration 7

The Massive Company Ltd. was incorporated on 1st July 2017 for the purpose of acquiring North Ltd., South Ltd., and West Ltd.

The summarized balance sheets of these companies as on 30th June 2017 are as follows :

	North Ltd. ₹	*South Ltd.* ₹	*West Ltd.* ₹
Assets			
Tangible fixed assets –at cost less depreciation	*5,00,000*	*4,00,000*	*3,00,000*

Goodwill	*Nil*	*60,000*	*Nil*
Other assets	*2,00,000*	*2,80,000*	*85,000*
	7,00,000	*7,40,000*	*3,85,000*

	North Ltd. ₹	*South Ltd.* ₹	*West Ltd.* ₹
Liabilities			
Issued ordinary share capital shares of ₹ 10 each	*4,00,000*	*5,00,000*	*2,50,000*
P & L A/c	*1,50,000*	*1,10,000*	*60,000*
10% Debentures	*70,000*	*Nil*	*40,000*
Trade payables	*80,000*	*1,30,000*	*35,000*
	7,00,000	*7,40,000*	*3,85,000*
	₹	₹	₹
Average annual profits before			
Debentures interest (July 2016 to June 2017 inclusive)	*90,000*	*1,20,000*	*50,000*
Professional valuation of tangible assets on			
30th June 2017	*6,20,000*	*4,80,000*	*3,60,000*

(1) The directors in their negotiations agreed that: (i) the recorded goodwill of South Ltd. is valueless; (ii) the "Other assets" of North Ltd. are worth ₹ 30,000; (iii) the valuation of 30th June 2017 in respect of tangible fixed assets should be accepted, (iv) these adjustments are to be made by the individual company before the completion of the acquisition.

(2) The acquisition agreement provides for the issue of 12 per cent unsecured Debentures to the value of the net assets of companies North Ltd., South Ltd., and West Ltd., and for the issuance of ₹ 10 nominal value ordinary shares for the capitalized average profit of each acquired company in excess of net assets contributed. The capitalisation rate is established at 10 per cent.

You are required to calculate purchase consideration and show the purchase consideration as discharged.

Solution

Statement of Purchase Consideration

(₹)

Mode	*North Ltd.*	*South Ltd.*	*West Ltd.*	*Total*
1) 12% Unsecured Debenture [Basis Net Assets] (WN 1)	5,00,000	6,30,000	3,70,000	15,00,000
2) Shares [Basis Capitalised Average Profits in excess of net				

assets contributed] (WN 2)	3,30,000	5,70,000	90,000	9,90,000
Total	8,30,000	12,00,000	4,60,000	24,90,000

Working Notes

1 Calculation of Debentures to be issued

	North Ltd. ₹	₹	*South Ltd.* ₹	₹	*West Ltd.* ₹	₹
Tangible Fixed assets	6,20,000		4,80,000		3,60,000	
Other Assets	30,000	6,50,000	2,80,000	7,60,000	85,000	4,45,000
Less : Trade payables	80,000		1,30,000		35,000	
10% Debenture	70,000	(1,50,000)	—	(1,30,000)	40,000	75,000
Net assets		5,00,000		6,30,000		3,70,000

2 Calculation of Shares to be issued

	North Ltd. ₹	*South Ltd.* ₹	*West Ltd.* ₹
Average Annual Profits Before Debenture Interest	90,000	1,20,000	50,000
Less : Debenture Interest	(7,000) (70,000 X 10 %)	NIL	(4,000) (40,000 X 10 %)
Average Annual Profits after debenture interest	83,000	1,20,000	46,000
Capitalised average profits	8,30,000	12,00,000	4,60,000
Less: Net assets (WN 1)	(5,00,000)	(6,30,000)	3,70,000
Excess to be issued as Shares	3,30,000	5,70,000	90,000

Illustration 8

Given below are the summarized Balance Sheets of AX Ltd. and TX Ltd. as on 31.12.2017. TX Ltd. was merged with AX Ltd. with effect from 1.1.2018 and the merger was in the nature of purchase.

Summarised Balance Sheets as on 31.12.2017

Equity and Liabilities	*AX Ltd.* ₹	*TX Ltd.* ₹	*Assets*	*AX Ltd.* ₹	*TX Ltd.* ₹
Share Capital:					
Equity Shares of ₹ 10 each	*7,00,000*	*2,50,000*	*Fixed Assets*	*9,50,000*	*4,00,000*
General Reserve	*4,90,000*	*1,70,000*	*Investments*		

Surplus (P & L A/c)	*2,10,000*	*65,000*	*(Non-trade)*	*2,00,000*	*50,000*
Export Profit Reserve	*70,000*	*40,000*	*Inventory*	*1,20,000*	*50,000*
12 % Debentures	*1,00,000*	*1,00,000*	*Trade receivables*	*75,000*	*80,000*
Trade payables	*30,000*	*45,000*	*Advance Tax*	*80,000*	*20,000*
Prov. for Taxation	*1,00,000*	*60,000*	*Cash & Bank*		
			Balances	*2,75,000*	*1,30,000*
	17,10,000	*7,30,000*		*17,00,000*	*7,30,000*

AX Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of TX Ltd. at par. Non-trade investments of AX Ltd. fetched @25% while those of TX Ltd. fetched @18%. Profit before tax of AX Ltd. and TX Ltd. during 2015, 2016 and 2017 and were as follows:

	AX Ltd. ₹	*TX Ltd.* ₹
2015	*5,00,000*	*1,50,000*
2016	*6,50,000*	*2,10,000*
2017	*5,75,000*	*1,80,000*

Goodwill may be calculated on the basis of capitalisation method taking 20% as normal rate of return for profit before tax. Purchase consideration is discharged by AX Ltd. on the basis of intrinsic value per share. Prepare Balance Sheet of AX Ltd. after merger.

Solution

Balance Sheet of AX Ltd.
(after merger with TX Ltd.)

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	9,24,000
(b) Reserves and Surplus	2	14,50,960
(2) **Non-Current Liabilities**		
Long-term borrowings	3	2,00,000
(3) **Current Liabilities**		
(a) Trade payables	4	75,000
(b) Short-term Provision	5	1,60,000
Total		28,09,960

II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	Tangible assets	6	13,50,000
	Intangible assets (Goodwill) [WN 1]		3,80,000
	(b) Non-current Investments (2,00,000+,50,000)		2,50,000
	(2) **Current assets**		
	(a) Inventories (1,20,000 + 50,000)		1,70,000
	(b) Trade Receivables (75,000 + 80,000)		1,55,000
	(c) Cash & Cash equivalents (2,75,000 + 1,30,000 – 40)		4,04,960
	(d) Other current assets	7	1,00,000
	Total		28,09,960

Notes to Accounts

			(₹)	(₹)
1.	**Share Capital**			
	92,400 Equity Shares of ₹ 10 each [70,000+22,400]			9,24,000
	(of the above shares, 22,400 shares were issued to the vendors otherwise than cash)			
2.	**Reserves and surplus**			
	General Reserve		4,90,000	
	P&L A/c		2,10,000	
	Securities Premium [22,400 × [40.40-10]		6,80,960	
	Export profit reserve	70,000		
	Add: Balance of TX Ltd.	40,000	1,10,000	
	Amalgamation Adjustment Reserve		(40,000)	14,50,960
3.	**Long Term Borrowings**			
	12% Debentures		1,00,000	
	Add: 12% debentures issued at par other than cash		1,00,000	2,00,000
4.	**Trade payables**			
	Trade payables		30,000	
	Add: Taken over		45,000	75,000
5	**Short-term provision**			
	Provision for Taxation		1,00,000	
	Add: Provision for Taxation of TX Ltd.		60,000	1,60,000

6.	**Tangible assets**		
	Fixed Assets	9,50,000	
	Add: Taken over	4,00,000	13,50,000
7.	**Other current assets**		
	Advance Tax (80,000 + 20,000)		1,00,000

Working Notes

(1) Valuation of Goodwill

(i) *Capital Employed*

		AX Ltd.		TX Ltd.
	₹	₹	₹	₹
Assets as per Balance Sheet		17,00,000		7,30,000
Less : Non-trade Investment		(2,00,000)		(50,000)
		15,00,000		6,80,000
Less : Liabilities:				
12% Debentures	1,00,000		1,00,000	
Trade payables	30,000		45,000	
Provision for Taxation	1,00,000	(2,30,000)	60,000	(2,05,000)
Capital Employed		12,70,000		4,75,000

(ii) *Average Profit Before Tax*

		AX Ltd.		TX Ltd.
		₹		₹
2015		5,00,000		1,50,000
2016		6,50,000		2,10,000
2017		5,75,000		1,80,000
		17,25,000		5,40,000
Simple Average		5,75,000		1,80,000
Less : Non-trading income*		(50,000)		(9,000)
		5,25,000		1,71,000
(iii) *Goodwill*				
Capitalised value of average profit	$\frac{5,25,000}{20} \times 100$	26,25,000	$\frac{1,71,000}{20} \times 100$	8,55,000
Less: Capital Employed [From (i)above]		(12,70,000)		(4,75,000)
Goodwill		13,55,000		3,80,000

* For AX Ltd. (2,00,000 @ 25 %) and TX Ltd. (50,000 @ 18 %)

(2) Intrinsic Value per Share

		AX Ltd. ₹		TX Ltd. ₹
Goodwill [WN 1]	13,55,000		3,80,000	
Other Assets	17,00,000	30,55,000	7,30,000	11,10,000
Less : Liabilities				
12% Debentures	1,00,000		1,00,000	
Trade payables	30,000		45,000	
Provision for Tax	1,00,000	(2,30,000)	60,000	(2,05,000)
Net Assets		28,25,000		9,05,000
Intrinsic value per share [Net Assets / No. of Shares]		28,25,000 / 70,000		9,05,000 / 25,000
		= ₹ 40.40 (rounded off)		= ₹ 36.20

(3) Purchase Consideration & discharge

Intrinsic Value of TX Ltd. [a]	₹ 36.20 per share
No. of shares [b]	25,000
Purchase Consideration c= [a x b]	₹ 9,05,000
Intrinsic Value of AX Ltd. [d]	₹ 40.40 per share
No. of shares to be issued [c / d]	22,400.99
No. of shares to be issued [rounded off]	22,400.00
Cash for fractions	₹ 40 [₹ 9,05,000 – (22,400 X 40.40)]

Illustration 9

Smith Ltd. is considering buying the business of B Ltd., the final accounts of which for the last three years were as follows:

Draft Profit and Loss Accounts for the years ended 31st Dec.

	2015 ₹	*2016* ₹	*2017* ₹
Sales	*2,00,000*	*1,90,000*	*2,24,000*
Less: Material consumed	*1,00,000*	*95,000*	*1,12,000*
Business expenses	*80,000*	*80,000*	*82,000*

Depreciation	*12,000*	*13,000*	*14,000*
Net Profit	*8,000*	*2,000*	*16,000*

Draft Balance Sheets as at 31st Dec.

	2014 ₹	2015 ₹	2016 ₹	2017 ₹
Fixed Assets, at cost	1,00,000	1,20,000	1,40,000	1,80,000
Less : Depreciation	(70,000)	(82,000)	(95,000)	(1,09,000)
	30,000	38,000	45,000	71,000
Inventory-in-trade	16,000	17,000	18,500	21,000
Trade receivables	21,000	24,000	26,000	28,000
Cash in hand and at Bank	32,000	11,000	28,000	13,200
Prepaid Expenses	1,000	500	2,000	1,000
	1,00,000	90,500	1,19,500	1,34,200
Equity Capital	50,000	50,000	70,000	70,000
Securities Premium	—	—	5,000	5,000
General Reserve	16,000	24,000	26,000	42,000
Debentures	20,000	—	—	—
Trade payables	11,000	13,000	14,000	14,000
Accrued Business Expenses	3,000	3,500	4,500	3,200
	1,00,000	90,500	1,19,500	1,34,200

Smith Ltd. wishes the offer to be based upon trading cash flows rather than book profits. By trading cash flow is meant cash received from Trade receivables less cash paid to Trade payables and for business expenses (excluding depreciation), together with an allowance for average annual expenditure on fixed assets of ₹ 15,000 per year.

The actual expenditure on fixed assets is to be ignored, as is any cash received or paid out on the issue or redemption of shares or debentures.

Smith Ltd. wishes the trading cashflow to be calculated for each of the years 2015, 2016 and 2017, and for these to be combined using weighting of 20% for 2015, 30% for 2016 and 50% for 2017 to give an average annual trading cashflow.

Smith Ltd. considers that the average annual trading cashflow should show a return of 10% on its investment.

You are required to calculate:

(a) the trading cashflow for each of the years 2015, 2016 and 2017;

(b) the weighted average annual trading cashflow

(c) the price which Smith Ltd. should offer for the business.

Solution

(a) **Trading Cash Flows of B Ltd.**

	2015 ₹	2016 ₹	2017 ₹
Profit earned during the years	8,000	2,000	16,000
Add : Depreciation (As given in P & L Statement)	12,000	13,000	14,000
Increase in Trade payables	2,000	1,000	—
Increase in Accrued Business Expenses	500	1,000	—
Decrease in Prepaid Expenses	500	—	1,000
(A)	23,000	17,000	31,000
Less :Increase in Inventory	1,000	1,500	2,500
Increase in Trade receivables	3,000	2,000	2,000
Increase in Prepaid Expenses	—	1,500	—
Decrease in Accrued Business Expenses	—	—	1,300
(B)	4,000	5,000	5,800
Gross Trading Cash flow (A)–(B)	19,000	12,000	25,200
Less : Adjustment for allowance for average expenditure in fixed assets	(15,000)	(15,000)	(15,000)
Trading Cash Flow	4,000	(3,000)	10,200

(b) **Weighted average annual trading Cash flow**

Year	*Trading cash flow*	*Weight*	*Weighted Trading Cash flow*
2015	4,000	20%	800
2016	(3,000)	30%	(900)
2017	10,200	50%	5,100
Total	11,200		5,000

(c) **Price Smith Ltd. should offer for the business**

Return on Investment = 10%

Weighted Average annual cash flow = ₹ 5,000

Therefore, the price to be offered will be=

$$\frac{\text{Average Annual Cash Flow}}{\text{Return on Investment}} = \frac{₹\ 5{,}000}{10\%} = ₹\ 50{,}000$$

Illustration 10

Batliboi & Co. Ltd. carried on manufacturing business. Its products were sold to wholesalers and the company had its own retail shop. Adhikary & Co., Private Ltd. carried on similar manufacturing business, but all goods produced were sold through the company's own retail shops.

The summarised balance sheets of the two companies as at 31st March, 2017 were as follows:

	Batliboi & Co. Ltd. ₹	Adhikary & Co. (P) Ltd. ₹		Batliboi & Co. Ltd. ₹	Adhikary & Co. (P) Ltd. ₹
Share Capital			Fixed Assets :		
Authorised Equity			Freehold Properties		
Shares of ₹ 10	40,00,000	6,00,000	at cost	10,00,000	2,50,000
Issued & fully paid up	25,00,000	6,00,000	Plant & Machinery at		
P & L A/c	3,40,000	90,000	cost less depreciation	13,00,000	1,00,000
Trade payables	4,20,000	70,000	Total Fixed Assets	23,00,000	3,50,000
			Current Assets :		
			Inventory	4,80,000	1,20,000
			Trade receivables	2,30,000	80,000
			Bank	2,50,000	2,10,000
	32,60,000	7,60,000		32,60,000	7,60,000

The original cost of Plant and Machinery was:

Batliboi & Co. Ltd.	₹ 26,00,000
Adhikary & Co. (P) Ltd.	₹ 2,00,000

The following arrangements were made and carried out on April 1, 2017:

(1) *Batliboi & Co. Ltd purchased from the shareholders of Adhikary & Co. (P) Ltd. all the issued shares @ ₹ 14 per share.*

(2) *The shareholders of Adhikary & Co. (P) Ltd. took over one of the freehold properties of Adhikary & Co. (Private) Ltd. for ₹ 60,000, at the book value of the same. It was agreed that the amount should be set off against the amount due to them under (1) above and the balance due to them to be satisfied by the issue of an appropriate number of equity shares in Batliboi & Co. Ltd. at ₹ 19.50 per share*

The necessary transfer in regard to the setting off the price of the property taken over by the shareholders against the amount due to them from Batliboi & Co. Ltd. were made in the books of the two companies.

(3) *All manufacturing was to be carried on by Batliboi and Co. Ltd. and all retail business is to be carried on by Adhikary & Co. (Private) Ltd. in this connection.*

(i) *Batliboi & Co. Ltd. purchased the whole of Adhikary & Co. (P) Ltd.'s plant and machinery for ₹ 1,50,000 and certain of their free-hold property (cost ₹ 1,00,000) at ₹ 1,20,000.*

(ii) Adhikary & Co. (P) Ltd. purchased Batliboi & Co. Ltd's. freehold retail shop buildings (cost to Batliboi &. Co. Ltd, ₹ 75,000) at ₹ 60,000 and took over the retail inventory at ₹ 80,000 at the book value.

(4) Batliboi & Co. Ltd. drew a cheque in favour of Adhikary & Co. (P) Ltd. for the net amount due, taking into account all the matters mentioned above.

(5) Immediately after the transfer of shares in (1) above, Adhikary & Co. (P) Ltd. declared and paid a dividend of ₹ 60,000 (ignore Dividend Distribution Tax).

You are required to prepare the Balance Sheets of Batliboi & Co. Ltd. and Adhikary & Co. (P) Ltd. immediately after the completion of the above transaction.

Solution

Balance Sheet of Batliboi & Co as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	29,00,000
(b) Reserves and Surplus	2	7,05,000
(2) **Current Liabilities**		
Trade Payables		4,20,000
Total		40,25,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
(b) Tangible assets	4	24,95,000
(c) Non-current Investments	5	7,80,000
(2) **Current assets**		
(a) Inventories		4,00,000
(b) Trade Receivables		2,30,000
(c) Cash & Cash equivalents		1,20,000
Total		40,25,000

Notes to Accounts

		(₹)	*(₹)*
1.	**Share Capital**		
	2,90,000 Shares of ₹10 each fully paid up of which 40,000 shares were issued pursuant to a contract without payment being received in cash		29,00,000
2.	**Reserves and surplus**		
	Securities Premium Account	3,80,000	
	Profit & Loss Account	3,25,000	7,05,000

3.	**Tangible Assets**			
	Freehold Properties			
	As per last balance sheet	10,00,000		
	Addition during the year	1,20,000		
		11,20,000		
	Less: Sold during the year	(75,000)	10,45,000	
	Plant & Machinery			
	As per last balance sheet	13,00,000		
	Addition during the year	1,50,000	14,50,000	24,95,000
4.	**Non-current Investment**			
	Shares in subsidiary company			7,80,000

Working Notes :

(1) Calculation of shares to be issued by Batliboi & Co Ltd. to the shareholders of Adhikary & Co. (P) Ltd. [Basis Point (1) and (2) of the question]

	₹
60,000 shares @ ₹ 14 per share	8,40,000
Less : Value of freehold property	(60,000)
Net amount due	7,80,000
No of shares issued 7,80,000 / ₹ 19.5 = 40,000 shares	
Amount credited to Share Capital	4,00,000
Amount credited to Securities Premium	3,80,000
	7,80,000

(2) Net Amount Payable to Adhikary & Co. (P) Ltd.

Particulars	Amount
Assets taken over by Batliboi & Co. Ltd.	
Plant & Machinery	₹ 1,50,000
Free-hold Property	₹ 1,20,000
Total (A)	₹ 2,70,000
Assets sold to Adhikary & Co. (P) Ltd.	
Freehold Retail shop building	₹ 60,000
Retail Stock	₹ 80,000
Total (B)	₹ 1,40,000
Net Payable (A-B)	₹ 1,30,000
Add : Freehold properties taken over by the shareholders of Adhikary & Co. (P) Ltd. (Para 2 of point 2)	₹ 60,000
Net Amount Payable	₹ 1,90,000

(3) ₹ 15,000 loss on the sale of Building to Adhikary & Co. (P) Ltd., has been debited to the Profit & Loss Account of Batliboi & Co.

(4) Investment A/c has been credited by dividend received ₹ 60,000 out of pre-acquisition profit from Adhikary & Co.

(5) Cash Balance:

As given	2,50,000
Add : Dividend received	60,000
	3,10,000
Less : Paid to Adhikary & Co. Ltd. including ₹ 60,000 for assets taken over by its erstwhile shareholders	(1,90,000)
	1,20,000

Balance Sheet of Adhikary & Co. (P) Ltd. as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	6,00,000
(b) Reserves and Surplus	2	1,00,000
(2) **Current Liabilities**		
Trade Payables		70,000
Total		7,70,000
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	4	1,50,000
(2) **Current assets**		
(a) Inventories		2,00,000
(b) Trade Receivables		80,000
(c) Cash & Cash equivalents		3,40,000
Total		7,70,000

Notes to Accounts

		(₹)	(₹)
1.	**Share Capital**		
	60,000 Shares of ₹10 each fully paid		6,00,000

2.	**Reserves and surplus**			
	Profit & Loss Account			1,00,000
3.	**Tangible Assets**			
	Freehold Properties			
	As per last balance sheet	2,50,000		
	Addition during the year	60,000		
		3,10,000		
	Less: Sold during the year	(1,60,000)	1,50,000	
	Plant & Machinery			
	As per last balance sheet	1,00,000		
	Less: Sold during the year (cost of sales)	(1,00,000)	-	1,50,000

Working Notes:

		₹
(1)	*Profit & Loss Account (given)*	*90,000*
	Add : Profit on sale of machinery and freehold property	*70,000*
		1,60,000
	Less: Dividend paid	*(60,000)*
		1,00,000

(2) Freehold properties have been reduced by ₹ 1,00,000 transferred to Batliboi & Co. & ₹ 60,000 taken over by the shareholders of Adhikari & Co. (P) Ltd.

(3)	*Cash at Bank :*	*₹*
	Balance as given.	*2,10,000*
	Add: Received from Batliboi & Co	*1,90,000*
		4,00,000
	Less : Dividend Paid	*(60,000)*
		3,40,000

Illustration 11

Rich Ltd. and Poor Ltd. decided to amalgamate their business with a view to a public share issue. A holding company, Mix Ltd., is to be incorporated on 1st May 2017 with all authorised capital of ₹ 60,000,000 in ₹ 10 ordinary shares. The company will acquire the entire ordinary share capital of Rich Ltd. and of Poor Ltd. in exchange for an issue of its own shares.

The consideration for the acquisition is to be ascertained by multiplying the estimated profits available to *the ordinary shareholders by agreed price earnings ratio. The following relevant figures are given:*

	Rich Ltd. ₹	*Poor Ltd.* ₹
Issued share capital		
Ordinary shares of ₹ 10 each	*30,00,000*	*12,00,000*
6% Cumulative Preference shares of ₹ 100 each	*—*	*10,00,000*
5% Debentures, redeemable in 2018		*8,00,000*
Estimated annual maintainable profits, before deduction of debenture interest & taxation	*6,00,000*	*2,40,000*
Price/earning ratio	*15*	*10*

The shares in the holding company are to be issued to members of the subsidiaries on 1st June 2017, at a premium of ₹ 2.50 a share and thereafter these shares will be marketable on the Stock Exchange.

It is anticipated that the merger will achieve significant economics but will necessitate additional working capital. Accordingly, it is planned that on 31st December 2017, Mix Ltd. will make a further issue of 60,000 ordinary shares to the public for cash at the premium of ₹ 3.75 a share. These shares will not rank for dividends until 31st December 2017.

In the period ending 31st December 2017, bank overdraft facilities will provide funds for the payment of management etc. expenses estimated at ₹ 6,000.

It is further assumed that interim dividends on ordinary shares, relating to the period from 1st June to 31st December 2017 will be paid on 31st December 2017 by Mix Ltd. at 3½ %, by Rich Ltd. at 5% and by Poor Ltd. at 2%.

You are required to project, as on 31st December 2017 for Mix Ltd., (a) the Balance Sheet as it would appear immediately after fully subscribed share issue, and (b) the Profit and Loss Account for the Period ending 31st December 2017.

Assume the rate of corporation tax to be 40%. You can make any other assumption you consider relevant.

Solution

Projected Balance Sheet of Mix Ltd. as on December 31, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	54,00,000
(b) Reserves and Surplus	2	14,25,000
Total		68,25,000
II. **Assets**		
(1) **Non-current assets**		
Non-current Investments	3	60,00,000

(2) **Current assets**		
Cash & Cash equivalents		8,25,000
Total		68,25,000

Projected Profit and Loss Account for the Period ending December 31, 2017

Particulars		*Note No.*	*(₹)*
I. Other Income		4	1,74,000
II. Total Revenue	(A)		1,74,000
I. Expenses			
Management Expenses			6,000
II. Total Expenses	(B)		6,000
Net Profit before Tax (A-B)			1,68,000

Notes to Accounts

		(₹)	*(₹)*
1.	**Share Capital**		
	Authorised : 6,00,000 Equity shares of ₹10 each		60,00,000
	Issued : 5,40,000 (WN1) Equity shares of ₹ 10 each	54,00,000	54,00,000
2.	Reserves and surplus		
	Securities Premium Account (WN 1)		14,25,000
	Profit and Loss	1,68,000	
	Deduct Dividend WN 3	(1,68,000)	-
			14,25,000
3.	**Non-current Investments**		
	Subsidiary Companies shares at cost		60,00,000
4.	**Other Income**		
	Dividend Received		
	Rich Ltd. (30,00,000 X 5 %)	1,50,000	
	Poor Ltd. (12,00,000 X 2 %)	24,000	1,74,000

Working Notes:

1. Share Capital

	Rich Ltd.	*Poor Ltd.*
Estimated annual maintainable profits before deduction	₹	₹
of debenture interest and taxation	6,00,000	2,40,000
Deduct Debenture interest	-	(40,000)
	6,00,000	2,00,000
Deduct Corporation tax 40 percent	(2,40,000)	(80,000)

	3,60,000	1,20,000
Deduct Preference dividend	–	(60,000)
Profit for equity shareholders	3,60,000	60,000
P/E Ratio	15	10
Total consideration (Profit x P.E. Ratio)	54,00,000	6,00,000
Share Issue Price (₹ 10 + ₹ 2.5 Premium)	₹ 12.5	₹ 12.5
Number of shares to be issued	4,32,000 shares	48,000 shares
Share capital (₹ 10 x no. of shares to be issued)	43,20,000	4,80,000
Securities premium (₹ 2.50 x no. of shares to be issued)	10,80,000	1,20,000

Total Shares Issued to Rich Ltd. and Poor Ltd. = 4,32,000 + 48,000 = 4,80,000

Shares issued to public = 60,000

Total Shares issued as on 31st Dec 2017 = 5,40,000

Securities Premium Balance

From shares issued to Rich & Poor Ltd. = 4,80,000 x 2.5 = ₹ 12,00,000

From shares issued to public = 60,000 x 3.75 = ₹ 2,25,000

Total Securities Premium = ₹ 14,25,000

(2) Bank Account

	₹		₹
To Shares issued (Dec.31, 2017)		By Management expenses	6,000
60,000 shares at ₹ 13.75 each	8,25,000	By Dividend paid (WN 3)	1,68,000
To Dividends received:		By Balance c/d	8,25,000
Rich Ltd. (30,00,000 X 5%)	1,50,000		
Poor Ltd. (12,00,000 X 2%)	24,000		
	9,99,000		9,99,000

3 Dividend to be paid by Mix Ltd.

Total Shares as on 31st Dec 2017	₹ 54,00,000
Less : 60,000 shares not qualifying for dividend	₹ 6,00,000
Shares eligible for dividend	₹ 48,00,000
Dividend @ 3.5 %	₹ 1,68,000

Illustration 12

A Ltd. agreed to absorb B Ltd. on 31st March 2017, whose summarized balance sheet stood as follows:

Equity and Liabilities	₹	*Assets*	₹
Share Capital			

80,000 shares of		*Fixed Assets*	*7,00,000*
₹ 10 each fully paid	*8,00,000*	*Investments*	*–*
Reserves & Surplus		*Current Assets*	
General Reserve	*1,00,000*	*Loans & Advances*	
Secured Loan	*—*	*Inventory in trade*	*1,00,000*
Unsecured Loan	*—*	*Trade receivables*	*2,00,000*
Current Liabilities & Provisions			
Trade payables	*1,00,000*		
	10,00,000		*10,00,000*

The consideration was agreed to be paid as follows:

(a) A payment in cash of ₹ 5 per share in B Ltd. and

(b) The issue of shares of ₹ 10 each in A Ltd., on the basis of 2 Equity Shares (valued at ₹ 15) and one 10% cumulative preference share (valued at ₹ 10) for every five shares held in B Ltd.

The whole of the share capital consists of shareholdings in exact multiple of five except the following holding.

Chopra	*116*	
Karki	*76*	
Amar Singh	*72*	
Malhotra	*28*	
Other individuals	*8*	*(eight members holding one share each)*
	300	

It was agreed that A Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in B Ltd. i.e. ₹ 65 for five shares of ₹ 50 paid.

Prepare a statement showing the purchase consideration receivable in shares and cash.

Solution

(a) Schedule of Fraction

	Holding of Shares (A)	*Exchangeable in nearest multiple of five (B)*	*Exchange in equity (C) = (B) / 5 X 2*	*Preference Exchangeable (D) = (B) / 5 X 1*	*Non (E) = (A) – (B)*
Chopra	116	115	46	23	1
Karki	76	75	30	15	1
Amarsingh	72	70	28	14	2
Malhotra	28	25	10	5	3
Others	8	-	-	-	8
	300	285	114	57	15

(b) Shares Exchangeable: Equity Shares in A Ltd.

		No.		No.
(i)	80,000–300 (Total A above)	79,700	2/5 there of	31,880
	300-15 (Total E Above)	285	2/5 there of	114
		79,985		31,994

Shares Exchangeable: Preference Shares in A Ltd.

Shares held			
as in b (i)	79,700	1/5 there of	15,940
as in b (ii)	285	1/5 there of	57
	79,985		15,997

(c) There are 15 shares in B Ltd. which are not capable of exchange into equity and preference shares of A Ltd. they will be paid $150 \times \frac{65}{50} =$ ₹ 195

Purchase Consideration	₹
31,994 Equity Shares @ ₹ 15 each	4,79,910
15,997 Preference shares @ ₹ 10 each	1,59,970
Cash on 79,985 @ ₹ 5 each	3,99,925
	10,39,805
Add: Cash for 15 shares	195
	10,40,000

Illustration 13

The summarized Balance Sheets of Big Ltd. and Small Ltd. as on 31.03.2017 were as follows:

	Big Ltd.	Small Ltd.		Big Ltd.	Small Ltd.
	(₹)	(₹)		(₹)	(₹)
Equity Share Capital (₹ 10)	*8,00,000*	*3,00,000*	*Building*	*2,00,000*	*1,00,000*
10% Preference Share Capital (₹ 100)	–	*2,00,000*	*Machinery*	*5,00,000*	*3,00,000*
			Furniture	*1,00,000*	*60,000*
General reserve	*2,50,000*	*70,000*	*Investment:*		
Profit and Loss Account	*2,00,000*	*1,00,000*	*6,000 shares of Small Ltd.*	*60,000*	–
Trade payables	*2,00,000*	*3,00,000*			
			Inventory	*1,50,000*	*1,90,000*
			Trade receivables	*3,50,000*	*2,50,000*

			Cash and Bank	90,000	70,000
	14,50,000	9,70,000		14,50,000	9,70,000

Big Ltd. has taken over the entire undertaking of Small Ltd. on 30.09.2017, on which date the position of current assets except Cash and Bank balances and Current Liabilities were as under:

	Big Ltd. (₹)	Small Ltd. (₹)
Inventory	*1,20,000*	*1,50,000*
Trade receivables	*3,80,000*	*2,50,000*
Trade payables	*1,80,000*	*2,10,000*

Profits earned for the half year ended on 30.09.2017 after charging depreciation at 5% on building, 15% on machinery and 10% on furniture, are:

Big Ltd.	*₹ 1,02,500*
Small Ltd.	*₹ 54,000*

On 30.08.2017 both Companies have declared 15% dividend for 2016-17.

Goodwill of Small Ltd. has been valued at ₹ 50,000 and other Fixed assets at 10% above their book values on 31.03.2017. Preference shareholders of Small Ltd. are to be allotted 10% Preference Shares of Big Ltd. and equity shareholders of Small Ltd. are to receive requisite number of equity shares of Big Ltd. valued at ₹ 15 per share in satisfaction of their claims.

Show the Balance Sheet of Big Ltd. as of 30.09.2017 assuming absorption is through by that date.

Solution

Balance Sheet of Big Ltd.

As at 30th September, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	12,96,000
(b) Reserves and Surplus	2	5,90,500
(2) **Current Liabilities**		
Trade Payables		3,90,000
Total		22,76,500
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		

	Tangible assets	3	12,30,500
(2)	**Current assets**		
	(a) Inventories		2,70,000
(b)	Trade receivables		6,30,000
	(c) Cash & Cash equivalents		1,46,000
	Total		22,76,500

Notes to Accounts

				(₹)	(₹)
1.	**Share Capital**				
	1,09,600 Equity shares of ₹ 10 each			10,96,000	
	10% Preference shares			2,00,000	
	(Of the above shares, 29,600 equity shares and all preference shares are allotted as fully paid up for consideration other than cash)				12,96,000
2.	**Reserves and surplus**				
	Capital reserve			1,000	
	Securities Premium Account			1,48,000	
	General Reserve			2,50,000	
	Profit & Loss Account			1,91,500	5,90,500
3.	**Tangible Assets**				
	Building		2,00,000		
	Less: Depreciation		(5,000)		
			1,95,000		
	Add: Taken over		1,07,500	3,02,500	
	Machinery		5,00,000		
	Less: Depreciation		(37,500)		
			4,62,500		
	Add: Taken over		3,07,500	7,70,000	
	Furniture		1,00,000		
	Less: Depreciation		(5,000)		
			95,000		
	Add: Taken over		63,000	1,58,000	12,30,500

Working Notes:

1. Ascertainment of Cash and Bank Balances as on 30th September, 2017

Balance Sheets as at 30th September, 2017

Liabilities	*Big Ltd.* (₹)	*Small Ltd.* (₹)	*Assets*	*Big Ltd.* (₹)	*Small Ltd.* (₹)
Equity Share Capital	8,00,000	3,00,000	Building (WN 3)	1,95,000	97,500
10% Preference Share Capital	–	2,00,000	Machinery (WN 3)	4,62,500	2,77,500
General reserve	2,50,000	70,000	Furniture (WN 3)	95,000	57,000
Profit and Loss Account WN 2	1,91,500	89,000	Investment	60,000	–
Trade payables(Given)	1,80,000	2,10,000	Inventory (Given)	1,20,000	1,50,000
			Trade receivables (Given)	3,80,000	2,50,000
			Cash and Bank (Balancing figure)	1,09,000	37,000
	14,21,500	8,69,000		14,21,500	8,69,000

2 Balance of Profit and Loss Account on 30th September, 2017

	Big Ltd. (₹)	*Small Ltd.* (₹)
Net profit (for the first half)	1,02,500	54,000
Balance brought forward	2,00,000	1,00,000
	3,02,500	1,54,000
Less: Dividend on Preference Share Capital Paid	–	(20,000)
Less: Dividend on Equity Share Capital Paid (15 %)	(1,20,000)	(45,000)
	1,82,500	89,000
Add: Dividend received as Big Ltd. holds 6,000 shares in Small Ltd. i.e. 6,000 X ₹ 1.5 or $\left[\frac{1}{5}\times 45{,}000\right]$	9,000	–
Profit and Loss Account Balance as on 30.09.2017	1,91,500	89,000

3 Fixed Assets on 30th September, 2017 (Before absorption)

	Big Ltd. (₹)	*Small Ltd.* (₹)
(1) Building		
As on 1.4.2017	2,00,000	1,00,000

Less: Depreciation for 6 months (5% p.a.)	(5,000)	(2,500)
	1,95,000	97,500
(2) Machinery		
As on 1.4.2017	5,00,000	3,00,000
Less: Depreciation for 6 months (15% p.a.)	(37,500)	(22,500)
	4,62,500	2,77,500
(3) Furniture		
As on 1.4.2017	1,00,000	60,000
Less: Depreciation for 6 months (10% p.a.)	(5,000)	(3,000)
	95,000	57,000

4 Calculation of Shares Allotted

Assets taken over:		₹
Goodwill		50,000
Building (Book Value as on 31.03.2017)	1,00,000	
Add: 10%	10,000	
	1,10,000	
Less: Depreciation (01.04.2017 to 30.09.2017)	(2,500)	1,07,500
Machinery (Book Value as on 31.03.2017)	3,00,000	
Add: 10%	30,000	
	3,30,000	
Less: Depreciation (01.04.2017 to 30.09.2017)	(22,500)	3,07,500
Furniture (Book Value as on 31.03.2017)	60,000	
Add: 10%	6,000	
	66,000	
Less: Depreciation (01.04.2017 to 30.09.2017)	3,000	63,000
Inventory		1,50,000
Trade receivables		2,50,000
Cash and Bank		37,000
		9,65,000
Less: Liabilities taken over:		
Trade payables		(2,10,000)
Net assets taken over		7,55,000
Less: Allotment of 10% Preference Shares to preference shareholders of Small Ltd.		(2,00,000)
		5,55,000

Less: Belonging to Big Ltd.*** $\left[\frac{1}{5}\times 5{,}55{,}000\right]$		(1,11,000)
Payable to other Equity Shareholders		4,44,000
Number of equity shares of ₹ 10 each to be issued (valued at ₹ 15 each)	$\frac{4{,}44{,}000}{15} = 29{,}600$	

[*** 6,000 shares out of 30,000 shares of Small Ltd. are already with Big Ltd.]

5. Ascertainment of Goodwill / Capital Reserve

			₹
(A)	Net Assets taken over		7,55,000
(B)	Preference shares allotted	2,00,000	
	Payable to other equity shareholders	4,44,000	
	Cost of investments	60,000	(7,04,000)
(C)	Capital Reserve [(A) – (B)]		51,000
(D)	Goodwill taken over		50,000
(E)	Final figure of Capital Reserve [(C) – (D)]		1,000

Illustration 14

Ram Limited and Shyam Limited carry on business of a similar nature and it is agreed that they should amalgamate. A new company, Ram and Shyam Limited, is to be formed to which the assets and liabilities of the existing companies, with certain exception, are to be transferred. On 31st March, 2017, the Balance Sheets of the two companies were as under:

Ram Limited

Balance Sheet as at 31st March, 2017

Liabilities	*₹*	*Assets*	*₹*
Issued and Subscribed		*Freehold Property, at cost*	*2,10,000*
Share capital:		*Plant and Machinery, at cost less*	
30,000 Equity shares of ₹ 10		*depreciation*	*50,000*
each, fully paid	*3,00,000*	*Motor Vehicles, at cost*	
General Reserve	*1,60,000*	*less depreciation*	*20,000*
Profit and Loss Account	*40,000*	*Inventory*	*1,20,000*
Trade payables	*1,50,000*	*Trade receivables*	*1,64,000*
		Cash at Bank	*86,000*
	6,50,000		*6,50,000*

Shyam Limited
Balance Sheet as at 31st March, 2017

Liabilities	*₹*	*Assets*	*₹*
Issued and Subscribed		*Freehold Property, at cost*	*1,20,000*
Share Capital:		*Plant and Machinery, at cost less*	
16,000 Equity shares of ₹ 10		*depreciation*	*30,000*
each, fully paid	*1,60,000*	*Inventory*	*1,56,000*
Profit and Loss Account	*40,000*	*Trade receivables*	*42,000*
6% Debentures	*1,20,000*	*Cash at Bank*	*36,000*
Trade payables	*64,000*		
	3,84,000		*3,84,000*

Assets and Liabilities are to be taken at book-value, with the following exceptions:

(a) Goodwill of Ram Limited and of Shyam Limited is to be valued at ₹ 1,60,000 and ₹ 60,000 respectively.

(b) Motor Vehicles of Ram Limited are to be valued at ₹ 60,000.

(c) The debentures of Shyam Limited are to be discharged by the issue of 6% Debentures of Ram and Shyam Limited at a premium of 5%.

(d) The trade receivables of Shyam Ltd. realized fully and bank balance of Shyam Ltd, are to be retained by the liquidator and the trade payables of Shyam Ltd. are to be paid out of the proceeds thereof.

You are required to:

(i) Compute the basis on which shares in Ram and Shyam Limited will be issued to the shareholders of the existing companies assuming that the nominal value of each share in Ram and Shyam Limited is ₹ 10.

(ii) Draw up a Balance Sheet of Ram and Shyam Limited as of 1st April, 2017, the date of completion of amalgamation.

(iii) Write up journal entries, including bank entries, for closing the books of Shyam Limited.

Solution

Calculation of Purchase consideration

	Ram Ltd.	*Shyam Ltd.*
Purchase Consideration:	*₹*	*₹*
Goodwill	1,60,000	60,000
Freehold property	2,10,000	1,20,000
Plant and Machinery	50,000	30,000
Motor vehicles	60,000	-

Inventory	1,20,000	1,56,000
Trade receivables	1,64,000	-
Cash at Bank	86,000	-
	8,50,000	3,66,000
Less: Liabilities:		
6% Debentures (1,20,000 x 105%)	-	(1,26,000)
Trade payables	(1,50,000)	-
Net Assets taken over	7,00,000	2,40,000
To be satisfied by issue of shares of Ram and Shyam Ltd. @ ₹ 10 each	70,000	24,000

Balance Sheet Ram & Shyam Ltd. as at 1st April, 2017

		Particulars	*Note No.*	*Amount*
				₹
		EQUITY AND LIABILITIES		
1		**Shareholders' funds**		
	(a)	Share capital	1	9,40,000
	(b)	Reserves and Surplus	2	6,000
2		**Non-current liabilities**		
	(a)	Long-term borrowings	3	1,20,000
3		**Current liabilities**		
	(a)	Trade payables		1,50,000
		Total		12,16,000
		ASSETS		
1		**Non-current assets**		
	(a)	Fixed assets		
	i	Tangible assets	4	4,70,000
	ii	Intangible assets	5	2,20,000
2		**Current assets**		
	(a)	Inventories (1,20,000+1,56,000)		2,76,000
	(b)	Trade receivables		1,64,000
	(c)	Cash and cash equivalents		86,000
		Total		12,16,000

Notes to accounts

		₹	₹
1.	**Share Capital**		
	Equity share capital		
	94,000 shares of ₹10 each		9,40,000
2.	**Reserves and Surplus**		
	Securities Premium A/c (W.N.)		6,000
3.	**Long-term borrowings**		
	Secured		
	6% Debentures		1,20,000
4.	**Tangible assets**		
	Freehold property		
	Ram Ltd.	2,10,000	
	Shyam Ltd.	1,20,000	3,30,000
	Plant and Machinery		
	Ram Ltd.	50,000	
	Shyam Ltd.	30,000	80,000
	Motor vehicles Ram Ltd.		60,000
			4,70,000
5.	**Intangible assets**		
	Goodwill		
	Ram Ltd.	1,60,000	
	Shyam Ltd.	60,000	2,20,000

In the books of Shyam Ltd.
Journal Entries

			₹	₹
1.	Realisation A/c	Dr.	3,48,000	
	To Freehold Property			1,20,000
	To Plant and Machinery			30,000
	To Inventory			1,56,000
	To Trade receivables			42,000
	(Being all assets except cash transferred to Realisation Account)			
2.	6% Debentures A/c	Dr.	1,20,000	
	Trade payables A/c	Dr.	64,000	

	To Realisation A/c		1,84,000
	(Being all liabilities transferred to Realisation Account)		
3.	Equity Share Capital A/c Dr.	1,60,000	
	Profit and Loss A/c Dr.	40,000	
	To Equity shareholders A/c		2,00,000
	(Being equity transferred to equity shareholders account)		
4.	Ram and Shyam Ltd. Dr.	2,40,000	
	To Realisation A/c		2,40,000
	(Being purchase consideration due)		
5.	Bank A/c Dr.	42,000	
	To Realisation A/c		42,000
	(Being cash realized from trade receivables in full)		
6.	Realisation A/c Dr.	64,000	
	To Bank A/c		64,000
	(Being payment made to trade payables)		
7.	Shares in Ram and Shyam Ltd. Dr.	2,40,000	
	To Ram and Shyam Ltd.		2,40,000
	(Being purchase consideration received in the form of shares of Ram and Shyam Ltd.)		
8.	Realisation A/c Dr.	54,000	
	To Equity shareholders A/c		54,000
	(Being profit on Realisation account transferred to shareholders account)		
9.	Equity shareholders A/c Dr.	2,54,000	
	To Shares in Ram and Shyam Ltd.		2,40,000
	To Bank A/c		14,000
	(Being final payment made to shareholders)		

Working Note:

Calculation of Securities Premium balance

Debentures issued by Ram and Shyam Ltd. to Shyam Ltd. at 5% premium

Therefore, securities premium account will be credited with (₹ 1,20,000 x 5%) ₹ 6,000.

FINAL COURSE STUDY MATERIAL

PAPER 1

FINANCIAL REPORTING

MODULE – 3

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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SIGNIFICANT ADDITIONS/AMENDMENTS IN THIS EDITION

Chapter/Unit No.	Name of the Chapter	Changes
Chapter 5	Consolidated Financial Statements	**Para 1.3 amended**
		Para 1.5 and 1.6 newly added
Chapter 7	Share Based Payment	**Illustration 10 newly added**
Chapter 8	Financial Reporting for Financial Institutions	
Unit 1	Mutual Funds	**Paras 1.1, 1.3, 1.4, 1.5, 1.11, 1.13, 1.15, 1.17 and 1.23 amended**
		Paras 1.2, 1.6, 1.7 and 1.18 newly added
Unit 2	Non Banking Finance Companies	**Paras 2.2, 2.5, 2.6, 2.8, 2.11, 2.13, 2.14, 2.17, 2.18, 2.19 and 2.23 amended**
		Paras 2.3, 2.7, 2.21 and 2.22 newly added
		Illustration 3 newly added
Chapter 9	Valuation	**Paras 2.2 and 2.3 revised**
		Paras 2.4, 2.8 and 6.9 amended
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5

Consolidated Financial Statements of Group Companies

UNIT 1 : INTRODUCTION

1.1 Concept of Group, Holding Company and Subsidiary Company

It is an era of business growth. Many organizations are growing into large corporations by the process of acquisition, mergers, gaining control by one company over the other company, restructuring etc. Acquisition and mergers ultimately leads to either cost reduction or controlling the market or sharing the material supplies or product diversification or availing tax benefits or synergy. Whatever the motto behind these ventures is, the ultimate result is the large scale corporation. Formation of holding company is the most popular device for achieving these objectives.

Group of companies: Many a times, company expands by keeping intact their separate corporate identity. In this situation, a company (holding company) gains control over the other company (subsidiary company). This significant control is exercised by one company over the other by-

1. Purchasing specified number of shares or
2. Exercising control over the board of directors or on voting power of that company.

Unit of companies connected in these ways is collectively called a **Group of Companies.**

Holding Company and Subsidiary Company have been defined in Section 2 of the Companies Act, 2013.

Holding company:

As per Clause 46 of Section 2 of the Companies Act, 2013,

"Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

It may be defined as one, which has one or more subsidiary companies and enjoys control over them. Legally a holding company and its subsidiaries are distinct and separate entities. However, in substance holding and subsidiary companies work as a group. Accordingly, users of holding company accounts need financial information of subsidiaries to understand the performance and financial position of the holding company.

Subsidiary Company:

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as a company in which the holding company -

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

A company shall be deemed to be a subsidiary company of the holding company even if there is indirect control through the subsidiary company (ies).

The control over the composition of a subsidiary company's Board of Directors means exercise of some power to appoint or remove all or a majority of the directors of the subsidiary company.

'Total share capital', as defined in section 2(87) (ii) above, has been further clarified by the Rule 2(1)(r) of the Companies (Specification of Definitions Details) Rules, 2016. As per the Rule, total share capital includes

(a) paid up equity share capital

(b) convertible preference share capital.

Section 19 of the Companies Act, 2013 prohibits a subsidiary company from holding shares in the holding company. According to this section, no company shall, either by itself or through its nominees, hold any shares in its holding company and no holding company shall allot or transfer its shares to any of its subsidiary companies and any such allotment or transfer of shares of a company to its subsidiary company shall be void.

However, a subsidiary may continue to be a member of its holding company when

(a) the subsidiary company holds such shares as the legal representative of a deceased member of the holding co.

(b) the subsidiary company holds such shares as a trustee; or

(c) the subsidiary company is a shareholder even before it became a subsidiary company of the holding company.

The subsidiary company shall have a right to vote at a meeting of the holding company only in respect of the shares held by it as a legal representative or as a trustee,

In case (c) mentioned above, the subsidiary shall not have any voting rights in respect of the shares held.

1.2 Wholly Owned and Partly Owned Subsidiaries

S.No.	Wholly owned subsidiary company	Partly owned subsidiary company
1.	A wholly owned subsidiary company is one in which all the shares are owned by the holding	In a partly owned subsidiary, all the shares of subsidiary company are not acquired by the holding company i.e.

	company.	only the majority of shares (i.e., more than 50%) are owned by the holding company.
2.	100% voting rights are vested by the holding company.	Voting rights of more than 50% but less than 100% are vested by the holding company.
3.	There is no minority interest because all the shares with voting rights are held by the holding company.	There is a minority interest because less than 50% shares with voting rights are held by outsiders other than the holding company.

1.3 Purpose of Preparing the Consolidated Financial Statements

Section 129 (Clause 3) of the Companies Act, 2013 mandated the companies having one or more subsidiaries, to prepare Consolidated Financial Statements. According to this section, where a company has one or more subsidiaries, it shall, in addition to separate financial statements will prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. It shall also attach along with its financial statements, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in the prescribed form. For the purpose of section 129, 'subsidiary' includes 'Associate company' and 'Joint venture'.

Also as per the AS 21, where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

Consolidated financial statements are the financial statements of a 'group' presented as those of a single enterprise, where a 'group' refers to a parent and all its subsidiaries. Parent company needs to inform the users about the financial position and results of operations of not only of their enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity.

Consolidated Financial Statements are intended to show the financial position of the group as a whole - by showing the economic resources controlled by them, by presenting the obligations of the group and the results the group achieves with its resources.

Where a company is required to prepare Consolidated Financial Statements, i.e., consolidated balance sheet and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of the Schedule III as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following:

(i) Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

(ii) "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

Schedule III to the Companies Act, 2013 contains the 'General Instructions for Preparation of Consolidated Financial Statements'. Students are advised to refer the same from Schedule III which has been given as appendix at the end of the Study Material (Module I).

Accounting Standard (AS) 21 also lays down the accounting principles and procedures for preparation and presentation of consolidated financial statements.

1.4 Exclusion from Preparation of Consolidated Financial Statements

As per AS 21, a subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with AS 13 'Accounting for Investments'. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

However, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an investment is not excluded from consolidation, until the investment is actually disposed off.

Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.

Exclusion of a subsidiary from consolidation on the ground that its business activities are dissimilar from those of the other enterprises within the group is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by AS 17 'Segment Reporting', help to explain the significance of different business activities within the group.

1.5 *Consolidation of its subsidiary which is a Limited Liability Partnership (LLP) or a partnership firm*

As per rule 6 of Companies (Accounts) Rules, 2014, under the heading 'Manner of consolidation of accounts' it is provided that consolidation of financial statements of a company shall be done in accordance with the provisions of Schedule III to the Companies Act, 2013 and the applicable Accounting Standards.

It is noted that relevant Indian Accounting Standard i.e., Ind AS 110, Consolidated Financial Statements provides that where an entity has control on one or more other entities, the controlling entity is required to consolidate all the controlled entities. Since, the word 'entity' includes a company as well as any other form of entity, therefore, LLPs and partnership firms are required to be consolidated. Similarly, under Accounting Standard (AS) 21, as per the definition of subsidiary, an enterprise controlled by the parent is required to be consolidated. The term 'enterprise' includes a company and any enterprise other than a company. Therefore, under AS also, LLPs and partnership firms are required to be consolidated.

Accordingly, in the given case, holding company is required to consolidate its subsidiary which is an LLP or a partnership firm.

1.6 Consolidation of Limited Liability Partnership (LLP) which is an associate or joint venture

If LLP or a partnership firm is an associate or joint venture of holding company, even then the LLP and the partnership firm need to be consolidated in accordance with the requirements of applicable Accounting Standards.

UNIT 2: CONSOLIDATED FINANCIAL STATEMENTS

2.1 Advantages of Consolidated Financial Statements

As per AS 21, "Consolidated financial statements are the financial statements of a group presented as those of a single enterprise". The main advantages of consolidation are given below:

(i) **Single Source Document:** From the consolidated financial statements, the users of accounts can get an overall picture of the holding company and its subsidiaries. Consolidated Profit and Loss Account gives the overall profitability of the group

(ii) **Intrinsic value of share:** Intrinsic share value of the holding company can be calculated directly from the Consolidated Balance Sheet.

(iii) **Return on Investments in Subsidiaries:** The holding company controls its subsidiary. So its return on investments in subsidiaries should not be measured in terms of dividend alone. Consolidated Financial Statements provide information for identifying revenue profit for determining return on investment.

(iv) **Acquisition of Subsidiary:** The Minority Interest data of the Consolidated Financial Statement indicates the amount payable to the outside shareholders of the subsidiary company at book value which is used as the starting point of bargaining at the time of acquisition of a subsidiary by the holding company.

(v) **Evaluation of Holding Company in the market:** The overall financial health of the holding company can be judged using Consolidated Financial Statements. Those who want to invest in the shares of the holding company or acquire it, need such consolidated statement for evaluation.

2.2 Components of Consolidated Financial Statements

Accounting Standard 21, 'Consolidated Financial Statements' should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

As per AS 21, consolidated financial statements normally include

- Consolidated Balance Sheet
- Consolidated Statement of Profit and Loss Account
- Consolidated Cash Flow Statement (in case parent presents cash flow statement)
- Notes and statements and explanatory schedules that form the integral part thereof.

The consolidated financial statements are presented to the extent possible in the same format as that adopted by the parent for its separate financial statements.

All the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statement. For preparing consolidated financial statements, the following principles may be observed in respect of notes and other explanatory material that form an integral part thereof:

(a) Notes which are necessary for presenting a true and fair view of the consolidated financial statements are included in the consolidated financial statements as an integral part thereof.

(b) Only the notes involving items which are material need to be disclosed. Materiality for this purpose is assessed in relation to the information contained in consolidated financial statements. In view of this, it is possible that certain notes which are disclosed in separate financial statements of a parent or a subsidiary would not be required to be disclosed in the consolidated financial statements when the test of materiality is applied in the context of consolidated financial statements.

(c) Additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having no bearing on the true and fair view of the consolidated financial statements need not be disclosed in the consolidated financial statements.

Illustrative list of 'Notes to the separate financial statements' of the parent and/or the subsidiary, which in general should need not be included in the consolidated financial statements are given at the end of AS 21 for better understanding.

2.3 Consolidation Procedures

Rule 6 of the Companies (Accounts) Rules, 2014 states that the manner of consolidation of financial statements of the company shall be in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. AS 21, lays down the procedure for consolidation of financial statements of the companies within the group.

When preparing consolidated financial statements, the individual balances of the parent and its subsidiaries are aggregated on a line-by-line basis, and then certain consolidation adjustments are made.

For example, the cash, trade receivables and prepayments of the parent and each subsidiary are added together to arrive at the cash, trade receivables and prepayments of the group, before consolidation adjustments are made.

The objective is that the consolidated financial statements should present the information contained in the consolidated financial statements of a parent and its subsidiaries as if they were the financial statements of a single economic entity.

In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps are then taken:

1. the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated. In case cost of acquisition exceeds or is less than the acquirer's interest, goodwill or capital reserve is calculated retrospectively.
2. intragroup transactions, including sales, expenses and dividends, are eliminated, in full;
3. unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full;
4. unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered;

5. minority interest in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and
6. minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.

2.4 Calculation of Goodwill/Capital Reserve (Cost of Control)

As on the date of investment, the cost of investment and the equity in the subsidiary needs to be calculated. AS 21 defines equity as the 'residual interest in the assets of an enterprise after deducting all its liabilities.' In other words, it is equal to the net worth of the enterprise.

Once the above is calculated, goodwill or capital reserve is calculated as under:

Goodwill = Cost of Investment - Parent's share in the equity of the subsidiary on date of investment

Capital Reserve = Parent's share in the equity of the subsidiary on date of investment – Cost of investment

The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment.

However, if the financial statements of a subsidiary as on the date of investment are not available and if it is impracticable to draw the financial statements of the subsidiary as on that date, financial statements of the subsidiary for the immediately preceding period are used as a basis for consolidation.

Adjustments are made to these financial statements for the effects of significant transactions or other events that occur between the date of such financial statements and the date of investment in the subsidiary.

It may be mentioned that positive or negative differential is separately recognised only in purchase method. This differential calculated as cost of control is shown in the consolidated balance sheet.

Example:

1. H Ltd. acquires 70% of the equity shares of S Ltd. on 1st January, 2017. On that date, paid up capital of S Ltd. was 10,000 equity shares of ₹ 10 each; accumulated reserve balance was ₹ 1,00,000. H Ltd. paid ₹ 1,60,000 to acquire 70% interest in the S Ltd. Assets of S Ltd. were revalued on 1.1.2017 and a revaluation loss of ₹ 20,000 was ascertained. The book value of shares of S Ltd. is calculated as shown below:

	₹
70% of the Equity Share Capital ₹ 1,00,000	70,000
70% of Accumulated Reserve ₹ 1,00,000	70,000

70% of Revaluation Loss ₹ 20,000	(14,000)
	1,26,000

So, H Ltd. paid a positive differential of ₹ 34,000 i.e ₹ (1,60,000 – 1,26,000). This differential is also called goodwill and is shown in the balance sheet under the head intangibles.

2. A Ltd. acquired 70% interest in B Ltd. on 1.1.2017. On that date, B Ltd. had paid-up capital of ₹ 1,00,000 consisting of 10,000 equity shares of ₹ 10 each and accumulated balance in reserve and surplus of ₹ 1,00,000. On that date, assets and liabilities of B Ltd. were also revalued and revaluation profit of ₹ 20,000 were calculated. A Ltd. paid ₹ 1,30,000 to purchase the said interest.

   In this case, the book value of Shares of B Ltd. is calculated as shown below:

	₹
70% of the Equity Share Capital ₹ 1,00,000	70,000
70% of Reserves and Surplus ₹ 1,00,000	70,000
70% of Revaluation Profit ₹ 20,000	14,000
	1,54,000

   So, H Ltd. enjoyed negative differential of ₹ 24,000 i.e. (1,54,000 – 1,30,000).

Illustration 1

Exe Ltd. acquires 70% of equity shares of Zed Ltd. as on 31st March, 2017 at a cost of ₹ 70 lakhs. The following information is available from the balance sheet of Zed Ltd. as on 31st March, 2017:

	₹ in lakhs
Fixed Assets	*120*
Investments	*55*
Current Assets	*70*
Loans & Advances	*15*
15% Debentures	*90*
Current Liabilities	*50*

The following revaluations have been agreed upon (not included in the above figures):

Fixed Assets	*Up by 20%*
Investments	*Down by 10%*

Zed Ltd. declared and paid dividend @ 20% on its equity shares as on 31st March, 2017. Exe Ltd. purchased the shares of Zed Ltd. @ ₹ 20 per share.

Calculate the amount of goodwill/capital reserve on acquisition of shares of Zed Ltd.

Solution

Revalued net assets of Zed Ltd. as on 31st March, 2017

	₹ in lakhs	*₹ in lakhs*
Fixed Assets [120 X 120%]		144.0
Investments [55 X 90%]		49.5
Current Assets		70.0
Loans and Advances		15.0
Total Assets after revaluation		278.5
Less: 15% Debentures	90.0	
Current Liabilities	50.0	(140.0)
Equity / Net Worth		138.5
Exe Ltd.'s share of net assets (70%)		96.95
Exe Ltd.'s cost of acquisition of shares of Zed Ltd.		
(₹ 70 lakhs – ₹ 7 lakhs*)		63.00
Capital reserve		33.95

* Total Cost of 70 % Equity of Zed Ltd	₹ 70 lakhs
Purchase Price of each share	₹ 20
Number of shares purchased [70/20]	3.5 lakhs
Dividend @ 20 % i.e. ₹ 2 per share	₹ 7 lakhs

Since dividend received is for pre-acquisition period, it has been reduced from the cost of investment in the subsidiary company**.**

Illustration 2

Variety Ltd. holds 46% of the paid-up share capital of VR Ltd. The shares were acquired at a market price of ₹ 17 per share. The balance of shares of VR Ltd. are held by a foreign collaborating company. A memorandum of understanding has been entered into with the foreign company providing for the following:

(a) The shares held by the foreign company will be sold to Variety Ltd. The price per share will be calculated by capitalising the yield at 15%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were ₹ 30 lakhs, ₹ 40 lakhs and ₹ 65 lakhs.

(b) The actual cost of the shares to the foreign company was ₹ 5,40,000 only. The profit that would accrue to them would be taxable at an average rate of 30%. The tax payable will be deducted from the proceeds and Variety Ltd. will pay it to the Government.

(c) Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after two years.

The above agreement was approved by all concerned for being given effect to on 1.4.2017. The total assets of VR Ltd. as on 31st March, 2017 was ₹ 1,00,00,000. It was decided to write down fixed assets by ₹ 1,75,000. Current liabilities of VR Ltd. as on the same date were ₹ 20,00,000. The paid-up share capital of VR Ltd. was ₹ 20,00,000 divided into 2,00,000 equity shares of ₹ 10 each.

Find out goodwill/capital reserve to Variety Ltd. on acquiring wholly the shares of VR Ltd.

Solution

(1) Computation of purchase consideration:

(a)	Yield of VR Ltd.: $\left[\frac{40}{100} \times \frac{30+40+65}{3}\right]$	₹ 18 Lakhs
(b)	Price per share of VR Ltd.	
	Capitalised yield $\left[\frac{18\,\text{lakhs}}{0.15}\right]$	₹ 120 lakhs
	Number of shares	2,00,000
	Price per share	₹ 60
(c)	Purchase consideration for 54% shares in VR Ltd. 2,00,000 × $\frac{54}{100}$ × ₹ 60	₹ 64.80
(d)	Discharge of purchase consideration:	
	Tax deducted at source (₹ 64.80 lakhs–₹ 5.40 lakhs) × $\frac{30}{100}$	₹ 17.82
	50% of purchase consideration (net of tax) in cash ₹(64.80–17.82)x50%	₹ 23.49
	Balance – Unsecured Loan	₹ 23.49

(2) Goodwill/Capital Reserve to Variety Ltd.:

		₹ in lakhs
Total Assets		100.00
Less: Reduction in value of Fixed Assets		(1.75)
		98.25
Less: Current Liabilities		(20.00)
Net Assets		78.25
Purchase consideration	64.80	
Investments [2,00,000 X 46 % X ₹ 17]	15.64	(80.44)
Goodwill		2.19

2.5 Minority Interests

Minority interest is that part of the net results of operations and of net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries, by the holding (parent) company.

In short, minority interest represents the claims of the outside shareholders of a subsidiary. Minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the shareholders of the holding company.

Minority interest in the income of the group should be separately presented.

The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to make good the losses. If the subsidiary subsequently reports profit, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

As per para 13(e) of AS 21, minority interest in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interest in the net assets consist of:

(i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(ii) the minorities share of movements in equity since the date the parent-subsidiary relationship came in existence.

2.6 Profit or Loss of Subsidiary Company

The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

For the purpose of consolidated balance sheet preparation, all reserves and profits (or losses) of subsidiary company should be classified into **pre and post-acquisition reserves and profits (or losses).**

Profits (or losses) earned (or incurred) by subsidiary company upto the date of acquisition of the shares by the holding company are pre acquisition or capital profits (or loss).

Similarly, all reserves of subsidiary company upto the date of acquisition are capital reserves from the view point of holding company. If the holding interest in subsidiary is acquired during the middle or some other period of the current year, pre-acquisition profit should be calculated accordingly.

The minority interest in the reserves and profits (or losses) of subsidiary company should be transferred to minority interest account which will also include share capital of subsidiary company held by outsiders / minority shareholders.

Minority Interest:
= Share Capital of subsidiary related to outsiders + Minority interest in reserves and profits of subsidiary company

The holding company's interest in the pre-acquisition reserves and profits (or losses) should be adjusted against cost of control to find out goodwill or capital reserve on consolidation. The balance of reserves and profits (or loss) of subsidiary company, representing holding company's interest in post-acquisition or revenue reserves and profits (or losses), should be added to the balances of reserves and profits (or losses) of holding company.

Illustration 3

A Ltd. acquired 70% of equity shares of B Ltd. on 1.4.2010 at cost of ₹ 10,00,000 when B Ltd. had an equity share capital of ₹ 10,00,000 and reserves and surplus of ₹ 80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of ₹ 2,50,000, ₹ 4,00,000, ₹ 5,00,000 and ₹ 1,20,000 respectively. Thereafter in 2014-13, B Ltd. experienced turnaround and registered an annual profit of ₹ 50,000. In the next two years i.e. 2015-16 and 2016-17, B Ltd. recorded annual profits of ₹ 1,00,000 and ₹ 1,50,000 respectively. Show the minority interests and cost of control at the end of each year for the purpose of consolidation.

Solution

As per para 26 of AS 21 "Consolidated Financial Statements", the losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered. Accordingly,

Year	*Profit/(Loss)*	*Minority Interest (30%)*	*Additional Consolidated P & L (Dr.) Cr.*	*Minority's Share of losses borne by A Ltd.*		*Cost of Control*
				₹	*Balance*	
At the time of acquisition in 2010		3,24,000 (W.N.)	-			
2010-11	(2,50,000)	(75,000)	(1,75,000)			2,44,000 (W.N.)
		2,49,000				
2011-12	(4,00,000)	(1,20,000)	(2,80,000)			2,44,000
	-	1,29,000				
2012-13	(5,00,000)	(1,50,000)				2,44,000
		(21,000)	(3,50,000)			
	Loss of minority borne	21,000	(21,000)	21,000	21,000	

	by Holding Co.					
		Nil	(3,71,000)			
2013-14	(1,20,000)	- (on application of para 26 of AS 21)	(1,20,000)	36,000	57,000	2,44,000
		Nil				
2014-15	50,000	- (on application of para 26 of AS 21)	50,000	(15,000)	42,000	2,44,000
		Nil				
2015-16	1,00,000	- (on application of para 26 of AS 21)	1,00,000	(30,000)	12,000	2,44,000
		Nil				
2016-17	1,50,000	45,000	1,05,000	(12,000)	Nil	2,44,000
		(12,000) (application of para 26)	12,000			
		33,000	1,17,000			

Working Note:

Calculation of Minority interest and Cost of control on 1.1.2010

		Share of Holding Co.	*Minority Interest*
	100%	*70%*	*30%*
	(₹)	*(₹)*	*(₹)*
Share Capital	10,00,000	7,00,000	3,00,000
Reserve	80,000	56,000	24,000
		7,56,000	3,24,000
Less: Cost of investment		(10,00,000)	
Goodwill		2,44,000	

2.7 Revaluation of Assets of Subsidiary Company

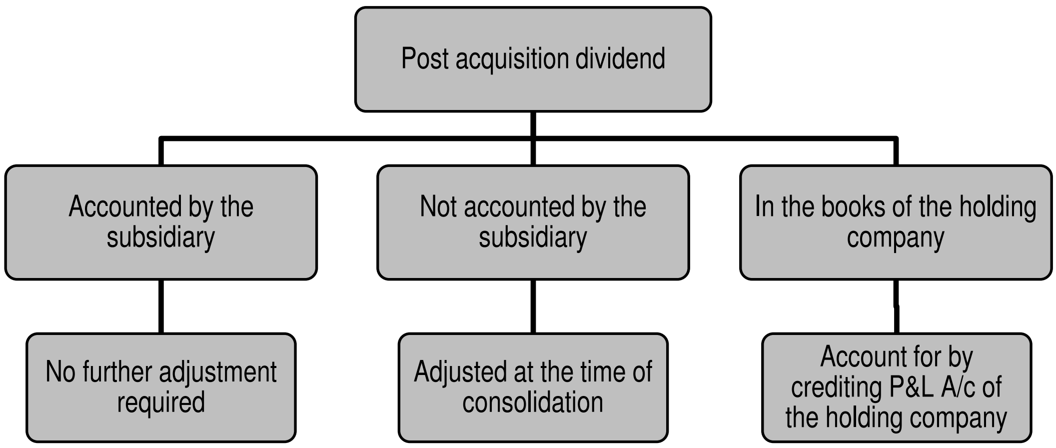
Profit or loss on revaluation of fixed assets of subsidiary should also be treated as capital profit or loss. But if the fall in the value of the asset occurs after the date of acquisition, the loss should be treated as revenue loss. Adjustment for depreciation would be made in the profit and loss account of the subsidiary.

Depreciation on changed value of the assets shall be given effect to. Depreciation on revalued assets will be taken as capital or revenue depending on the period for which the depreciation belongs

2.8 Dividend Received From Subsidiary Companies

The holding company, when it receives a dividend from a subsidiary company, must distinguish between the part received out of capital profits and that out of revenue profits - the former is credited to Investment Account, it being a capital receipt, and the later is adjusted as revenue income for being credited to the Profit & Loss Account. It must be understood that the term 'capital profit', in this context, apart from the generic meaning of the term, connotes profit earned by the subsidiary company till the date of acquisition. As a result, profits which may be of revenue nature for the subsidiary company may be capital profits so far as the holding company is concerned. If the controlling interest was acquired during the course of a year, profit for that year must be apportioned into the pre-acquisition and post-acquisition portions, on the basis of time in the absence of information on the point.

Treatment in case of post-acquisition dividend



Treatment in case of pre-acquisition dividend

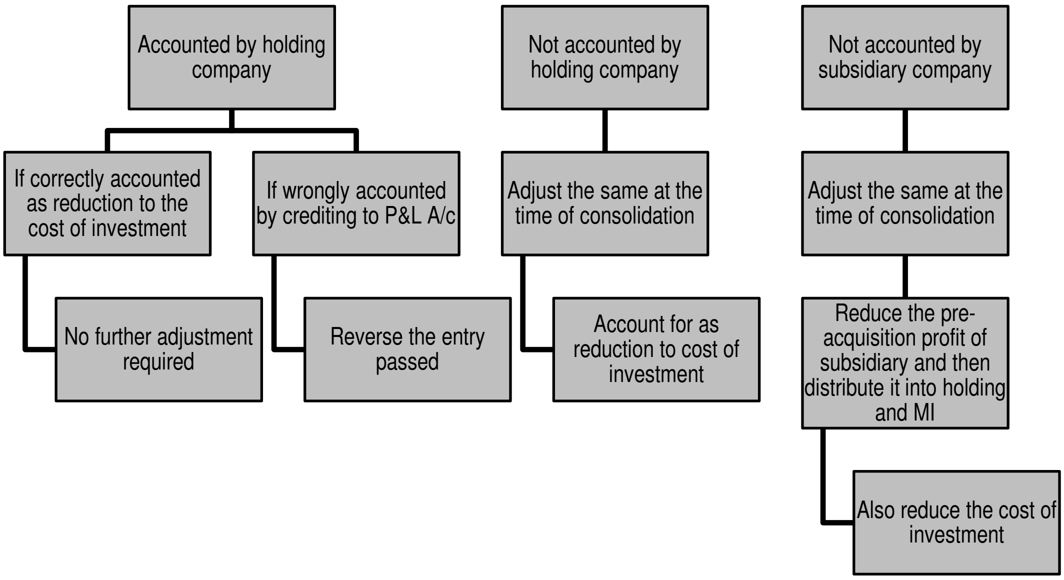


Illustration 4

H Ltd. acquired 3,000 shares in S Ltd., at a cost of ₹ 4,80,000 on 1st August, 2016. The capital of S Ltd. consisted of 5,000 shares of ₹ 100 each fully paid. The Profit & Loss Account of this company for 2016 showed an opening balance of ₹ 1,25,000 and profit for the year of ₹ 3,00,000. At the end of the year, it declared a dividend of 40%. Record the entry in the books of H Ltd., in respect of the dividend.

Solution

The profits of S Ltd., have to be divided between capital and revenue profits from the point of view of the holding company.

	Capital Profit ₹		*Revenue Profit* ₹
Balance on 1.1.2016	1,25,000	—	
Profit for 2016 (3,00,000 × 7/12)	1,75,000	(3,00,000×5/12)	1,25,000
Total	3,00,000		1,25,000
Proportionate share of H Ltd. (3/5)	1,80,000		75,000

Total Dividend Declared = ₹ 5,00,000 X 40 % = ₹ 2,00,000

H Ltd's share in the dividend = ₹ 2,00,000 X 3/5 = ₹ 1,20,000

The treatment of the dividend of ₹ 1,20,000 received by H Ltd., will depend on the character of profits which have been utilised by S Ltd., to pay the dividend. There are four possibilities:

(1) Earlier profits, included in the profit brought forward from the previous year have been used up first.

In that case, the dividend of ₹ 1,20,000 would be paid wholly out of capital or pre-acquisition profits. The entry in that case will be:

		₹	₹
Bank Account	Dr.	1,20,000	
To Investment Account			1,20,000

(2) The profit for 2016 alone has been utilised to pay the dividend, and no part of the profit brought forward has been utilised for the purpose. The share of H Ltd., in profit for the first seven months of S Ltd., is ₹ 1,05,000 i.e., ₹ 1,75,000 × 3/5 and that the profit for the remaining five months is ₹ 75,000. The dividend of ₹ 1,20,000 will be adjusted in this ratio: ₹ 70,000 out of profits up to the 1st August and ₹ 50,000 out of profits after that date. The dividend out of profits subsequent to August 1st will be revenue income and that out of earlier profits capital receipt. Hence the entry:

		₹	₹
Bank	Dr.	1,20,000	
To Investment Account			70,000
To Profit and Loss Account			50,000

(3) Later profits have been utilised first and then pre- acquisition profits. In such a case, the whole of ₹ 75,000 (share of H Ltd. in profits of S Ltd., after 1st August) would be received and treated as revenue income; the remaining dividend, ₹ 45,000 (₹ 1,20,000 less ₹ 75,000) would be capital receipt. The entry would be:

		₹	₹
Bank	Dr.	1,20,000	
To Investment Account			45,000
To Profit & Loss Account			75,000

(4) The two profits, pre-and post-acquisition, have been used up proportionally. The ratio would be ₹ 1,80,000 : 75,000; 1,20,000 × $\frac{75,000}{2,55,000}$ would be revenue receipt and the remaining capital. The entry would be:

		₹	₹
Bank	Dr.	1,20,000	
To Investment Account			84,706
To Profit & Loss Account			35,294

Notes:

(1) Points (3) and (4) above can arise only if there is definite information about the profits utilised; in practice such treatment is rare.

(2) The treatment outlined above in fact is not peculiar to holding companies-dividends received out of profits earned before purchase of investments normally also are credited to the Investment Account.

For instance, if shares in X Ltd., are purchased in January, 2016 and in April X Ltd., declares a dividend in respect of 2015, the dividend received by the holder of the shares correctly should not be treated as income but as capital receipt, and credited to Investment Account.

(3) The holding company, like other holders, records no entry on issue of bonus shares by the subsidiary company - only the number of shares held is increased.

Illustration 5

From the following data, determine in each case:

(1) Minority interest at the date of acquisition and at the date of consolidation.

(2) Goodwill or Capital Reserve.

(3) Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own Profit & Loss Account to be ₹ 2,00,000 in each case

Case	Subsidiary Company	% shares owned	Cost	Date of acquisition		Consolidation Date	
				1.1.2016		31.12.2016	
				Share Capital	Profit & Loss Account	Share Capital	Profit & Loss Account
			₹	₹	₹	₹	₹
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	55,000

Solution

(1) Minority Interest = Equity Attributable to minorities

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities i.e. in this given case Share Capital + Profit & Loss A/c

	Minority % Shares Owned [E]	Minority interest as at the date of acquisition [E] x [A + B] ₹	Minority interest as at the date of consolidation [E] X [C + D] ₹
Case 1 [100-90]	10 %	15,000	17,000
Case 2 [100-85]	15 %	19,500	18,000
Case 3 [100-80]	20 %	14,000	14,000
Case 4 [100-100]	NIL	Nil	Nil

(2) Calculation of Goodwill or Capital Reserve

	Shareholding % [F]	*Cost [G]*	*Total Equity [A] + [B] = [H]*	*Parent's Portion of equity [F] x [H]*	*Goodwill ₹ [G] – [H]*	*Capital Reserve ₹ [H] – [G]*
Case 1	90 %	1,40,000	1,50,000	1,35,000	5,000	—
Case 2	85 %	1,04,000	1,30,000	1,10,500	—	6,500
Case 3	80 %	56,000	70,000	56,000	Nil	Nil
Case 4	100 %	1,00,000	90,000	90,000	10,000	—

(3) The balance in the Profit & Loss Account on the date of acquisition (1.1.2016) is Capital Profit, as such the balance of Consolidated Profit & Loss Account shall be equal to Holding Co.'s Profit.

On 31.12.2016 in each case the following amount shall be added or deducted from the balance of holding Co.'s Profit & Loss Accounts.

	% Share holding [K]	P & L as on 31.12.2016 [L]	P & L as on consolidation date [M]	P & L post acquisition [N] = [M]-[L]	Amount to be added / (deducted) from holding's P & L [O] = [K] x [N]
1	90 %	50,000	70,000	20,000	18,000
2	85 %	30,000	20,000	(10,000)	(8,500)
3	80 %	20,000	20,000	NIL	NIL
4	100 %	40,000	55,000	15,000	15,000

Illustration 6

XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 2016 for ₹ 1,40,000. The issued capital of ABC Ltd., on 1st January, 2016 was ₹ 1,00,000 and the balance in the Profit & Loss Account was ₹ 60,000.

For the year ending on 31st December, 2016 ABC Ltd. has earned a profit of ₹ 20,000 and at the same time, declared and paid a dividend of ₹ 30,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

What is the amount of minority interest as on 1st January, 2016 and 31st December, 2016?

Solution

Total Dividend Paid = ₹ 30,000

Out of post-acquisition profit = ₹ 20,000

Out of pre-acquisition profit = ₹ 10,000

Hence, 2/3rd of dividend received by XYZ will be credited to P & L and 1/3rd will be credited to Investments.

XYZ Ltd.'s share of dividend = ₹ 30,000 X 80% = ₹ 24,000

In the books of XYZ Ltd.

	₹	₹	₹
Bank A/c Dr.	24,000		
To Profit & Loss A/c		16,000	
To Investments in ABC Ltd.		8,000	
(Dividend received from ABC Ltd. 1/3 credited to investment A/c being out of capital profits – as explained above)			
Goodwill on Consolidation:		₹	₹
Cost of shares less dividend out of capital profits			1,32,000
Less: Face value of capital		80,000	
Add: Share of capital profits [60,000-10,000 (dividend portion)] X 80 %		40,000	(1,20,000)
Goodwill			12,000
Minority interest on: 1st January, 2016: 20% of ₹ 1,60,000 [1,00,000 + 60,000]			32,000
31st December, 2016: 20% of ₹ 1,50,000 [1,00,000 + 60,000 + 20,000 – 30,000]			30,000

Illustration 7

The following balances appear in the books of a Holding Co. and its subsidiary on the dates stated:

	Jan. 1 2014	*Dec. 31 2014*	*Dec. 31 2015*	*Dec. 31 2016*
Holding Company	₹	₹	₹	₹
Investments in Subsidiary	*1,28,000*	*1,28,000*	*1,19,000*	*1,40,000*
Profit & Loss Account				
(Balance)	*1,35,000*	*1,60,000*	*1,48,000*	*1,55,000*
Subsidiary Company				
Share Capital	*1,00,000*	*1,00,000*	*1,00,000*	*1,00,000*
Profit & Loss Account				
(Balance before providing				
for dividend)	*50,000*	*62,000*	*70,000*	*80,000*

Subsidiary's issued capital consisted of 1,000 equity shares of ₹ 100 each. The Holding Co. purchased 800 shares on 1st January, 2014. It sold 50 shares on 1st January, 2015 and purchased 100 shares on 1st January, 2016. The Investment Account was debited with the cost of shares purchased and credited with the sale proceeds. The holding Co. has made no other entries in the Investment Account and credited all dividends received to the Profit & Loss Account. The subsidiary company paid a dividend of 15% in March each year in respect of the previous year.

Prepare a statement showing the amount of goodwill/cost of control and minority interest at the end of each year.

Solution:

Statement showing Goodwill or Cost of Control as on

	31st Dec. 2014 ₹	*31st Dec.* 2015 ₹		*31st Dec. 2016* ₹
Number of Shares held	800	750		850
% of Holding Co's shareholding	80 %	75 %		85 %
Cost of investment	1,28,000	1,16,000		1,08,750
Less: Dividend out of Capital Profit received on 31st March 2014	(12,000)			
	1,16,000			
Less: Cost of investment sold on 1st Jan 2015 $\left[\frac{50}{800} \times 1,16,000\right]$	—	(7,250)		
Add: Cost of investment purchased			21,000	
Less: Capital Dividend			(1,500)*	19,500
(A)	1,16,000	1,08,750		1,28,250
Nominal Value of Shares	80,000	75,000		85,000
Capital Profit	28,000	26,250		31,750**
	[50,000 × 80 % - 12,000]	[50,000 – 15,000 (dividend of last year) × 75 %]		[50,000 – 15,000] × 75 % + [70,000 – 15,000] × 10 %
(B)	1,08,000	1,01,250		1,16,750
Goodwill (A-B)	8,000	7,500		11,500

Note: In 2016, ₹ 21,000 must have been spent since by that amount the book value of investment has gone up. [1,40,000 – 1,19,000]

Minority interest		*Capital & Profits*		
		₹	₹	₹
31st Dec. 2014	20%	20,000	12,400 [62,000 X 20 %]	= 32,400
31st Dec. 2015	25%	25,000	17,500 [70,000 X 25 %]	= 42,500
31st Dec. 2016	15%	15,000	12,000 [80,000 X 15%]	= 27,000

* Dividend out of Capital Profits

** Alternative Calculation:

10% of 20,000 i.e. profit earned and not yet distributed after Jan., 2014 till 31st Dec. 2015 (55,000-35,000) plus 85% of ₹ 35,000 profit remaining undistributed out of profits as on 1.1.2014

In a particular situation it may so happen that the losses applicable to the minority in a consolidated subsidiary exceed the minority interest in the equity of the subsidiary. Such excess and any further losses should be charged against majority interest. If the subsidiary company subsequently reports profits, such profits should be allocated to majority interest unless the minority's share of losses previously absorbed has been recovered.

Illustration 8

A Ltd. acquired 70% of equity shares of B Ltd. as on 1st January, 2010 at a cost of ₹ 10,00,000 when B Ltd. had an equity share capital of ₹ 10,00,000 and reserves and surplus of ₹ 80,000. Both the companies follow calendar year as the accounting year. In the four consecutive years B Ltd. fared badly and suffered losses of ₹ 2,50,000, 4,00,000, ₹ 5,00,000 and ₹ 1,20,000 respectively. Thereafter in 2014, B Ltd. experienced turnaround and registered an annual profit of ₹ 50,000. In the next two years i.e. 2015 and 2016, B Ltd. recorded annual profits of ₹ 1,00,000 and ₹ 1,50,000 respectively.

Show the minority interests and cost of control at the end of each year for the purpose of consolidation.

Solution

	Minority Interest (30%) ₹	*Holding Interest (70%) ₹*	
Share of net assets of B Ltd. as on 1.1.2010	3,24,000	7,56,000	
Cost of acquisition	—	10,00,000	
	3,24,000	2,44,000	(goodwill)
Minority's share of losses of B Ltd: year ended 31.12.2010	75,000		
Minority interest as on 31.12.2010	2,49,000		
Minority's share of losses of B Ltd.:			
year ended 31.12.2011	1,20,000		
Minority interest as on 31.12.2011	1,29,000		
Minority's share of losses of B Ltd.			
year ended 31.12.2012	1,29,000*		
Minority interest as on 31.12.2012	Nil		
Minority's share of losses for 2013	Nil		
Minority's share of profits of B Ltd. for 2014	Nil		
Minority's share of profit for 2015	Nil		
Minority's share of profit for 2016 (₹ 45,000 – ₹ 12,000)	33,000*		
Minority interest as on 31.12.2016	33,000		

* In the year 2012, the minority's share of losses actually comes to ₹ 1,50,000. But since minority interest as on 31.12.2011 was less than the share of loss, the excess of loss of ₹ 21,000 is to be added to A Ltd.'s share of losses. Similarly, for the year 2013, the entire loss of B Ltd. is to be adjusted against A Ltd.'s profits for the purpose of consolidation. Therefore, upto 2013, the minority's share of B Ltd.'s losses of ₹ 57,000 are to be borne by A Ltd. Thereafter, the entire profits of B Ltd. will be allocated to A Ltd. unless the minority's share of losses previously absorbed (₹57,000) has been recovered. Such recovery is fully made in 2016 and therefore minority interest of ₹ 33,000 is shown after adjusting fully the share of losses of minority previously absorbed by A Ltd.

2.9 Preparation of Consolidated Balance Sheet

While preparing the consolidated balance sheet, assets and outside liabilities of the subsidiary company are merged with those of the holding company. Share capital and reserves and surplus of subsidiary company are apportioned between holding company and minority shareholders. These items, along with investments of holding company in shares of subsidiary company are not separately shown in consolidated balance sheet. The net amounts resulting from various computations on these items, shown as (a) minority interest (b) cost of control (c) holding company's share in post-acquisition profits of the subsidiary company (added to appropriate concerned account of the holding company) are entered in consolidated balance sheet. The method of calculation of these items with detailed treatment of other relevant issues has been dealt with in various paras separately.

As per para 15 of AS 21, if an enterprise makes two or more investments in another enterprise at different dates and eventually obtain control of the other enterprise the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence.

If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment for the purposes of paragraph 13 of AS 21, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.

Illustration 9

From the following summarized balance sheets of H Ltd. and its subsidiary S Ltd. drawn up at 31st March, 2017, prepare a consolidated balance sheet as at that date, having regard to the following:

(i) Reserves and Profit and Loss Account of S Ltd. stood at ₹ 25,000 and ₹ 15,000 respectively on the date of acquisition of its 80% shares by H Ltd. on 1st April, 2016.

(ii) Machinery (Book-value ₹ 1,00,000) and Furniture (Book value ₹ 20,000) of S Ltd. were revalued at ₹ 1,50,000 and ₹ 15,000 respectively on 1.4.2016 for the purpose of fixing the price of its shares. [Rates of depreciation: Machinery 10%, Furniture 15%.]

Summarised Balance Sheet of H Ltd. as on 31st March, 2017

	H Ltd.	S. Ltd.	Assets	H Ltd.	S Ltd.
	₹	₹		₹	₹
Equity and Liabilities			Non-current assets		
Shareholders' funds			Fixed assets		
Share Capital			Machinery	3,00,000	90,000
Shares of ₹ 100 each	6,00,000	1,00,000	Furniture	1,50,000	17,000
Reserves	2,00,000	75,000	Other non-current assets	4,40,000	1,50,000
Profit and Loss			Non-current Investments		

Account	*1,00,000*	*25,000*	*Shares in S Ltd.:*		
Trade Payables	*1,50,000*	*57,000*	*800 shares at ₹ 200 each*	*1,60,000*	*—*
	10,50,000	*2,57,000*		*10,50,000*	*2,57,000*

Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd.

as at 31st March, 2017

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		6,00,000
(b) Reserves and Surplus	1	3,44,600
(2) Minority Interest		48,150
(3) Current Liabilities		
(a) Trade Payables	2	2,07,000
Total		11,99,750
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	3	5,97,750
(ii) Intangible assets	4	12,000
(b) Other non- current assets	5	5,90,000
Total		11,99,750

Notes to Accounts

				₹
1.	**Reserves and Surplus**			
	Reserves (W.N.3)		2,00,000	
	Add: 4/5th share of S Ltd.'s post-acquisition reserves		40,000	2,40,000
	Profit and Loss Account		1,00,000	
	Add: 4/5th share of S Ltd.'s post-acquisition profits		4,600	1,04,600
				3,44,600
2.	**Trade Payables**			
	H Ltd.		1,50,000	
	S Ltd.		57,000	2,07,000
3.	**Tangible Assets**			
	Machinery			

	H. Ltd.		3,00,000	
	S Ltd.	1,00,000		
	Add: Appreciation	50,000		
		1,50,000		
	Less: Depreciation	(15,000)	1,35,000	
	Furniture			
	H. Ltd.		1,50,000	
	S Ltd.	20,000		
	Less: Decrease in value	(5,000)		
		15,000		
	Less: Depreciation	(2,250)	12,750	5,97,750
4.	**Intangible assets**			
	Goodwill [WN 6]			12,000
5.	**Other non-current assets**			
	H Ltd.		4,40,000	
	S Ltd.		1,50,000	5,90,000

Working Notes:

1.	**Pre-acquisition profits and reserves of S Ltd.**	₹
	Reserves	25,000
	Profit and Loss Account	15,000
		40,000
	H Ltd.'s = 4/5 × 40,000	32,000
	Minority Interest= 1/5 × 40,000	8,000
2.	**Profit on revaluation of assets of S Ltd.**	
	Profit on Machinery ₹ (1,50,000 – 1,00,000)	50,000
	Less: Loss on Furniture ₹ (20,000 – 15,000)	5,000
	Net Profit on revaluation	45,000
	H Ltd.'s share 4/5 × 45,000	36,000
	Minority Interest 1/5 × 45,000	9,000
3.	**Post-acquisition reserves of S Ltd.**	
	Post-acquisition reserves = ₹ (75,000 – 25,000)	50,000
	H Ltd.'s share 4/5 × 50,000	40,000
	Minority interest 1/5 × 50,000	10,000
4.	**Post -acquisition profits of S Ltd.**	
	Post-acquisition profits ₹ (25,000 – 15,000)	10,000
	Add: Excess depreciation charged furniture @ 15%	

on ₹ 5,000 i.e. (20,000 – 15,000)	750
	10,750
Less: Under depreciation on machinery @ 10%	
on ₹ 50,000 i.e. (1,50,000 – 1,00,000)	(5,000)
Adjusted post-acquisition profits	5,750
H Ltd.'s share 4/5 × 5,750	4,600
Minority Interest 1/5 × 5,750	1,150
5. Minority Interest	
Paid-up value of (1,000 – 800) = 200 shares	
held by outsiders i.e. 200 × ₹ 100	20,000
Add: 1/5th share of pre-acquisition profits and reserves	8,000
1/5th share of profit on revaluation	9,000
1/5th share of post-acquisition reserves	10,000
1/5th share of post-acquisition profit	1,150
	48,150
6. Cost of Control or Goodwill	
Paid-up value of 800 shares held by H Ltd. i.e. 800 × ₹ 100	80,000
Add: 4/5th share of pre-acquisition profits and reserves	32,000
4/5th share of profit on the revaluation	36,000
Intrinsic value of shares on the date of acquisition	1,48,000
Price paid up by H Ltd. for 800 shares	1,60,000
Less: Intrinsic value of the shares	(1,48,000)
Cost of control or Goodwill	12,000

2.10 Elimination of Intra-Group Transactions

In order to present financial statements for the group in a consolidated format, the effect of transactions between group enterprises should be eliminated. Para 16 of AS 21 states that intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

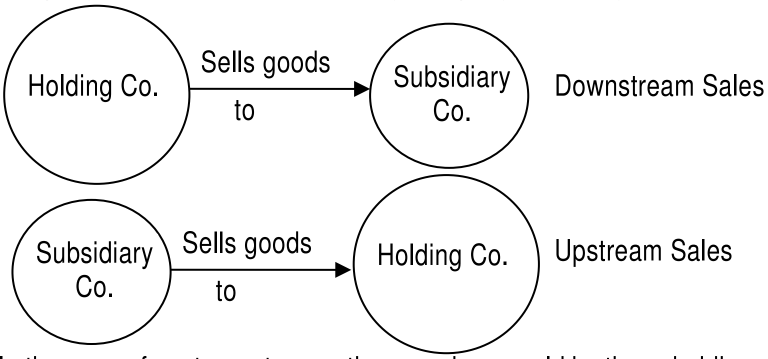
Liabilities due to one group enterprise by another will be set off against the corresponding asset in the other group enterprise's financial statements; sales made by one group enterprise to another should be excluded both from turnover and from cost of sales or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying enterprise has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets are reduced to cost to the group.

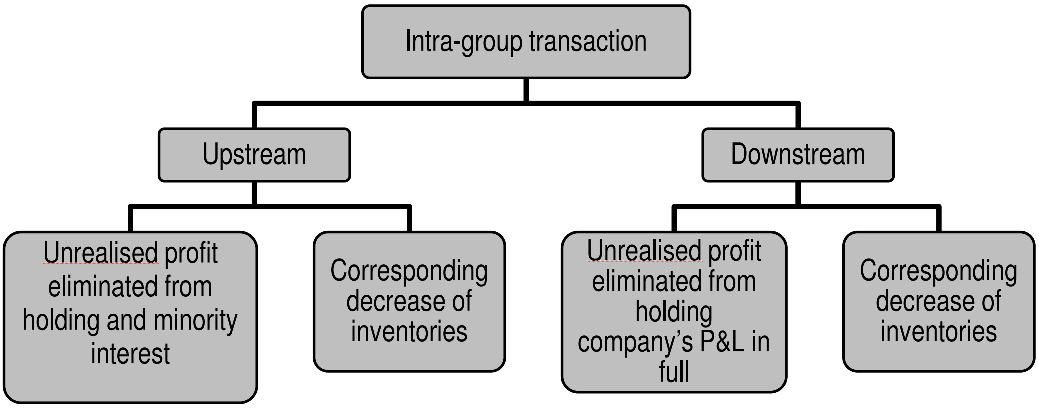
For transactions between group enterprises, unrealized profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

Unrealised profit in inventories: Where a group enterprise sells goods to another, the selling enterprise, as a separate legal enterprise, records profits made on those sales. If these goods are still held in inventory by the buying enterprise at the year end, however, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

Here, the point to be noted is that one has to see whether the intragroup transaction is "upstream" or "down-stream". **Upstream transaction** is a transaction in which the subsidiary company sells goods to holding company. While in the **downstream transaction** holding company is the seller and subsidiary company is the buyer.



In the case of upstream transaction, goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their share-holding besides deducting the same from unsold Inventory. But in the case of downstream transaction the whole profit is earned by the holding company, therefore whole unrealized profit should be adjusted from unsold Inventory account and consolidated profit and loss account only irrespective of the percentage of the shares held by the parent



Unrealised profit on transfer of non-current asset: Similar to the treatment described above for unrealized profits in inventories, unrealized inter-company profits arising from intra-group transfers of fixed assets are also eliminated from the consolidated financial statements.

Unrealised losses: Unrealised losses resulting from intra-group transactions that are deducted in arriving at the carrying amount of assets are also eliminated **unless cost cannot be recovered.**

2.11 Preparation of Consolidated Profit and Loss Account

Preparation of Consolidated Profit and Loss Account of holding company and its subsidiaries is not very difficult.

All the revenue items are to be added on line by line basis and from the consolidated revenue items inter-company transactions should be eliminated.

For example, a holding company may sell goods or services to its subsidiary, receives consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full.

If there remains any unrealised profit in the Inventory of good, of any of the Group Company, such unrealised profit is to be eliminated from the value of Inventory to arrive at the consolidated profit.

Illustration 10

Given below are the Profit & Loss Account of H Ltd. and its subsidiary Ltd. for the year ended 31st March, 2017:

	H Ltd. (*₹ in lacs*)	*S Ltd.* (*₹ in lacs*)
Incomes:		
Sales and other income	*5,000*	*1,000*
Increase in Inventory	*1,000*	*200*
	6,000	*1,200*

Expenses:		
Raw material consumed	*800*	*200*
Wages and Salaries	*800*	*150*
Production expenses	*200*	*100*
Administrative Expenses	*200*	*100*
Selling and Distribution Expenses	*200*	*50*
Interest	*100*	*50*
Depreciation	*100*	*50*
	2,400	*700*
Profit before tax	*3,600*	*500*
Provision for tax	*1,200*	*200*
Profit after tax	*2,400*	*300*
Dividend paid	*1,200*	*150*
Balance of Profit	*1,200*	*150*

Other Information:

H Ltd. sold goods to S Ltd. of ₹ 120 lacs at cost plus 20%. Inventory of S Ltd. includes such goods valuing ₹ 24 lacs. Administrative Expenses of S Ltd. include ₹ 5 lacs paid to H Ltd. as consultancy fees. Selling and Distribution expenses of H Ltd. include ₹ 10 lacs paid to S Ltd. as commission.

H Ltd. holds 80% of equity share capital of ₹ 1,000 lacs in S Ltd. before 2015-2016. H Ltd. took credit to its Profit and Loss Account, the proportionate amount of dividend declared and paid by S Ltd. for the year 2015-2016.

Solution

Consolidated Profit & Loss Account of H Ltd. and its subsidiary S Ltd.
for the year ended on 31st March, 2017

	Particulars	Note No.	₹ in Lacs
I.	Revenue from operations	1	5,865
II.	Total revenue		5,865
III.	Expenses		
	Cost of Material purchased/Consumed	3	1,180
	Changes of Inventories of finished goods	2	(1,196)
	Employee benefit expense	4	950
	Finance cost	6	150
	Depreciation and amortization expense	7	150
	Other expenses	5	535
	Total expenses		1,769
IV.	Profit before Tax (II-III)		4,096
V.	Tax Expenses	8	1,400
VI.	Profit After Tax		2,696

Profit transferred to Consolidated Balance Sheet		
Profit After Tax		2,696
Dividend paid		
H Ltd.	1,200	
S Ltd.	150	
	1,350	
Less: Share of H Ltd. in dividend of S Ltd.		
80% of ₹ 150 lacs	(120)	(1,230)
Profit to be transferred to consolidated balance sheet		1,466

Notes to Accounts

		₹ in Lacs	*₹ in Lacs*
1.	Revenue from Operations		
	Sales and other income		
	H Ltd.	5,000	
	S Ltd.	1,000	
		6,000	
	Less: Inter-company Sales	(120)	
	Consultancy fees received by H Ltd. from S Ltd.	(5)	
	Commission received by S Ltd. from H Ltd.	(10)	5,865
2.	Increase in Inventory		
	H Ltd.	1,000	
	S Ltd.	200	
		1,200	
	Less: Unrealised profits ₹ 24 lacs × $\frac{20}{120}$	(4)	1,196
			7,061
3.	Cost of Material purchased/consumed		
	H Ltd.	800	
	S Ltd.	200	
		1,000	
	Less: Purchases by S Ltd. from H Ltd.	(120)	880
	Direct Expenses		
	H Ltd.	200	
	S Ltd.	100	300
			1,180
4.	Employee benefits and expenses		
	Wages and Salaries:		

	H Ltd.	800	
	S Ltd.	150	950
5.	Other Expenses		
	Administrative Expenses		
	H Ltd.	200	
	S Ltd.	100	
		300	
	Less: Consultancy fees received by H Ltd. from S Ltd.	(5)	295
	Selling and Distribution Expenses:		
	H Ltd.	200	
	S Ltd.	50	
		250	
	Less: Commission received from S Ltd. from H Ltd.	(10)	240
			535
6.	Finance Cost		
	Interest:		
	H Ltd.	100	
	S Ltd.	50	150
7.	Depreciation and Amortisation		
	Depreciation:		
	H Ltd.	100	
	S Ltd.	50	150
8.	Provision for tax		
	H Ltd.	1,200	
	S. Ltd.	200	1,400

Note: Since the amount of dividend received by H Ltd. for the year 2015-2016 is not given, it has not been deducted from 'sales and other income' in consolidated profit and loss account and not added to consolidated opening retained earnings (which is also not given).

Illustration 11

The Trial Balances of H Ltd. and S Ltd. as on 31st December 2016 were as under:

	H Ltd.		*S Ltd.*	
	Dr. ₹	*Cr.* ₹	*Dr.* ₹	*Cr.* ₹
Equity Share Capital				
(Share of ₹ 100 each)		*10,00,000*		*2,00,000*
7% Preference Share Capital				
(Share of ₹ 100 each)		*—*		*2,00,000*
Reserves		*3,00,000*		*1,00,000*

6% Debentures		*2,00,000*		*2,00,000*
Trade Payables /Trade Receivables	*80,000*	*90,000*	*50,000*	*60,000*
P&L A/c balance		*20,000*		*15,000*
Purchases/Sales	*5,00,000*	*9,00,000*	*6,00,000*	*9,50,000*
Wages & Salaries	*1,00,000*	*—*	*1,50,000*	
Debenture Interest	*12,000*		*12,000*	
General Expenses	*80,000*		*60,000*	
Preference-Dividend				
up to 30.6.2016		*3,500*	*7,000*	
Inventory (31.12.2016)	*1,00,000*		*50,000*	
Cash at Bank	*13,500*		*6,000*	
Investment in S Ltd.	*5,28,000*		*—*	
Fixed Assets	*11,00,000*		*7,90,000*	
	25,13,500	*25,13,500*	*17,25,000*	*17,25,000*

Investment in S Ltd. were acquired on 1.4.2016 and consisted of 80% of Equity Capital and 50% of Preference Capital. Depreciation on fixed assets is written off @ 10% p.a. After acquiring control over S Ltd., H Ltd. supplied to it goods at cost plus 20%, the total invoice value of such goods being ₹ 60,000; 1/4 of such goods was still in Inventory at the end of the year.

Prepare the Consolidated Profit and Loss Account for the year ended on 31st December, 2016.

Solution

Note: It is assumed that Preference shares given in the question are non-convertible in nature.

Consolidated Profit and Loss Account of H Ltd. and S Ltd.
for the year ended 31st December, 2016

Particulars		*Note No.*	₹
I.	Revenue from operations	1	17,90,000
II.	Total revenue		17,90,000
III.	Expenses		
	Cost of Material purchased/Consumed	2	10,40,000
	Changes of Inventories of finished goods		
	Employee benefit expense (1,00,000 + 1,50,000)		2,50,000
	Finance cost (12,000 + 12,000)		24,000
	Depreciation and amortization expense [1,10,000+79,000]		1,89,000
	Other expenses [80,000 + 60,000]		1,40,000
	Total expenses		16,43,000
IV.	Profit before Tax (II-III)		1,47,000

Profit transferred to Consolidated Balance Sheet		
Profit After Tax		1,47,000
Preference dividend	3,500	
Preference dividend payable	3,500	(7,000)
		1,40,000
Less: Minority interest (WN 3)		(7,000)
Capital reserve*		(7,000)
Investment Account- dividend for 3 months (prior to acquisition)		(1,750)
Inventory reserve $\left[\frac{60,000}{4} \times \frac{20}{120}\right]$		(2,500)
Profit to be transferred to consolidated balance sheet		1,21,750

Notes to Accounts

		₹	₹
1	Revenue from Operations		
	H Ltd.	9,00,000	
	S Ltd.	9,50,000	
	Total	18,50,000	
	Less : Intra-group sales (H sold to S)	(60,000)	17,90,000
2	Cost of Materials Purchased/Consumed		
	H Ltd.	5,00,000	
	S Ltd.	6,00,000	
	Total	11,00,000	
	Less : Intra-group sales (H sold to S)	(60,000)	10,40,000

Working Note

Profit of Subsidiary

Revenue from Operations		9,50,000
Less : Expenses		
Cost of Material purchased/Consumed	6,00,000	
Changes of Inventories of finished goods		
Employee benefit expense	1,50,000	
Finance cost	12,000	
Depreciation and amortization expense	79,000	
Other expenses	60,000	

* Capital Reserve is made up of 3 month's profit upto 1.4.2016 i.e. ¼ x 35,000 x 80/100.

Total expenses		(9,01,000)
Profit Before Tax		49,000
Preference Dividend		7,000
Preference Dividend Payable		7,000
Profit available for shareholders		35,000
Minority Share (20%)		7,000

2.12 Preparation of Consolidated Cash Flow Statement

A holding company has to prepare a consolidated cash flow statement if it is required to prepare cash flow statement.

Same as Consolidated Profit and Loss account, the preparation of consolidated Cash flow statement is also not difficult. All the items of Cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated. Below given is the Consolidated Cash Flow Statement with hypothetical figures:

Consolidated Cash Flow Statement

			(₹ in million)
	A Company	*B Company*	*Total*
Cash Flow from Operating Activities			
Change in Reserve	8	2	10
Change in P & L A/c	0	1	1
Dividend Paid	22		22
Tax Provision	20	1	21
Depreciation	10	5	15
Interest	-10	10	0
	50	19	69
Less: Tax payment	-20	-1	-21
	30	18	48
Working Capital Adjustment	-13	12	-1
(A)	17	30	47
Cash Flow from Investment Activities			
Sale of fixed assets	30	0	30
Purchase of fixed assets	-30	-20	-50
(B)	0	-20	-20
Cash Flow from Financing Activities (C)	-22	-10	-32
Net cash flows (A+B+C)	-5	0	-5

2.13 Acquisition of Interest in Subsidiary at Different Dates

Often a holding company acquires a subsidiary in steps. As per para 15 of AS 21, "If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.

If two or more investments are made at different dates and eventually obtains control of the other enterprise,

Then the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence

If two or more investments are made over a period of time and holding subsidiary relationship came into existence from the first acquisition

Then the equity of the subsidiary at the date of investment, is generally determined on a step-by-step basis

If small investments are made over a period of time and then an investment is made that results in control

Then the date of the latest investment, as a practicable measure, may be considered as the date of investment

If two or more investments are made over a period of time and Lot 1 acquisition resulted in controlling interest, then steps to solve the question:

1. Take lot 1 date of acquisition as a base date
2. Classify the reserves and surplus into pre and post-acquisition
3. The revenue portion on the date of lot 1 along with any increase thereon till the date of acquisition of Lot 2 is capital profit for Lot 2
4. Deduct this figure from share of revenue profit of holding company
5. And add to the share of capital profit of holding company.

Illustration 12

'HIM' Limited is a company carrying on the business of beauty products and is having a subsidiary 'SIM' Limited. Their Balance-sheets as on 31st March 2016 were as under:

Equity and Liabilities	*HIM Limited (₹)*	*SIM Limited (₹)*
Shareholders' Funds		
Share Capital	*25,00,000*	*5,80,000*
Reserves and Surplus		

General Reserves		2,00,000	1,20,000
Profit and Loss Account		3,12,500	2,05,000
Current Liabilities			
Trade Payable		4,55,000	2,35,500
Bills Payable		28,000	83,000
	Total	34,95,500	12,23,500
Assets			
Non-Current Assets			
Fixed Assets		21,70,000	6,25,000
Investments			
4060 Shares in SIM Limited		5,10,000	-
Current Assets			
Inventories		4,80,000	3,19,200
Trade Receivable		1,80,000	1,64,000
Bills Receivable		68,000	1,00,000
Cash and Bank Balance		87,500	15,300
	Total	34,95,500	12,23,500

HIM Limited has also given the following information:

(i) *HIM Limited has acquired the shares in SIM Limited in two lots on two different dates. The relevant information at the time of acquisition of shares was as under:*

No. of shares acquired	Balance in General Reserve	Balance in Profit and Loss Account
1st acquisition 3480	80,000	25,000
2nd acquisition 580	85,000	1,02,000

(ii) *Bills Receivable of HIM Limited includes ₹15,000 being acceptance from SIM Limited.*

(iii) *Both the companies have declared dividends of 10% on 31st March 2016, but it has not been provided in the books of account.*

(iv) *SIM Limited's inventory includes stock of ₹ 1,45,000 purchased from HIM Limited. HIM Limited sells goods at mark up of 25% on its cost.*

Prepare the Consolidated Balance Sheet of HIM Limited along with 'Notes to accounts'.

Answer

Consolidated Balance Sheet of Him Ltd. and its subsidiary Sim Ltd.
as on 31st March, 2016

Particulars	Note No.	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		

	Share Capital	1	25,00,000
	Reserves and Surplus	2	3,79,300
(2)	**Minority Interest (W.N.2)**		2,54,100
(3)	**Current Liabilities**		
	Trade payable	3	7,86,500
	Other current liability	4	2,67,400
Total			41,87,300
II.	**Assets**		
(1)	**Fixed Assets**		
	Tangible assets (21,70,000 + 6,25,000)	5	27,95,000
	Intangible assets	6	22,300
(2)	**Current assets**		
	Inventories	7	7,70,200
	Trade Receivables	8	4,97,000
	Cash and Cash equivalents (87,500+15,300)	9	1,02,800
Total			41,87,300

Notes to Accounts

				₹
1.	**Share Capital**			
	Authorised, Issued, Subscribed and Paid up			
	25,000 Equity shares of ₹100 each			25,00,000
2.	**Reserves and Surplus**			
	General Reserve (W.N.4)		2,27,500	
	Profit & Loss Account (W.N.4)		1,51,800	3,79,300
3.	**Trade payables**			
	Trade Payables			
	Him Ltd.		4,55,000	
	Sim Ltd.		2,35,500	6,90,500
	Bills payable			
	Him Ltd.		28,000	
	Sim Ltd.	83,000		
	Less: Mutual owings	(15,000)	68,000	96,000
				7,86,500

4.	**Other current liability**			
	Dividend payable			
	Him Ltd.		2,50,000	
	Minority Interest		17,400	2,67,400
5.	**Tangible assets**			
	Him Ltd.		21,70,000	
	Sim Ltd.		6,25,000	27,95,000
6.	**Intangible assets**			
	Goodwill (W.N.3)			22,300
7.	**Inventories**			
	Him Ltd.		4,80,000	
	Sim Ltd.		3,19,200	
			7,99,200	
	Less: Unrealised profit		(29,000)	7,70,200
8.	**Trade Receivables**			
	Trade Receivables			
	Him Ltd.		1,80,000	
	Sim Ltd.		1,64,000	3,44,000
	Bills Receivable			
	Him Ltd.	68,000		
	Less: Mutual owings	(15,000)	53,000	
	Sim Ltd.		1,00,000	1,53,000
				4,97,000
9.	**Cash and Cash equivalents**			
	Him Ltd.		87,500	
	Sim Ltd.		15,300	1,02,800

Working Notes:

1. Analysis of Profits

	Pre-acquisition Profits	Post-acquisition	
		General Reserve	Profit & Loss Account
	₹	₹	₹
General Reserve	80,000	40,000	
Profit & Loss Account	25,000		1,80,000

For Lot 1 (A)	1,05,000	40,000	1,80,000
Pre-acquisition for Lot 2			
General Reserve (85,000 – 80,000)		5,000	
Profit & Loss Account (1,02,000-25,000)			77,000
Post-acquisition for Lot 2		35,000	1,03,000
Him Ltd. (70%) of (A)	73,500	28,000	1,26,000
Adjustment of pre-acquisition General Reserve for Lot 2 (10%)	500	(500)	
Adjustment of pre-acquisition Profit & Loss Account for Lot 2 (10%)	7,700	____	(7,700)
Him Ltd.	81,700	27,500	1,18,300
Minority Interest (30%) of (A)	31,500	12,000	54,000

2. Minority Interest

	₹
Share Capital (30%)	1,74,000
Add: Share of pre-acquisition profit of Sim Ltd.	31,500
Share of post-acquisition General Reserve	12,000
Share of post-acquisition Profit & Loss Account	54,000
	2,71,500
Less: Share of Dividend declared and payable	(17,400)
	2,54,100

3. Cost of Control/Goodwill

	₹
Cost of investments	5,10,000
Less: Share capital (70%)	(4,06,000)
Share of pre-acquisition profit	(81,700)
Goodwill	22,300

4. Consolidated General Reserve & Profit and Loss Account

	General Reserve	*Profit and Loss*
	₹	₹
Him Ltd.	2,00,000	3,12,500
Less: Dividend declared by Him Ltd.		(2,50,000)
Less: Unrealised profit	____	(29,000)
	2,00,000	33,500
Add: Share in post-acquisition item of Sim Ltd.	27,500	1,18,300
	2,27,500	1,51,800

Illustration 13

H Ltd. acquired 20% shares in S Ltd. on 1-7-2016 for ₹ 50 million, then another 20% on 1-10-2016 for ₹ 60 million and finally, another 20% on 1-11-2016 for ₹ 80 million. S Ltd. became subsidiary of H Ltd. on and from 1-11-2016. Balance of Reserve of S Ltd. as on 1-4-2016 (₹ in million) 60.

Summarised Balance Sheets of H Ltd. and S Ltd.
as on 31-3-2017

₹ in Million

	H Ltd.	*S Ltd.*
Equity Share Capital	*500*	*200*
General Reserve	*400*	*120*
Profit & Loss A/c	*10*	*12*
Sources	***910***	***332***
Fixed Assets		
Gross Block	*800*	*350*
Less: Accumulated Depreciation	*(100)*	*(30)*
Net Block	*700*	*320*
Investments	*190*	
Current Assets	*20*	*12*
Applications	***910***	***332***

Solution

In this case goodwill paid in acquiring cost of control should be computed step by step basis:

₹ in million

Goodwill	*1-7-2016*	*1-10-2016*	*1-11-2016*	*Total*	*Minority Interest*
Cost of investments (A)	50	60	80	190	
Book Value of Investments:					
Equity Share Capital	40 (200 X 20 %)	40 (200 X 20 %)	40 (200 X 20 %)	120.00	80 (200-120)
General Reserve 1-4-2016	12 (60 X 20 %)	12 (60 X 20 %)	12 (60 X 20 %)	36.00	24 (60-36)
Pre-acquisition profit of 2016-2017 WN 1	3.6	7.2	8.40	19.20	
(B)	55.6	59.2	60.40	175.20	
Cost of Control (A-B)	-5.60	0.80	19.60	14.80	
40% of post-acquisition reserve and profit					28.80
					132.80

Consolidated Profit & Loss a/c					
Balance of P & L A/c of H Ltd.					10
Share of current reserve [72 x 60 % - 19.2]					24
					34

Working Note:

Total Profit from 1-4-2016 to 31-03-2017 = 120 + 12 – 60 = 72 Million

Acquisition Date	*Pre-acquisition Period*	*Pre-acquisition Duration [A]*	*% Holding [B]*	*Profit amount 72 x [A]/12 X [B]*
1-7-2016	1-4-2016 to 1-7-2016	3 Months	20	3.6
1-10-2016	1-4-2016 to 1-10-2016	6 Months	20	7.2
1-11-2016	1-4-2016 to 1-11-2016	7 Months	20	8.4

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 2017

Particulars	*Note No.*	*(₹ in million)*
I. Equity and Liabilities		
(1) **Shareholder's Funds**		
(a) Share Capital		500.00
(b) Reserves and Surplus	1	434.00
(2) **Minority Interest**		132.80
Total		1,066.80
II. Assets		
(1) **Non-current assets**		
(a) Fixed assets		
(i) Tangible assets	2	1,020.00
(ii) Intangible assets (Goodwill)		14.80
(2) **Current assets (**20 + 12**)**		32.00
Total		1,066.80

Notes to Accounts

			(₹ in million)
1.	Reserves and Surplus		
	General reserve	400	
	Profit and Loss A/c [As calculated above]	34	434.00
2.	Tangible assets		
	Gross Block		1,150.0

Less: Accumulated Depreciation		(130.0)
Net Block		1,020.0

Another situation may be that a parent company increases or decreases its stake in the subsidiary.

For example, H Ltd. acquired 70% of the equity shares in S Ltd. It further acquires 10% of the equity shares subsequently or sells 10% of the equity shares. In both the cases step by step method should be followed for measuring goodwill/capital reserve.

2.14 Uniform Accounting Policies

Para 20 of AS 21 mentions that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances

If any company in the same group uses accounting policies other than those adopted in consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments should be made.

If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, the fact should be disclosed together with the proportions of items to which different accounting policies have been applied.

For example, if the subsidiary company follows LIFO method for valuation of inventories and the holding company follows FIFO method, the financial statement of subsidiary company should be restated by adjusting the value of inventories to bring the same in line with the valuation procedure adopted by the holding company. Then only consolidation can be considered.

Illustration 14

Consider the following summarized balance sheets of subsidiary B Ltd.:

	2015 ₹	2016 ₹		2015 ₹	2016 ₹
Share-Capital			*Fixed Assets*		
Issued & subscribed			*Cost*	*3,20,000*	*3,20,000*
5,000 equity shares			*Less: Accumulated*		
of ₹ 100 each	*5,00,000*	*5,00,000*	*depreciation*	*(48,000)*	*(96,000)*
Reserves & Surplus				*2,72,000*	*2,24,000*
Revenue reserves	*2,86,000*	*7,14,000*	*Investments*		
Current Liabilities &			*at cost*	*—*	*4,00,000*
Provisions:			*Current Assets:*		
Trade Payables	*4,90,000*	*4,94,000*	*Inventory*	*5,97,000*	*7,42,000*
Bank overdraft	*—*	*1,70,000*	*Trade Receivables*	*5,94,000*	*8,91,000*
Provision for taxation	*3,10,000*	*4,30,000*	*Prepaid Expenses*	*72,000*	*48,000*
			Cash at Bank	*51,000*	*3,000*
	15,86,000	*23,08,000*		*15,86,000*	*23,08,000*

Consider also the following information:

(a) B Ltd. is a subsidiary of A Ltd. Both the companies follow calendar year as the accounting year.

(b) A Ltd. values inventory on LIFO basis while B Ltd. used FIFO basis. To bring B Ltd.'s values in line with those of A Ltd. its value of inventory is required to be reduced by ₹ 12,000 at the end of 2015 and ₹ 34,000 at the end of 2016.

(c) Both the companies use straight-line method of depreciation. However, A Ltd. charges depreciation @ 10%.

(d) B Ltd. deducts 1% from Trade Receivables as a general provision against doubtful debts.

(e) Prepaid expenses in B Ltd. include advertising expenditure carried forward of ₹ 60,000 in 2015 and ₹ 30,000 in 2016, being part of initial advertising expenditure of ₹ 90,000 in 2015 which is being written off over three years. Similar amount of advertising expenditure of A Ltd. has been fully written off in 2015.

Restate the balance sheet of B Ltd. as on 31st December, 2016 after considering the above information, for the purpose of consolidation. Such restatement is necessary to make the accounting policies adopted by A Ltd. and B Ltd. uniform:

Solution

Adjusted revenue reserves of B Ltd.:

	₹	₹
Revenue reserves as given		7,14,000
Add: Depreciation over charged (₹ 16,000 × 2)	32,000	—
Provision for doubtful debts [8,91,000 / 99 X 1]	9,000	41,000
		7,55,000
Less: Reduction in value of Inventory	34,000	
Advertising expenditure to be written off	30,000	(64,000)
Adjusted revenue reserve		6,91,000

Restated Balance Sheet of B Ltd.
as at 31st December, 2016

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		5,00,000
(b) Reserves and Surplus	1	6,91,000
(2) Current Liabilities		
(a) Short term borrowings	2	1,70,000
(b) Trade Payables		4,94,000
(c) Short-term provision	3	4,30,000
Total		22,85,000
II. Assets		
(1) Non-current assets		

(a) Fixed assets		
Tangible assets	4	2,56,000
(b) Non-current Investment		4,00,000
(2) Current assets		
(a) Inventories		7,08,000
(b) Trade Receivables		9,00,000
(c) Cash & Cash Equivalents		3,000
(d) Other current assets	5	18,000
Total		22,85,000

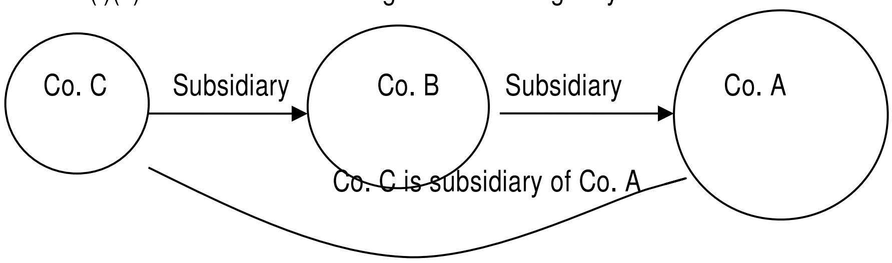
Notes to Accounts

			₹
1.	**Reserves and Surplus**		
	Revenue Reserve		6,91,000
2.	**Short term borrowings**		
	Bank overdraft		1,70,000
3.	**Short-term provision**		
	Provision for taxation		4,30,000
4.	**Tangible Assets**		
	Cost	3,20,000	
	Less: Depreciation to date	(64,000)	2,56,000
5.	**Other current assets**		
	Prepaid expenses		18,000

2.15 Chain Holding

Suppose that Company B is subsidiary of Company A and Company C is subsidiary of Company B.

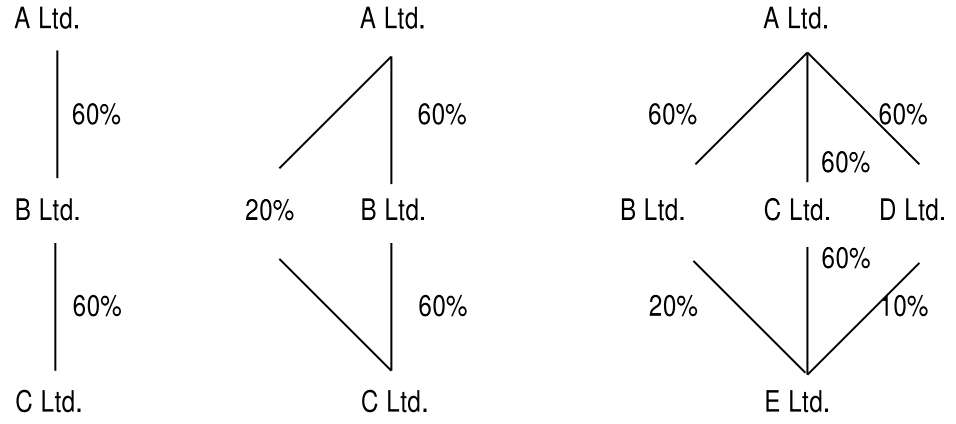
By virtue of Section 2 (86) of the Companies Act, 2013* C becomes subsidiary of Company A. Popularly, Company C is called sub-subsidiary of Company A and the type of holding mentioned in Section 4(l)(c) is called chain holding. Chain holding may take various forms



Chain Holding

* Section 4(1)(c) of the Companies Act, 1956.

In Type 1 the parent company does not hold any share in the sub-subsidiary. In Type 2 both the parent and subsidiary hold shares of sub-subsidiary. In Type 3 more than one subsidiaries of the parent company hold shares in the sub-subsidiary. There may be different other types of chain holding.



Type 1 **Type 2** **Type 3**

Treatment of Capital Profit of Sub-subsidiary in the Consolidation Process: There are two approaches, namely, **direct method and indirect method.** Capital Profit of the sub-subsidiary should be firstly apportioned between minority interest and group interest. The group interest should be taken directly for calculation of goodwill/capital reserve. This is called direct method.

Let us take an example. A Ltd.; holds 60% shares of B Ltd. and 20% shares of C Ltd.; B Ltd. holds 60% shares of C Ltd. Total profit of C Ltd. is ₹ 1,00,000 of which pre-acquisition profit is ₹ 40,000.

As per direct method capital profit (i.e., pre-acquisition profit in this case) should be apportioned as follows:

₹ 40,000 × $\frac{20}{100}$ = ₹ 8,000 to minorities of C Ltd.

₹ 40,000 × $\frac{80}{100}$ = ₹ 32,000 to the group which is to be considered for calculating goodwill or capital reserve.

For computation of goodwill / capital reserve for the purpose of consolidation, cost of group investments is compared to their face value. Cost of investments should be arrived at after adjusting pre-acquisition profit/loss relating to such investments. So direct approach appears to be more logical.

In the indirect approach, pre-acquisition profit/loss is apportioned among minorities of the sub-subsidiaries and to the respective group companies. From the shares of respective group companies, their minority interests are deducted and the parent company gets its indirect shares. In the example given above A Ltd.'s direct shares to C Ltd.; is to the extent of 20% and indirect through B Ltd. is 60% of 60% i.e. 36%. So while computing goodwill or capital reserve for the purpose of consolidation (only 20% + 36%) i.e. 56% of the capital profit of C Ltd. is considered. In other words, the calculation will be as follows:

$$₹\ 40,000 \times \frac{20}{100} = ₹\ 8,000 \text{ to minorities of C Ltd.}$$

$$₹\ 40,000 \times \frac{20}{100} = ₹\ 8,000 \text{ to A Ltd.}$$

$$₹\ 40,000 \times \frac{60}{100} = ₹\ 24,000 \text{ to B Ltd.}$$

Out of B Ltd.'s share of ₹ 24,000 A Ltd. will get 60%. This means A Ltd.'s indirect share in capital profit of C Ltd. is ₹ 24,000 × 60% i.e. ₹ 14,400. In total ₹ 22,400 (14,400 + 8,000) is to be taken for computation for goodwill/capital reserve. This comes to 56% of ₹ 40,000.

Illustration 15

Prepare the Consolidated Balance Sheet as on December 31, 2016 of group of companies A Ltd., B Ltd. and C Ltd. Their summarized balance sheets on that date are given below:

Liabilities	*A Ltd.* ₹	*B Ltd.* ₹	*C Ltd.* ₹
Share Capital (share of ₹ 100 each)	*1,25,000*	*1,00,000*	*60,000*
Reserves	*18,000*	*10,000*	*7,200*
Profit & Loss A/c	*16,000*	*4,000*	*5,000*
Trade Payables	*7,000*	*3,000*	—
A Ltd.	—	*7,000*	—
C Ltd.	*3,300*	—	—
Total	*1,69,300*	*1,24,000*	*72,200*
Assets			
Fixed Assets	*28,000*	*55,000*	*37,400*
Investments in shares-			
B Ltd.	*85,000*	—	—
C Ltd.	—	*53,000*	—
Inventory	*22,000*	*6,000*	—
B Ltd.	*8,000*	—	—
Trade Receivables	*26,300*	*10,000*	*31,500*
A Ltd.	—	—	*3,300*
Total	*1,69,300*	*1,24,000*	*72,200*

Other information:

(i) A Ltd. holds 750 shares in B Ltd. and B Ltd. holds 400 shares in C Ltd. These holdings were acquired on 30th June, 2016

(ii) On 1st January, 2016 the following balances stood in the books of B Ltd. and C Ltd.

	B Ltd. ₹	*C Ltd.* ₹
Reserves	*8,000*	*6,000*
P & L Account	*1,000*	*1,000*

(iii) C Ltd., sold goods costing ₹ 2,500 to B Ltd. for ₹ 3,100. These goods still remain unsold.

Solution

Workings Notes:

Shareholding Pattern

	B Ltd.	*C Ltd.*
Total Number of Shares	1,000	600
A Ltd's Holding	750	NA
B Ltd's Holding	NA	400
Minority Holding	250	200
Minority %	25 %	33.33%

(1) Analysis of Profits:

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
C Ltd.			
Reserve on 1.1.2016	6,000	—	—
Additional Reserve created in 2016 [7,200 – 6,000] = 1,200	600 [1,200 X ½]	600 [1,200 X ½]	—
P & L A/c, Balance on 1.1.2016	1,000	—	—
Profit for 2016 [5,000 – 1,000] = 4,000	2,000 [4,000 X ½]	—	2,000 [4,000 X ½]
	9,600	600	2,000
Due to outsiders, 1/3	3,200	200	667
Share of B Ltd. (2/3)	6,400	400	1,333

B Ltd.			
From C Ltd.	6,400*	400	1,333
Reserve on 1.1.2016	8,000	—	—
Additional Reserve created in 2016 [10,000-8,000] = 2,000	1,000 [2,000 X ½]	1,000 [2,000 X ½]	—
Profit and Loss A/c:			
Balance on 1.1.2016	1000	—	—
Profit during 2016 [4,000-1,000] = 3,000	1,500 [3,000 X ½]	—	1,500 [3,000 X ½]
	17,900	1,400	2,833
Due to outsiders (1/4)	4,475	350	708
Share of A Ltd.	13,425	1,050	2,125
A Ltd.		18,000	16,000
			18,125
Less: Inventory Reserve (2/3)			(400)
		19,050	17,725

Notes:

(i) During 2016, ₹ 1,200 has been added to the Reserves of C Ltd., and ₹ 2,000 to the Reserves of B Ltd. The profit must have been earned during the whole of the year; hence, half of these figures (i.e., up to 30.6.2016) must be considered as capital pre-acquisition and the remaining revenue.

(ii) Total unrealised profit is ₹ 600, i.e., ₹ 3,100 less ₹ 2,500.

(2) Minority Interest: [From the calculations above]

	B Ltd. ₹	*C Ltd.* ₹
Share Capital	25,000	20,000
Share of Capital Profits	4,475	3,200
Share of Revenue Reserves	350	200
Share of Revenue Profits	708	667
Less: Inventory reserve		(200)
Total	30,533	23,867
Grand Total		54,400

*This problem has been solved by following 'indirect approach'. All subsequent illustrations are solved by following 'direct approach'.

(3) Cost of Control:

Amount paid:		
A Ltd.	85,000	
B Ltd.	53,000	1,38,000
Less: Par value of shares in:		
B Ltd.	75,000	
C Ltd.	40,000	
Capital Profits*	13,425	(1,28,425)
Cost of Control*/ Goodwill		9,575

(4) Since X Ltd. shows ₹ 8,000 against B Ltd. whereas B Ltd., shows only ₹ 7,000 in favour of A Ltd., it must be assumed that B Ltd., has remitted ₹ 1,000 to A Ltd.; not yet received by A Ltd. The amount is in transit.

(5) If capital profit is increased by ₹ 1,600 cost of control will be ₹ 7,975.

Consolidated Balance Sheet of A Ltd.
and its subsidiaries B Ltd. and C Ltd.,
as on 31st December, 2016

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		1,25,000
(b) Reserves and Surplus	1	36,775
(2) Minority Interest (W.N 2)		54,400
(3) Current Liabilities		
Trade Payables	2	10,000
Total		2,26,175
II. Assets		
(1) Non-current assets		
Fixed assets		
(i) Tangible assets	3	1,20,400
(ii) Intangible assets	4	9,575

* The whole of this amount may preferably be adjusted against cost of control, instead of being added to the profits of B Ltd. Consequently, capital profits will increase by ₹ 1,600 with a corresponding reduction in Minority interest.

(2)	**Current assets**		
	(a) Inventories	5	27,400
	(b) Trade receivables	6	67,800
	(c) Cash & Cash equivalents	7	1,000
	Total		2,26,175

Notes to Accounts

			₹
1.	**Reserves and Surplus**		
	Reserves (W.N.1)	19,050	
	Profit and Loss Account (W.N.1)	17,725	36,775
2.	**Trade Payables**		
	A Ltd.	7,000	
	B Ltd.	3,000	10,000
3.	**Tangible Assets**		
	A Ltd.	28,000	
	B Ltd.	55,000	
	C Ltd.	37,400	1,20,400
4.	**Intangible assets**		
	Goodwill (W.N 3)		9,575
5.	**Inventories**		
	A Ltd.	22,000	
	B Ltd.	6,000	
		28,000	
	Less : Inventory reserve	(600)	27,400
6	**Trade Receivables**		
	A Ltd.	26,300	
	B Ltd.	10,000	
	C Ltd.	31,500	67,800
7	**Cash & Cash equivalents**		
	Cash in transit		1,000

2.16 Treatment of Subsidiary Company having Preference Share Capital

If the holding company has some investments in the preference shares of subsidiary, the carrying amount of such investments along with carrying amount of investments in equity shares of subsidiary company should be set off against the holding company's share in the equity of such subsidiary. The difference is treated as goodwill or capital reserve. The interest of minority shareholders of the subsidiary company will then include such portion of preference share capital of the subsidiary company which is not held by holding company.

However, if a subsidiary company has cumulative preference shares which are partly held outside the group, the holding company should compute its share of profits or losses of subsidiary after adjusting for the subsidiary's preference dividend attributable to minority shareholders, whether or not such dividends have been declared. By comparison, dividends in respect of non-cumulative shares are only recognized when declared.

2.17 Inter-Company Holdings

It is possible that the subsidiary company may also hold shares in the holding company. As per the proviso of section 19 of the Companies Act, 2013, the law would permit this if either the subsidiary company had already acquired the shares before the holding company acquired the shares in the subsidiary or it holds such shares as a trustee; or it holds such shares as the legal representative of a deceased member of the holding company. However, the subsidiary company would have **no voting rights at a meeting** of its holding company on the shares it acquired before the holding company acquired the shares in the subsidiary.

In such a situation, the calculation of the minority interest would have to be based on the fact that the subsidiary also has a claim on the profits of the holding company. The calculation will have to be made separately for revenue and capital profits since, otherwise, cost of control cannot be ascertained correctly.

For the purpose, such profits of the holding company as existed when the subsidiary company acquired the shares should be treated as capital profits. The calculation of the minority interest would involve an algebraical equation.

Illustration 15

You are given below the summarized balance sheets of two companies A Ltd. and B Ltd. as at 31-12-2016. Prepare their consolidated Balance Sheet.

Liabilities	*A Ltd. ₹*	*B Ltd. ₹*	*Assets*	*A Ltd. ₹*	*B Ltd. ₹*
Share Capital:			*Investment:*		
(₹ 100 each)	*5,00,000*	*2,00,000*	*1,600 shares*		
Profits:			*in B Ltd.*	*2,20,000*	
Capital profit	*1,00,000*	*80,000*	*1,000 shares*		
Revenue profit	*3,00,000*	*50,000*	*in A Ltd.*		*1,50,000*
Trade Payables	*1,50,000*	*60,000*	*Sundry Assets*	*8,30,000*	*2,40,000*
	10,50,000	*3,90,000*		*10,50,000*	*3,90,000*

Solution

A holds 1,600 shares out of 2,000 shares of B Ltd. i.e. 4/5th of B Ltd.

B holds 1,000 shares out of 5,000 shares of A Ltd. i.e. 1/5th of A Ltd.

Suppose:

A = Revenue Profits of A Ltd., and

B = Revenue Profits of B Ltd.

Then,

$$A = 3,00,000 + \frac{4}{5}B$$

$$B = 50,000 + \frac{1}{5}A$$

$$B = 50,000 + \frac{1}{5}(3,00,000 + \frac{4}{5}B) \text{ [Substituting for A]}$$

$$B = 50,000 + 60,000 + \frac{4}{25}B$$

$$B = 1,10,000 + \frac{4}{25}B$$

$$25B = 27,50,000 + 4B$$

$$21B = 27,50,000 \text{ or } B = 1,30,952$$

Minority interest in Revenue profits is 1/5 of ₹ 1,30,952 or ₹ 26,190. Total revenue profits being ₹ 3,50,000 [3,00,000 + 50,000] for A Ltd. and B Ltd together, ₹ 3,23,810 [3,50,000 – 26,190] remains for the group.

Capital Profits:

$$A = 1,00,000 + \frac{4}{5}B$$

$$B = 80,000 + \frac{1}{5}A$$

$$B = 80,000 + \frac{1}{5}(1,00,000 + \frac{4}{5}B)$$

$$B = 80,000 + 20,000 + \frac{4}{25}B$$

$$B = 1,00,000 + \frac{4}{25}B$$

$$25B = 25,00,000 + 4B$$

$$21B = 25,00,000$$

$$B = 1,19,048$$

Minority Interest @1/5 would be ₹ 23,810.

Total being ₹ 1,80,000 for the group it would be ₹ 1,56,190

Total Minority interest:

	₹
Shares held by outsiders [2,00,000 X 1/5]	40,000
Revenue Profit	26,190
Capital Profit	23,810
	90,000

Cost of control:

		(₹)
Amount paid by both companies		3,70,000
Less: Face Value:		
Shares in B Ltd.	1,60,000	
Shares in A Ltd.	1,00,000	
Capital Profits (₹ 1,19,048 – ₹ 23,810)	95,238	(3,55,238)
Goodwill		14,762

Alternative working note:

	A Ltd. ₹	*B Ltd.* ₹
Capital Profits	1,00,000	80,000
Less: Transfer to make B's Capital Profit ₹ 1,19,048	(39,048)	+39,048
	60,952	1,19,048
Minority Interest		(23,810)
Share of A Ltd.		95,238
Revenue Profits	3,00,000	50,000
Less: Transfer to make B's Profit ₹ 1,30,952	(80,952)	+80,952
	2,19,048	1,30,952
Less: Minority Interest		(26,190)
Share of A Ltd.	1,04,762	
	3,23,810	1,04,762

Consolidated Balance Sheet of A Ltd. and its subsidiary B Ltd.
as on 31st December, 2016

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	4,00,000
(b) Reserves and Surplus	2	3,84,762
(2) Minority Interest		90,000
(3) Current Liabilities		
(a) Trade Payables	3	2,10,000
Total		10,84,762
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	4	10,70,000
Intangible assets		14,762
Total		10,84,762

Notes to Accounts

			₹
1.	**Share Capital**		
	(5000-1000) Shares of ₹ 100 each		4,00,000
2.	**Reserves and Surplus**		
	Capital profit	60,950	
	Revenue profit	3,23,810	3,84,760
3.	**Trade Payables**		
	A Ltd.	1,50,000	
	B Ltd.	60,000	2,10,000
4.	**Tangible Assets**		
	A Ltd.	8,30,000	
	B Ltd.	2,40,000	10,70,000

2.18 Different Reporting Dates

For the purposes of preparing consolidated financial statements, the financial statements of all subsidiaries should, wherever practicable, be prepared:

- To the same reporting date; and
- For the same reporting period as of the parent.

When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent.

(Reference: Para 18 & 19 of AS 21)

When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided that difference in reporting dates is not more than six months.

However, adjustments should be made for the effects of significant transactions or other events that occur between the date of the subsidiary's financial statements and the date of the parent's financial statements. The length of the reporting periods and any difference in the reporting dates should be the same from period to period.

AS 21 does not define 'significant events and transactions', but they may include business combinations, asset impairments, and the crystallization of contingent liabilities. A potentially significant transaction or other event requires a careful analysis of the relevant facts and circumstances to determine if an adjustment is required.

2.19 Investment in the Debentures of the Subsidiary Company

For the purposes of preparing consolidated financial statements, debentures of subsidiary held by the holding company should be eliminated. Profit or loss arising on elimination shall be adjusted against Profit and Loss account of the holding company. No goodwill or capital reserve will be ascertained.

Illustration 16

Consider the following summarised balance sheets:

	A Ltd. (As on 31.3.2017)	*B Ltd. (As on 31.12.2016)*		*A Ltd. (As on 31.3.2017)*	*B Ltd. (As on 31.12.2016)*
	₹	₹		₹	₹
Share Capital (Shares			*Fixed Assets*	*6,50,000*	*4,05,000*
of ₹ 10 each)	*10,00,000*	*5,00,000*	*Investment:*		
Reserves and Surplus	*4,50,000*	*2,05,000*	*40,000 Shares*		
Secured Loan:			*in B Ltd.*	*8,00,000*	—
13% Debentures			*1,000 Debentures*		
(₹ 100 each)	—	*3,00,000*	*in B Ltd.*	*1,50,000*	—
Current Liabilities:			*Current Assets:*		

Trade payables	*3,80,000*	*80,000*	*Inventory*	*2,00,000*	*3,50,000*
Other liabilities	*2,00,000*	*40,000*	*Trade Receivables*	*1,50,000*	*2,65,000*
			Cash and Bank	*80,000*	*1,05,000*
	20,30,000	*11,25,000*		*20,30,000*	*11,25,000*

On 5th January 2017, certain inventory of B Ltd. costing ₹ 20,000 were completely destroyed by fire. The insurance company paid 75% of the claim.

On 20th January, 2017, A Ltd. sold goods to B Ltd. costing ₹ 1,50,000 at an invoice price of cost plus 20%.

50% of those goods were resold by B Ltd. to A Ltd. within 31st March, 2017 (these were then sold by A Ltd. to a third party before 31st March, 2017). As on 31st March, 2017, B Ltd. owes ₹ 60,000 to A Ltd. in respect of those goods. Pre-acquisition profits of B Ltd. were ₹ 75,000. Prepare consolidated balance sheet as on 31st March, 2017 after making necessary adjustments in the balance sheet of B Ltd.

Solution

Consolidated Balance Sheet of A Ltd. and its subsidiary B Ltd.
As on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		10,00,000
(b) Reserves and Surplus (W.N.5.)		5,09,000
(2) Minority Interest (W.N 3.)		1,46,000
(3) Non-current liabilities		
(a) Long term borrowings	1	2,00,000
(4) Current Liabilities		
(a) Trade Payables	2	4,60,000
(b) Other current liabilities (₹ 2,00,000 + ₹ 40,000)		2,40,000
Total		25,55,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	3	10,55,000
(ii) Intangible assets	4	3,40,000
(2) Current assets		
(a) Inventories	5	6,05,000
(b) Trade receivables	6	3,55,000
(c) Cash & Cash equivalents	7	2,00,000
Total		25,55,000

Notes to Accounts

			₹
1.	**Long Term Borrowings**		
	Secured loans		
	13% Debentures (₹ 100 each)		2,00,000
2.	**Trade Payables**		
	A Ltd.	3,80,000	
	B Ltd.(W.N 1)	1,40,000	
		5,20,000	
	Less : Mutual indebtedness	(60,000)	4,60,000
3.	**Tangible Assets**		
	A Ltd.	6,50,000	
	B Ltd.	4,05,000	10,55,000
4.	**Intangible assets**		
	Goodwill (W.N 2)		3,40,000
5.	**Inventories**		
	A Ltd.	2,00,000	
	B Ltd. [WN 1	4,20,000	
		6,20,000	
	Less : Unrealised profit [90,000 X 20/120]	(15,000)	6,05,000
6	**Trade Receivables**		
	A Ltd.	1,50,000	
	B Ltd.	2,65,000	
		4,15,000	
	Less : Mutual indebtedness	(60,000)	3,55,000
7	**Cash & Cash equivalents**		
	A Ltd.	80,000	
	B Ltd.[W.N 1	1,20,000	2,00,000

Working Notes:

1. Adjustments to be made in the balance sheet items of B Ltd.:

Assets side	₹
Inventories:	
As given on 31.12.2016	3,50,000
Add : Unsold Inventory out of goods purchased from A Ltd.	90,000

	4,40,000
Less: Loss of Inventory by fire	(20,000)
	4,20,000
Cash & Bank balance:	
As given on 31.12.2016	1,05,000
Add: Insurance claim received [20,000 × 75 %]	15,000
	1,20,000
Liabilities side:	
Trade payables:	
As given on 31.12.2016	80,000
Add: Owings to A Ltd. on 31.3.2017	60,000
	1,40,000
Reserves and Surplus:	
As given on 31.12.2016	2,05,000
Less: Abnormal Loss on goods destroyed [20,000 – 15,000]	(5,000)
	2,00,000
Add: Profit from sale of goods purchased from A Ltd.	30,000
	2,30,000

2. Goodwill / capital reserve on consolidation:

	₹	₹
Amount paid for 40,000 Shares		8,00,000
Less: Nominal value of proportionate share capital	4,00,000	
Share of pre-acquisition profits (80% of ₹ 75,000)	60,000	(4,60,000)
Goodwill		3,40,000

3. Minority Interest: 10,000 / 50,000 shares = 20%

	₹
Paid up value of 10,000 shares	1,00,000
Add: 20% of Reserves & Surplus of B Ltd. (20% of ₹ 2,30,000)	46,000
	1,46,000

4. Profit /Loss on Debentures acquired

	₹
Amount paid for 1,000 Debentures	1,50,000
Less: Nominal value of proportionate 13% debentures	(1,00,000)
Loss charged to Profit and Loss Account	50,000

5. Reserves and Surplus of A Ltd.:

Balance as on 31.3.2017	4,50,000
Add: Share of revenue reserves of B Ltd.	
([80% of ₹ 1,55,000 (2,30,000 – 75,000)]	1,24,000
	5,74,000
Less: Unrealised profit on Inventory $\left[\frac{1}{6} \times ₹\ 90{,}000\right]$	(15,000)
Loss on elimination of debentures acquired	(50,000)
	5,09,000

2.20 Miscellaneous Illustrations

Illustration 17

A Ltd. acquired 1,600 ordinary shares of ₹ 100 each of B Ltd. on 1st July 2016. On December 31, 2016 the summarised Balance Sheets of the two companies were as given below:

Liabilities	*A Ltd.* ₹	*B Ltd.* ₹	*Assets*	*A Ltd.* ₹	*B Ltd.* ₹
Capital (Shares of			*Land & Buildings*	*1,50,000*	*1,80,000*
₹ 100 each fully			*Plant & Machinery*	*2,40,000*	*1,35,000*
paid)	*5,00,000*	*2,00,000*	*Investment in B Ltd.*		
Reserves	*2,40,000*	*1,00,000*	*at cost*	*3,40,000*	—
Profit & Loss A/c	*57,200*	*82,000*	*Inventory*	*1,20,000*	*36,400*
Bank Overdraft	*80,000*	—	*Trade Receivable*	*59,800*	*40,000*
Trade Payable	*47,100*	*17400*	*Cash*	*14,500*	*8,000*
	9,24,300	*3,99,400*		*9,24,300*	*3,99,400*

The Profit & Loss Account of B Ltd. showed a credit balance of ₹ 30,000 on 1st January, 2016 out of which a dividend of 10% was paid on 1st August; A Ltd. has credited the dividend received to its Profit & Loss Account. The Plant & Machinery which stood at ₹ 1,50,000 on 1st January, 2016 was considered as worth ₹ 1,80,000 on 1st July, 2016; this figure is to be considered while consolidating the Balance Sheets. The rate of depreciation on plant & machinery is 10%.

Prepare consolidated Balance Sheet as on December 31, 2016.

Solution

Consolidated Balance Sheet of A Ltd. and its subsidiary, B Ltd.
as on 31st December, 2016

Particulars	**Note No.**	**(₹)**
I. Equity and Liabilities		
(1) Shareholder's Funds		

	(a)	Share Capital	1	5,00,000
	(b)	Reserves and Surplus	2	3,08,800
(2)	**Minority Interest (W.N 5)**			83,600
(3)	**Current Liabilities**			
	(a)	Trade Payables	3	64,500
	(b)	Short term borrowings	4	80,000
		Total		10,36,900
II.	**Assets**			
(1)	**Non-current assets**			
		Fixed assets		
		(i) Tangible assets	5	7,41,000
		(ii) Intangible assets	6	17,200
(2)	**Current assets**			
	(a)	Inventories	7	1,56,400
	(b)	Trade receivables	8	99,800
	(c)	Cash & Cash equivalents (Cash)	9	22,500
		Total		10,36,900

Notes to Accounts

				₹
1.	**Share Capital**			
	5,000 shares of ₹ 100 each			5,00,000
2.	**Reserves and Surplus**			
	Reserves		2,40,000	
	Profit & loss (W.N.8)		68,800	3,08,800
3.	**Trade Payables**			
	A Ltd.	47,100		
	B Ltd.	17,400		64,500
4.	**Short term borrowings**			
	Bank overdraft			80,000
5.	**Tangible Assets**			
	Land and building (1,50,000 + 1,80,000)		3,30,000	
	Plant & Machinery (W.N 7)		4,11,000	7,41,000
6.	**Intangible assets**			
	Goodwill (W.N 6)			17,200

7.	**Inventories**			
	A Ltd.		1,20,000	
	B Ltd.		36,400	1,56,400
8	**Trade Receivables**			
	A Ltd.	59,800		
	B Ltd.	40,000		
				99,800
9	**Cash & Cash equivalents**			
	Cash			
	A Ltd.		14,500	
	B Ltd.		8,000	22,500

Share holding Pattern

Total Shares of B Ltd	2,000 shares
Shares held by A Ltd	1,600 shares i.e. 80 %
Minority Shareholding	400 shares i.e. 20 %

Working Notes:

1. The dividend @ 10% on 1,600 shares, ₹ 16,000 received by A Ltd. should have been credited to the investment A/c, being out of pre-acquisition profits. A Ltd., must pass a correcting entry, viz.

Profit & Loss Account	Dr. ₹ 16,000	
To investment		₹ 16,000

2. The Plant & Machinery of B Ltd. would stand in the books at ₹ 1,42,500 on 1st July, 2016, considering only six months' depreciation on ₹ 1,50,000 total depreciation being ₹ 15,000. The value put on the assets being ₹ 1,80,000 there is an appreciation to the extent of ₹ 37,500.

3. **Capital profits of B Ltd.**

	₹	₹
Reserve on 1.1.2016		1,00,000
Profit & Loss Account Balance on 1.1.2016	30,000	
Less: Dividend paid	(20,000)	10,000
Profit for 2016: Total ₹ 82,000 less ₹ 10,000		
i.e. ₹ 72,000; upto 1.7.2016		36,000
Appreciation in value of Plant & Machinery		37,500
		1,83,500
Less: 20% due to outsiders		(36,700)
Holding company's share		1,46,800

4. Revenue profits of B Ltd.:

Profit after 1.7.2016 [82,000 – 10,000] x ½	36,000
*Less:*10% depreciation on ₹ 1,80,000 for 6 months less depreciation already	
Charged for 2nd half year on 1,50,000 (9,000 – 7,500)	(1,500)
	34,500
Less: 1/5 due to outsiders	(6,900)
Share of A Ltd.	27,600

5. Minority interest:

Par value of 400 shares	40,000
Add: 1/5 Capital Profits [WN 3]	36,700
1/5 Revenue Profits [WN 4]	6,900
	83,600

6. Cost of Control:

Amount paid for 1,600 shares	3,40,000	
Less: Dividend out of pre-acquisition profits	(16,000)	3,24,000
Par value of shares	1,60,000	
Capital Profits –share of A Ltd. [WN 3]	1,46,800	(3,06,800)
Cost of Control or Goodwill		17,200

7. Value of plant & Machinery:

A Ltd.		2,40,000
B Ltd.	1,35,000	
Add: Appreciation on 1.7.2016 [1,80,000 – (1,50,000 – 7,500)]	37,500	
	1,72,500	
Add: Deprecation for 2nd half charged on pre-revalued value	7,500	
Less: Depreciation on ₹ 1,80,000 for 6 months	(9,000)	1,71,000
		4,11,000

8. Profit & Loss Account (Consolidated):

A Ltd. as given	57,200	
Less: Dividend transferred to Investment A/c	(16,000)	41,200
Share of A Ltd. in revenue profits of B Ltd. (WN 4)		27,600
		68,800

Illustration 18

The summarised balance sheets of three companies, A Ltd., B Ltd., C Ltd., as on 31st December, 2016 are given below:

Liabilities:	A Ltd. ₹	B Ltd. ₹	C Ltd. ₹
Share Capital (shares of ₹ 100 each)	1,50,000	1,00,000	60,000
Reserves	20,000	10,000	7,500
Profit & Loss A/c	50,000	30,000	25,000
Trade Payables	20,000	25,000	15,000
A Ltd.	—	10,000	8,000
	2,40,000	1,75,000	1,15,500
Assets	**A Ltd. ₹**	**B Ltd. ₹**	**C Ltd. ₹**
Goodwill	20,000	15,000	10,000
Fixed Assets	70,000	50,000	60,000
Shares in B Ltd. (750 shares)	90,000	—	—
In C Ltd. (100 shares)	15,000	—	—
In C Ltd. (350 shares)	—	52,000	—
Due from: B Ltd.	12,000		
C Ltd.	8,000		
Current Assets	25,000	58,000	45,500
	2,40,000	1,75,000	1,15,500

All shares were acquired on 1st July, 2016. On 1st Jan., 2016, the balances were:

	A Ltd.	B Ltd.	C Ltd.
Reserves	10,000	10,000	5,000
Profit & Loss A/c	5,000	5,000(Dr.)	3,000

Profits during 2016 were earned evenly over the year.

In August, 2016 each company declared and paid an interim dividend of 10% p.a. for six months. A Ltd. and B Ltd., have credited their Profit & Loss Account with the dividends received. During 2016, C Ltd. fabricated a machine costing ₹ 10,000 which it sold to B Ltd. for ₹ 12,000, B Ltd. then sold the machine to A Ltd., for ₹ 13,000, the transactions being completed on 31st December, 2016.

Prepare the consolidated Balance Sheet of the group as on 31st December, 2016.

Solution

Consolidated Balance Sheet of A Ltd. and its Subsidiaries B Ltd. & C Ltd., as on 31st December, 2016

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,50,000
(b) Reserves and Surplus	2	85,402
(2) Minority Interest [W.N (iv)]		59,691
(3) Current Liabilities		
(a) Trade Payables	3	60,000
Total		3,55,093
II. Assets		
(1) Non-current assets		
Fixed assets		
(i) Tangible assets	4	1,77,000
(ii) Intangible assets	5	47,593
(2) Current assets	6	1,30,500
Total		3,55,093

Notes to Accounts

				₹
1.	Share Capital			
	1,500 shares of ₹ 100 each			1,50,000
2.	Reserves and Surplus			
	Reserves of A Ltd	20,000		
	Add: Share in C Ltd. [WN (i)]	208		
	Add: Share in B Ltd. [WN (ii)]	548	20,756	
	Profit & loss[W.N.(v)]		64,646	85,402
3.	Trade Payables			
	A Ltd		20,000	
	B Ltd.		25,000	
	C Ltd		15,000	60,000
4.	Tangible Assets			
	Given in balance sheet		1,80,000	
	Less : Unrealised profit		(3,000)	1,77,000

5.	Intangible assets		
	Given in balance sheet	45,000	
	Add : Goodwill on consolidation (W.N iii)	2,593	47,593
6.	Current assets		
	A Ltd.	25,000	
	B Ltd.	58,000	
	C Ltd.	45,500	
		1,28,500	
	Add : Cash in Transit *	2,000	1,30,500

*A Ltd shows ₹ 12,000 receivable from B Ltd. whereas B Ltd. shows ₹ 10,000 payable to A Ltd. Hence, ₹ 2,000 has been treated as cash in transit

Working notes:

Shareholding Pattern

	B Ltd.	*C Ltd.*
Total Shares	1,000	600
Held By A Ltd.	750 i.e. 3/4th	100 i.e. 1/6th
Held by B Ltd.	NA	350 i.e. 7/12th
Outsiders	250 i.e. 1/4th	150 i.e. 1/4th

(i) Analysis of Profits of C Ltd.

	₹	*Capital Profit* ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
General Reserve on 1.1.2016		5,000		
Profit & Loss A/c on 1.1.2016		3,000		
Increase in Reserve [7,500 – 5,000]		1,250	1,250	
Profit for the year	12,500 [25,000 x ½]			
Less: Interim Dividend	(3,000)	9,500		12,500 [25,000 x ½]
		18,750	1,250	12,500
Less: Minority Interest 3/12		4,687	312	3,125
Brought Forward		14,063	938	9,375
Share of A Ltd. 2/12		3,125	208	2,083
Share of B Ltd. 7/12		10,938	730	7,292

(ii) Analysis of Profits of B Ltd.

		₹	₹	₹	₹
Reserve on 1.1.2016			10,000		
Profit & Loss on 1.1.2016			(5,000)		
Profit for the year [30,000+5,000+5,000]	40,000				
Less: Interim dividend of C Ltd. [3,000 X 7/12]	(1,750)				
	38,250	19,125 [38,250 × ½]			19,125 [38,250 × ½]
Less: Interim Div.		(5,000)	14,125		
Share in C Ltd.			______	730	7,292
			19,125	730	26,417
Minority Interest ¼			(4,781)	182	6,604
Share of A Ltd. [3/4]			14,344	548	19,813

(iii) Cost of Control / Capital Reserve

	₹	₹
Investments in B Ltd.		
(90,000 – 3,750)	86,250	
Investments in C Ltd.		
(15,000 – 500)	14,500	
(52,000 – 1,750)	50,250	1,51,000
Less: Paid up Value of Investments		
in B Ltd.	75,000	
in C Ltd.	45,000	
Capital Profit in B Ltd. [WN (ii)]	14,344	
Capital Profit in C Ltd. [WN (i)]	14,063	(1,48,407)
		2,593

(iv) Minority Interest

	B Ltd. ₹	*C Ltd.* ₹
Share Capital	25,000	15,000
Capital Profits [WN (i) & (ii)]	4,781	4,687

Revenue Reserve [WN (i) & (ii)]	182	312
Revenue Profits [WN (i) & (ii)]	6,604	3,125
	36,567	23,124

(v) Profit and Loss Account – A Ltd.

	₹
Balance	50,000
Less: Dividend credited to Investment (3,750+500)	(4,250)
	45,750
Share in B Ltd.	19,813
Share in C Ltd.	2,083
	67,646
Less: Intergroup Profit on Plant [13,000-10,000]	(3,000)
	64,646

Illustration 19

The following information was extracted from the books of A Limited group as on 31st March, 2017:

	A Ltd. ₹	B Ltd. ₹	C Ltd. ₹
Profit and Loss Account:			
Balance on 31st March, 2017 after provision for dividends of 10% in respect of calendar year 2016-2017 but excluding dividend received	*50,000*	*36,000*	*26,000*
Net trading profit earned in 2015-2016	*60,000*	*42,000*	*28,000*
	1,10,000	*78,000*	*54,000*
Less: Dividends of 10 per cent (received in 2016-2017) in respect of year 2015-2016	*(40,000)*	*(30,000)*	*(20,000)*
	70,000	*48,000*	*34,000*
Net trading profit earned in 2016-2017 (before taking into account dividends of 10 per cent in respect of year 2016-2017)	*50,000*	*50,000*	*30,000*
	1,20,000	*98,000*	*64,000*
Dividends Received:			
From B Limited in 2015-2016	*20,000*		
From B Limited in 2016-2017	*25,000*		
From C Limited in 2016-2017		*15,000*	
Share Capital Authorised and Fully paid - Equity			

Shares of ₹ 1 each	*4,00,000*	*3,00,000*	*2,00,000*
Trade Payables	*20,000*	*5,000*	*17,000*
	5,85,000	*4,18,000*	*2,81,000*
Fixed Assets at cost less Depreciation	*2,10,000*	*1,88,000*	*2,61,000*
Current Assets	*60,000*	*30,000*	*20,000*
Investment at cost:			
2,00,000 Equity Shares in B Ltd.			
bought on March 31, 2017	*2,50,000*		
50,000 Equity Shares in B Ltd.			
bought on March 31, 2016	*65,000*		
1,50,000 Equity Shares in C Ltd.		*2,00,000*	
bought on March 31, 2016			
	5,85,000	*4,18,000*	*2,81,000*

All the companies pay dividends of 10 per cent on Paid-up share capital in March following the end of the accounting year. The receiving companies enter the dividends in their books when dividends are received. You are required to prepare:

(a) Consolidated Balance Sheet as on 31st March, 2017.

(b) Statements showing the composition of:

(i) Consolidated Profit and Loss Account.

(ii) Minority Interest, and

(iii) Cost of Control, Goodwill. Ignore taxation.

Solution

(a) Consolidated Balance Sheet of A Ltd., and subsidiaries B Ltd. and C Ltd.

as on 31st March, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	4,00,000
(b) Reserves and Surplus	2	1,68,417
(2) **Minority Interest** [Refer (ii)]		1,26,083
(3) **Current Liabilities**		
(a) Trade payables	3	42,000
(b) Other Current liabilities	4	50,000
Total		7,86,500

II.	**Assets**		
	(1) **Non-current assets**		
	Fixed assets		
	i. Tangible assets	5	6,59,000
	ii. Intangible assets	6	17,500
	(2) **Current assets**		1,10,000
	Total		7,86,500

Notes to Accounts

		(₹)	(₹)
1.	**Share Capital**		
	4,00,000 Equity shares of ₹ 1 each fully paid		4,00,000
2.	**Reserves and surplus**		
	Profit and Loss Account {b(i)}		1,68,417
3.	**Trade Payables**		
	Trade Payables		42,000
4.	**Other Current Liabilities**		
	Dividend payable:		
	A Ltd. 40,000		
	Minority Interest 10,000		50,000
5.	**Tangible Assets**		
	Fixed Assets less depreciation		6,59,000
6.	**Intangible assets**		
	Goodwill [Refer (iii)]		17,500

(b) **(i)** Consolidated Profit and Loss Account of A Ltd. and its subsidiaries, B Ltd. and C Ltd., for the year ended on 31st March, 2017.

	₹	₹
Profit and Loss account balance of last year		
A Ltd.	1,10,000	
B Ltd.	78,000	
C Ltd.	54,000	2,42,000
Add: Dividend received		20,000
in 2015-2016 (for 2014-2015)*		
Add: Profit for the year:		
A Ltd.	50,000	

B Ltd.	50,000	
C Ltd.	30,000	1,30,000
	₹	₹
Less: Dividend for 2015-2016*		
A Ltd.	40,000	
B Ltd. (Net) [30,000-25,000]	5,000	
C Ltd. (Net) [20,000-150,000]	5,000	50,000
Minority Interest:		
B Ltd.	20,083	
C Ltd.	16,000	36,083
Capital Receipts*		40,000
Capital Profits		
B Ltd.	32,000	
C Ltd.	25,500	57,500
Dividend for 2016-2017		40,000
Profit transferred to Consolidated P&L A/c		1,68,417

					Net Amount (₹) (after eliminating intragroup dividend)	
For	*Dividend Paid*		*Dividend Received*		*Dividend Paid*	*Dividend Received*
	By	*₹*	*By*	*₹*	*₹*	*₹*
2014-15			A Ltd. (From B Ltd.)	20,000		20,000 (By A Ltd)
2015-16	A Ltd.	40,000			40,000 (By A Ltd.)	
2015-16	B Ltd.	30,000	A Ltd. (From B Ltd.)	25,000	5,000 (By B Ltd.)	
2015-16	C Ltd.	20,000	B Ltd. (From C Ltd.)	15,000	5,000 (By C Ltd.)	
					50,000	20,000

* To be credited to Investments in subsidiaries ₹ 25,000 from B Ltd. [₹ 20,000 dividend received in 2015-2016 (for 2014-2015) + ₹ 5,000 dividend received in 2016-2017 (for 2015-2016)] and ₹ 15,000 from C Ltd.

(ii) Minority Interest :

B Ltd = 50,000 shares / 3,00,000 shares = 1/6th

C Ltd = 50,000 shares / 2,00,000 shares = 1/4th

	B Ltd. ₹	*C Ltd.* ₹
Share Capital	50,000	50,000
Capital Profits	6,000	8,500
Revenue Profits	14,083	7,500
	70,083	66,000
Total		1,36,083
Less: Shown as dividend		(10,000)
		1,26,083

(iii) Cost of control/Goodwill

Cost of Investment in B Ltd. – 2,00,000	₹	₹
(Shares ₹ 2,50,000 less Dividend,		
₹ 20,000 received in 2015-2016)		2,30,000
Cost of Investments in B Ltd. – 50,000		
(Shares less dividend received in 2016-2017)		60,000
Cost of Investment in C Ltd. held by B Ltd.		
(less dividend received in 2016-2017)		1,85,000
		4,75,000
Paid-up value of Shares in B Ltd.	2,50,000	
Paid-up value of Shares in C Ltd.	1,50,000	
Capital Profits in B Ltd.	32,000	
Capital Profits in C Ltd.	25,500	4,57,500
Goodwill		17,500

Working Note:

Analysis of Profits

	Capital Profit ₹	*Revenue Profit* ₹
C Ltd.		
Balance on 31st March, 2016, after dividend	34,000	
Profit for the year ending on 31st March, 2017		
before dividend for 2016-2017		30,000

	34,000	30,000
Minority Interest (1/4)	8,500	7,500
	25,500	22,500
B Ltd.		
Balance on 31st March, 2015	36,000	—
Profit in 2015-2016 after dividend for 2015-2016	—	12,000
Profit for 2016-2017 (before dividend),	—	50,000
Revenue Profit from C Ltd.	—	22,500
	36,000	84,500
Minority Interest (1/6)	6,000	14,083
	30,000	70,417
1/6 of retained profit for 2015-2016 treated as Capital profit on purchase of 50,000 shares on 31st March, 2016	+ 2,000	(2,000)
	32,000	68,417

Illustration 20

The summarised Balance Sheets of the following three companies are given below:

	As on 31st March, 2017 (₹ in lakhs)		
	Eagle Ltd.	*Garuda Ltd.*	*Bird Ltd.*
Liabilities			
Equity Shares (₹ 10 each, fully paid up)	60	48	40
7½% Cumulative Preference Shares			
(₹ 100 each fully paid up)	15	12	10
Capital Reserve on Revaluation of Land,			
Buildings and Machinery	120		
General Reserve	25	15	10
8% 2,500 Mortgage Debenture Bonds of			
₹ 1,000 each	25		
Secured Loans and Advances from Banks	153	71	52
Unsecured Loans:			
(i) From Garuda Ltd.	—	—	12
(ii) From Bird Ltd.	15	—	—
(iii) Deposits from Public	18	12	3
Current Liabilities and Provisions:			
(i) Inter-Company Balances	9	—	—
(ii) Other liabilities and provisions	314	125	72
Total	754	283	199

Assets			
Fixed Assets (Net)	*272*	*104*	*42*
Investments (at Cost)			
2,50,000 Equity Shares of Garuda Ltd.	*25*		
80,000 Equity Shares of Bird Ltd.	*8*		
1,60,000 Equity Shares of Bird Ltd.		*20*	
10,000 Cumulative Preference Shares of Eagle Ltd.			*10*
1,500 Mortgage Debentures of Eagle Ltd.			*14*
Current Assets	*353*	*123*	*112*
Profit and Loss Account	*96*	*36*	*21*
Total	*754*	*283*	*199*

(i) Eagle Ltd. subscribed for the shares of Garuda Ltd. and Bird Ltd. at par at the time of first issue of shares by the latter companies.

(ii) Garuda Ltd., subscribed for 80,000 shares of Bird Ltd. at par at the time of first issue and later acquired by purchase in the market 80,000 shares of Bird Ltd. at ₹ 15 each when Reserves and Surplus of Bird Ltd. stood at ₹ 5 lakhs.

(iii) Current Assets of Garuda Ltd. and Bird Ltd. included ₹ 4 lakhs and ₹ 6 lakhs respectively being the current accounts balance against Eagle Ltd. These accounts remained unreconciled.

(iv) Preference dividends were in arrears for:

8 years in the case of Eagle Ltd. and 4 years in the case of other two companies.

Prepare the Consolidated Balance Sheet.

Solution

Note: It is assumed that Preference shares given in the question are non-convertible in nature.

Consolidated Balance Sheet of Eagle Ltd.,
and its subsidiaries Garuda Ltd., and Bird Ltd.
as on 31st March, 2017

Particulars	*Note No.*	*(₹ in lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	65.00
(b) Reserves and Surplus	2	31.94
(2) Minority Interest	3	44.06
(3) Non-current liabilities		
Long term borrowings	4	319.00
(4) Current Liabilities		
Other current liabilities (314+125+72)		511.00
Total		971.00

II. Assets		
(1) Non-current assets		
Fixed assets		
(i) Tangible assets (272+104+42)		418.00
(ii) Intangible assets	5	1.00
(2) Current assets [353+123+112-15-9-12]		552.00
Total		971.00

Notes to Accounts

			₹
1.	Share Capital		
	6,00,000 Equity shares of ₹ 10 each fully paid	60.00	
	5,000 [15,000 – 10,000], 7-1/2% preference share of ₹ 100 each	5.00	65.00
2.	Reserves and Surplus		
	Capital Reserve (Given in balance sheet)	120.00	
	Less: Profit & Loss Accounts (W.N. iii)	(88.06)	31.94
3.	Minority Interest		
	Garuda	23.00	
	Bird	16.00	
		39.00	
	Loss in subsidiaries		
	Garuda [WN (ii)]	(12.94)	
	Bird [WN (i)](6-2)	(4.00)	
		(16.94)	
		22.06	
	Preference share [12 +10]	22.00	44.06
4.	Long term borrowings		
	Secured		
	8% Mortgage Debentures [25 – 15]	10.00	
	Loan & Advances from banks (153+71+52)	276.00	286.00
	Unsecured		
	Public Deposits (18+12+3)	33.00	33.00
			319.00

5.	Intangible assets		
	Goodwill (W.N iv)		1.00

Note: Preference Dividends were in arrears for eight years in Eagle Ltd. and four years in subsidiaries.

Working Notes:

	Garuda	*Bird*
Total Shares	4,80,000	4,00,000
Held by Eagle Ltd.	2,50,000 i.e.25/48th	80,000 i.e 1/5th
Held by Garuda Ltd.	NA	1,60,000 i.e. 2/5th
Minority Interest	2,30,000 i.e. 23/48th	1,60,000 i.e. 2/5th

Garuda Ltd. is the subsidiary of Eagle Ltd. since the issue of shares by Garuda Ltd.

Bird Ltd. is subsidiary of Eagle Ltd. after the acquisition of 80,000 shares from Garuda Ltd. from the market. Thereafter, both Garuda and Bird Ltd. become the subsidiary of Eagle Ltd. Hence, the capital profit will be ₹ 5 lakhs

(i) Analysis of Profits of Bird Ltd.

		(₹ in lakhs)
Loss after adjusting Reserve and *Profit on Debenture in Eagle Ltd.*		10
	*Capital Profit**	*Revenue Loss*
Share of Eagle Ltd. [1/5th]	1	3
Share of Garuda Ltd.[2/5th]	2	6
Share of Minority [2/5th]	2	6
	5	15

(ii) Analysis of Garuda Ltd.

Loss, *less* Reserve [36-15]	21
Add : Loss in Bird Ltd.	6
	27
Share of Eagle Ltd. 25/48	14.06
Share of Minority [23/48]	12.94

(iii) Profit & Loss A/c Eagle Ltd.

Loss *less* Reserve [96-25]		71.00
Loss in Garuda Ltd.	14.06	
Loss in Bird Ltd.	3.00	17.06
		88.06

(iv) Cost of Control

Cost of Investments in Garuda Ltd.		25
Cost of Investments in Bird Ltd. [8 + 20]		28
		53
Paid up value of shares in:		
Garuda Ltd.	25	
Bird Ltd. [8+16]	24	
Capital profit in Bird Ltd. [1+2]	3	52
		1

Note: In accordance with para 15 of AS 21, the consolidated financial statements have been presented from the date on which holding subsidiary relationship comes in existence.

Illustration 21

On 1st January, 2016, Investments Ltd. a new company, raised its first Capital of ₹ 3,00,000 from the issue of 30,000 shares of ₹ 10 each at par, and on that date acquired the following shareholdings:

A Ltd. – 3,000 shares of ₹ 10 each fully paid for ₹ 35,000

B Ltd. – 10,000 shares of ₹ 10 each fully paid for ₹ 72,000

C Ltd. – 8,000 shares of ₹ 10 each fully paid for ₹ 92,000.

Apart from these transactions and those detailed below, investments Ltd. neither paid not received other monies during 2016.

The following are the summarised Balance Sheets of the Subsidiary Companies on 31st December, 2016:

	A Ltd. ₹	B Ltd. ₹	C Ltd. ₹
Goodwill	4,000	—	15,000
Freehold Property	18,000	41,000	50,000
Plant	16,000	30,000	12,000
Inventory	11,000	32,000	21,000
Trade Receivables	4,000	8,000	17,000
Cash at Bank	1,000	2,000	11,500
Profit and Loss Account	—	18,000	—
	54,000	1,31,000	1,26,500
Share Capital	40,000	1,20,000	1,00,000
Reserves (as on 1.1.2016)	3,000	—	7,500
Profit and Loss Account	6,000	—	15,000

Trade Payables	*5,000*	*11,000*	*4,000*
	54,000	*1,31,000*	*1,26,500*

Other relevant information:

(1) The freehold property of C Ltd. is to be revalued at ₹ 65,000 as on 1.1.2016.

(2) Additional depreciation for the year 2016 of ₹ 3,000 on the plant of B Ltd is to be provided.

(3) The Inventory of A Ltd. as on 31st December, 2016 has been undervalued by ₹ 2,000 and is to be adjusted.

(4) As on 31st December, 2016 Investments Ltd. owed A Ltd. ₹ 3,500 and is owed ₹ 6,000 by B Ltd. C Ltd. is owed ₹ 1,000 by A Ltd. and ₹ 2,000 by B Ltd.

(5) The balances on Profit and Loss Accounts as on 31st December, 2015 were: A Ltd. ₹ 2,000 (credit); B Ltd ₹ 12,000 (debit); and C Ltd. ₹ 4,000 (credit).

The credit balances of A Ltd. and C Ltd. were wholly distributed as dividends in March, 2016.

(6) During 2016, A Ltd. and C Ltd. declared and paid interim dividends of 8% and 10% respectively.

You are required to prepare the Consolidated Balance Sheet of Investments Ltd. and its subsidiary companies as on 31st December, 2016, ignore taxation.

Solution

Consolidated Balance Sheet of Investments Ltd. and its subsidiaries A Ltd., B Ltd. and C Ltd. as on 31st December, 2016

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	3,00,000
(b) Reserves and Surplus	2	46,850
(2) Minority Interest (W.N vi)		56,750
(3) Current Liabilities		
(a) Trade Payables	3	11,000
Total		4,14,600
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	4	1,79,000
Intangible assets	5	19,000

(2)	**Current assets**		
	(a) Inventories (W.N viii)		66,000
	(b) Trade receivables	6	22,500
	(c) Cash & Cash equivalents (W.N vii)		1,28,100
	Total		4,14,600

Notes to Accounts

			₹
1.	**Share Capital**		
	30,000 shares of ₹ 10 each		3,00,000
2.	**Reserves and Surplus**		
	Capital Reserves (W.N. v)	25,950	
	Profit & loss (W.N.iv)	20,900	46,850
3.	**Trade Payables**		
	Trade Payables [5+11+4+3.5]	23,500	
	Less : Inter Co.[3.5+6+1+2]	(12,500)	11,000
4.	**Tangible Assets**		
	Freehold property (W.N. viii)	1,24,000	
	Plant (W.N viii)	55,000	1,79,000
5.	**Intangible assets**		
	Goodwill (Given in balance sheet)		19,000
6.	**Trade Receivables (W.N. viii)**	35,000	
	Less : Inter Co. debts	(12,500)	22,500

Shareholding Pattern

	A Ltd.	*B Ltd.*	*C Ltd.*
No. of shares	4,000	12,000	10,000
Held by Investment	3,000 i.e. $3/4^{th}$	10,000 i.e. $5/6^{th}$	8,000 i.e. $4/5^{th}$
Minority Interest	$1/4^{th}$	$1/6^{th}$	$1/5^{th}$

Working Notes:

Analysis of Profits:

		Capital Profit ₹	*Revenue Profit* ₹
(i)	**C Ltd.**		
	Profit & Loss Account on 1.1.2016 less Div. (4000 – 4000)	—	

	Reserve on 1st Jan., 2016	7,500	
	Appreciation in the value of Freehold Property [65,000-50,000]	15,000	
	Profit for the year after interim dividend		15,000
	Total	22,500	15,000
	Minority Interest 20%	4,500	3,000
	Share of Investments Ltd.	18,000	12,000
(ii)	**B Ltd.**		
	Loss on the date of acquisition	–12,000	
	Loss suffered during the year after additional dep of 3,000 (18,000+3,000– 12,000)		–9,000
		–12,000	–9,000
	Minority Interest (1/6)	2,000	1,500
	Share of Investment Ltd. (5/6)	–10,000	–7,500
(iii)	**A Ltd.**		
	Reserve on 1.1.2016	3,000	
	Profit on 1.1.2016 less Dividend (2,000 – 2,000)	—	—
	Profit earned during the year (after interim dividend ₹ 3,200) and Inventory adjustment [6,000 + 2,000]		8,000
		3,000	8,000
	Minority Interest (1/4)	750	2,000
		2,250	6,000
(iv)	Profit & Loss of Investment Ltd.		
	Revenue Profit of C Ltd. [WN (i)]	₹ 12,000	
	Revenue Loss of B Ltd. [WN (ii)]	– 7,500	
	Revenue Profit of A Ltd. [WN (iii)]	₹ 6,000	
			10,500
	Add: Interim dividend received [30,000 X 8 % +80,000 × 10 %]		10,400
			20,900
(v)	**Cost of Control / Capital Reserve**		
	Cost of Investments in A Ltd. less Dividend (35,000 – 1,500)		33,500
	Cost of Investments in B Ltd.		72,000
	Cost of Investments in C Ltd. less Dividend (92,000 – 3,200)		88,800
			1,94,300
	Paid up value of Shares held in A Ltd.	30,000	
	Paid up value of Shares held in B Ltd.	1,00,000	
	Paid up value of Shares held in C Ltd.	80,000	
	Capital Profits in A Ltd.	2,250	

	Capital Loss in B Ltd.	–10,000	
	Capital Profits in C Ltd.	18,000	2,20,250
	Capital Reserve		25,950

(vi) Minority Interest

	A Ltd. ₹	*B Ltd.* ₹	*C Ltd.* ₹
Share Capital	10,000	20,000	20,000
Capital Profits/(Loss)	750	–2,000	4,500
Revenue Profits	2,000	–1,500	3,000
	12,750	16,500	27,500
			56,750

(vii) Bank A/c - Investments Ltd.

	₹		₹
To Share Capital	3,00,000	By Investments in A Ltd.	35,000
To Investments in A Ltd.[Dividend]	1,500	By Investments in B Ltd.	72,000
To Investments in C Ltd.[Dividend]	3,200	By Investments in C Ltd.	92,000
To Dividends-A Ltd.[Dividend]	2,400	By B Ltd. (indebtedness)	6,000
C Ltd.[Dividend]	8,000	By Balance c/d	1,13,600
To A Ltd.	3,500		
	3,18,600		3,18,600

(viii) Sundry Assets

		Freehold Property ₹	*Plant* ₹	*Inventory* ₹	*Trade Receivables* ₹	*Cash at Bank* ₹
(a)	Investments Ltd.	—	—	—	6,000	1,13,600
(b)	A Ltd.	18,000	16,000	13,000	4,000	1,000
(c)	B Ltd	41,000	27,000	32,000	8,000	2,000
(d)	C Ltd.	65,000	12,000	21,000	17,000	11,500
		1,24,000	55,000	66,000	35,000	1,28,100
	Less : Inter Co. debts				(12,500)	
					22,500	

Illustration 22

The following condensed balance sheets of H Ltd. and S Ltd. were prepared as on 31st December, 2016:

Assets	***H Ltd.*** ₹	***S Ltd.*** ₹
Goodwill	*1,12,000*	*40,000*
Plant & Machinery	*95,000*	*50,400*
Furniture	*7,000*	*4,600*
9,000 ordinary shares in S Ltd.	*1,20,000*	—
2,000 ordinary shares in H Ltd.	—	*24,000*
Inventory-in-trade	*48,000*	*1,14,000*
Trade Receivables	*70,000*	*45,000*
Cash at Bank	*17,000*	*13,000*
	4,69,000	*2,91,000*
Liabilities		
Share Capital		
Ordinary shares of 10 each	*1,80,000*	*1,00,000*
7½% Pref. shares of ₹ 10 each	*1,50,000*	*80,000*
Premium on ordinary shares	*36,000*	—
Reserves	*26,000*	*30,000*
Trade Payables	*17,000*	*61,000*
Profit & Loss Account	*60,000*	*20,000*
	4,69,000	*2,91,000*

Trade Payables of H Ltd. include ₹ 15,000 due to S Ltd. for goods supplied since the acquisition of the shares. These goods are charged at 10% above cost. The Inventory of H Ltd. include goods costing ₹ 33,000 purchased from S Ltd.

H Ltd. acquired the shares of S Ltd. on 1st July, 2016. As at the date of last preceding balance sheet of S Ltd., viz., 31st Dec., 2015; the plant and machinery stood in the books at ₹ 56,000, the reserve at ₹ 30,000 and the profit and loss account at ₹ 8,000. The plant was revalued by H Ltd. on the date of acquisition of the share of S Ltd. at ₹ 60,000 but no adjustments were made in the books of S Ltd. On 31st Dec., 2015, the debit balance of profit and, loss account was ₹ 22,750 in the books of H Ltd.

Both the companies have provided depreciation on all their fixed assets at 10% per annum. You are required to prepare a consolidated balance sheet on 31st Dec., 2016 and supporting schedule for computation.

Solution

Note: It is assumed that Preference shares given in the question are non-convertible in nature.

Consolidated Balance Sheet or H Ltd., and its subsidiary S Ltd., as on 31st December, 2016

Particulars	Note No.	(₹)
I. Equity and Liabilities		

(1) Shareholder's Funds		
(a) Share Capital	1	3,10,000
(b) Reserves and Surplus	2	1,01,116
(2) Minority Interest	3	1,02,545
(3) Current Liabilities		
(a) Trade Payables	4	63,000
(b) Other current liabilities (Pref. dividend of H Ltd.)		11,250
Total		5,87,911
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	5	1,63,600
Intangible assets	6	1,35,311
(2) Current assets		
(a) Inventories ₹ (48,000+1,14,000-3,000)		1,59,000
(b) Trade receivables ₹ (70,000+45,000-15000)		1,00,000
(c) Cash & Cash equivalents₹ (17,000+13,000)		30,000
Total		5,87,911

Notes to Accounts

				₹
1.	**Share Capital**			
	18,000 equity shares of ₹ 10 each		1,80,000	
	Less : Held by S Ltd.		(20,000)	
			1,60,000	
	15,000 pref. shares of ₹ 10 each fully paid		1,50,000	3,10,000
2.	**Reserves and Surplus**			
	Reserve (W.N. iv)		17,479	
	Profit & Loss (W.N v)	50,637		
	Less : Inventory Reserve	(3,000)	47,637	
	Securities Premium		36,000	1,01,116
3.	**Minority Interest**			
	Preference shares		80,000	
	Dividend		6,000	
	Equity shares		10,000	
	Capital profit (W.N.ii)		5,632	
	Revenue profit (W.N v)		913	1,02,545

4.	**Trade Payables**			
	Trade Payables		78,000	
	Less : Inter Co.		(15,000)	63,000
5.	**Tangible Assets**			
	Plant & Machinery			
	H Ltd.	95,000		
	S Ltd. ₹ (50,400+6,800-200)	57,000	1,52,000	
	Furniture ₹ (7,000+,4,600)		11,600	1,63,600
6.	**Intangible assets**			
	Goodwill (Given in balance sheet)		1,52,000	
	Add: On consolidation of S ltd. in H Ltd. (W.N. vi)		4,000	
			1,56,000	
	Less : Capital Reserve (W.N vi)		(20,689)	1,35,311

Working Notes:

(i) (a) Analysis of profits of S Ltd. (Pre-allocation)

	Capital Profit ₹	*Revenue Profit* ₹
Reserves	30,000	
Profit and Loss Account 1.1.2016	8,000	
Profit for the year after		
Pref. Div. ₹ (12,000 – 6,000)	3,000	3,000
Profit on Revaluation		
₹ (60,000 – 53,200)	6,800	
Additional Depreciation [3,000-2,800]		(200)
	47,800	2,800

(b) Analysis of Profits of H Ltd.

	Capital Profit ₹	*Revenue Profit* ₹
Reserves	13,000	13,000
Profit and Loss Account on 1.1.2016	(22,750)	
Profit for the year after preference dividend ₹ (82,750 – 11,250 =71,500)	35,750	35,750
	26,000	48,750

(ii) Capital profits of H Ltd. & S Ltd. (post allocation)

Suppose capital profits of H Ltd. = *a*
and capital profits of S Ltd. = *b*

Total Capital profits of H Ltd. $= 26{,}000 + \frac{9}{10} b$

Total Capital profits of S Ltd. $= 47{,}800 + \frac{1}{9} a$

$a = 26{,}000 + \frac{9}{10}\left[47{,}800 + \frac{1}{9}a\right]$

$a = 76{,}689$

$b = 47{,}800 + \frac{1}{9}(76{,}689)$

$b = 56{,}321$

	₹
Minority Interest in Capital profits of S Ltd.	5,632
Share of holding Co. H Ltd.	50,689
	56,321

(iii) Revenue profits of H Ltd. and S Ltd. (post allocation)

Assume revenue profits of H Ltd. = *x*
and revenue profits of S Ltd. = *y*

Total Revenue profits of H Ltd. $= 48{,}750 + \frac{9}{10} y$

Total Revenue profits of S Ltd. $= 2{,}800 + \frac{1}{9} x$

or $x = 48{,}750 + \frac{9}{10}\left(2{,}800 + \frac{1}{9}x\right)$

or $\frac{81}{90} x = 51{,}270$

or $x = 56{,}967$

$y = 2{,}800 + \frac{1}{9}(56{,}967)$

$y = 9{,}130$

		H Ltd. ₹	S Ltd. ₹
(iv)	**Capital Profits**		
	As per Working Note 1	26,000	47,800
	Adjustment as per equation	(8,521)	8,521
		17,479	56,321

	Minority Interest 10%		5,632
	Share of H Ltd.		50,689
(v)	**Revenue Profits**		
	(60,000 – 11,250 Pref. Dividend)	48,750	2,800
	Adjustment	(6,330)	+6,330
		42,420	9,130
	Minority interest	8,217	913
	Share of H Ltd.	50,637	8,217
(vi)	**Cost of Control**		
	H Ltd. in S Ltd.		
	Cost of Investments		1,20,000
	Paid up value	90,000	
	Capital Profits	50,689	1,40,689
	Capital Reserve		20,689
	Cost of Investments		24,000
	Paid up value		20,000
	Goodwill		4,000

Illustration 23

Able Ltd. made an offer to acquire all the shares of Baker Ltd. at a price of ₹ 25 per share, to be satisfied by the allotment of five shares in Able Ltd. for every four shares in Baker Ltd.

By the date of expiration of the offer, which was on 1st January, 2017, share-holders owning 75% of the shares in Baker Ltd. accepted the offer and the acquisition was effective from that date.

The accounting date of Baker Ltd. was on 31st March in each year, but to conform to Able Ltd., accounts were prepared to 30th June, 2017, covering the fifteen months to the date.

The draft summarised accounts of the companies on 30th June, 2017 which do not include any entries regarding the acquisition of shares in Baker Ltd., were as follows:

Balance Sheet as on 30th June, 2017

Equity and Liabilities *Shareholders' funds*	₹	*Able Ltd.* ₹	₹	*Baker Ltd.* ₹
Share Capital –				
Equity shares of ₹ 10 each				
Authorised :		*3,00,000*		*75,000*
Issued & fully paid:		*1,50,000*		*60,000*

Reserves & Surplus:				
General Reserve	55,000			
Surplus Profit & Loss Account	62,000	1,17,000		20,000
Trade Payables		27,000		7,000
Provision for taxation		33,000		6,000
		3,27,000		93,000
Assets				
Non-current assets				
Tangible assets				
Freehold property, at cost		2,00,000		38,000
Plant & Machinery at cost	50,000		12,000	
Less: Depreciation	18,000	32,000	3,000	9,000
Quoted Investment at Cost		7,000		—
Current assets				
Inventory at Cost		32,000		21,000
Trade Receivables		41,000		17,000
Balance at Bank		15,000		8,000
		3,27,000		93,000

Draft Profit & Loss Account for the period ended on 30th June, 2017

	Able Ltd. One Year ₹	Baker Ltd. 15 months ₹
Balance brought forward	14,000	12,000
Profit for the period	80,000	18,000
	94,000	30,000
Taxation for the period	32,000	6,000
Interim Dividend paid, 30th Nov., 2016	—	4,000
Balance carried forward	62,000	20,000
	94,000	30,000

The Directors of Able Ltd. recommended and declared a final dividend of 20% to the shareholders on register as on 30th June, 2017. The Directors of Baker Ltd., declared a final dividend of 12½% payable on 30th September, 2017.

You are required to prepare the consolidated Balance Sheet of Able Ltd. and Baker Ltd. on 30th June, 2017.

Solution

Consolidated Balance Sheet of Able Ltd. and its subsidiary Baker Ltd. as on 30th June, 2017

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	2,06,250
(b) Reserves and Surplus	2	1,63,725
(2) Minority Interest (W.N iii)		18,125
(3) Current Liabilities		
(a) Trade Payables (27,000+7,000)		34,000
(b) Short term provisions	3	39,000
(b) Other current liabilities	4	43,125
Total		5,04,225
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	5	2,79,000
Intangible assets	6	84,225
(b) Non-current investment		7,000
(2) Current assets		
(a) Inventories ₹ (32,000+21,000)		53,000
(b) Trade Receivables ₹ (41,000+17,000)		58,000
(c) Cash & Cash equivalents ₹ (15,000+8,000)		23,000
Total		5,04,225

Notes to Accounts

			₹
1.	**Share Capital**		
	20,625 (15,000 + 5,625) equity shares of ₹ 10 each		2,06,250
2.	**Reserves and Surplus**		
	General Reserve (Given in balance sheet)	55,000	
	Profit & Loss [W.N (vi)]	24,350	
	Securities Premium	84,375	1,63,725
3.	**Short term provisions**		
	Provision for taxation		39,000

4.	**Other current liabilities**		
	Dividend payable		
	Minority Interest	1,875	
	Own Shareholders	41,250	43,125
5.	**Tangible Assets**		
	Plant & Machinery ₹ (32,000 + 9,000)	41,000	
	Freehold property ₹ (2,00,000 + 38,000)	2,38,000	2,79,000
6.	**Intangible assets**		
	Goodwill (W.N ii)		84,225

Working Notes:

		₹	₹
(i)	*Number of shares to be issued:*		
	75% of shares of Bakers Ltd.	4,500	
	No. of shares of Able Ltd. 4,500 × 5/4	5,625	
	Value of 5,625 Shares @ ₹ 25		1,40,625
	Face value of 5,625 Shares @ ₹ 10		56,250
	Securities Premium		84,375
(ii)	*Cost of Control :*		
	Cost of Shares in Baker Ltd.		
	Share Capital	56,250	
	Securities Premium	84,375	1,40,625
	Less: Face value of shares acquired	45,000	
	Pre-acquisition profits	11,400	(56,400)
	Goodwill on consolidation		84,225
(iii)	*Minority Interest:*		
	Share Capital A/c, 1/4		15,000
	Profit & Loss A/c, 1/4		5,000
			20,000
	Less: Dividend paid @ 12½% on ₹ 15,000 (shown separately)		(1,875)
			18,125
(iv)	*Pre-acquisition profit of Baker Ltd.:*		
	Profit & Loss A/c as per Balance Sheet		20,000
	Less: Post-acquisition profit, 6/15 of ₹ 18,000	7,200	
	Less: Taxation thereon 6/15 of ₹ 6,000	(2,400)	(4,800)
			15,200
	3/4 thereof		11,400

(v)	*Profit & Loss A/c – Able Ltd.*		
	Balance as per P & L A/c		62,000
	Less: Dividend (20% on ₹ 2,06,250)		41,250
	Balance to Consolidated P & L A/c		20,750
(vi)	*Profit and Loss A/c - Baker Ltd.*		
	Balance as per Profit and Loss A/c		20,000
	Less : Minority Interest (20,000 X 25 %)	5,000	
	Pre-acquisition profit (WN (iv))	11,400	16,400
	Balance in Consolidated P & L A/c		3,600
	Total of (v) and (vi)		24,350

Note: It is assumed that whole of the dividend of ₹ 41,250 declared by Able Ltd. will be appropriated from revenue, although part of that dividend is due to the ex-shareholders of Baker Ltd.

Illustration 24

In preparing the consolidated balance sheet of H Ltd. as on 31st March, 2017 you are required to show clearly what amount, if any, you would include in respect of W Ltd. with regard to:

(a) Cost of control/reserve;

(b) Profit or loss; and

(c) Minority interest.

under each of the following assumptions :

(i) 48,000 of the shares then in issue of W Ltd. were acquired at a cost of ₹ 75,000 on 1st June, 2014 H Ltd. participated in the dividend of ₹ 8,000.

(ii) 40,000 of the shares then in issue of W Ltd. were acquired at a cost of ₹ 60,000 on 31st March, 2015; H Ltd. participated in the bonus issue but not in the dividend of ₹ 9,000.

(iii) 60,000 of the shares then in issue of W Ltd. were acquired at a cost of ₹ 80,000 on 1st October, 2016; H Ltd. did not participate in the dividend of ₹ 6,000.

The balance sheet of W Ltd. as on 31st March, 2017 showed:

	₹
Share Capital, Authorised & Issued of ₹ 1 each	*80,000*
Undistributed profits	*24,000*
7% Debentures	*40,000*

The Profit & Loss Appropriation Accounts, for four years ended 31st December, 2016 were as follows:

	2013-2014 ₹	*2014-2015* ₹	*2015-2016* ₹	*2016-2017* ₹
Balance at the beginning of the year	*16,000*	*22,000*	*43,000*	*28,000*
Bonus issue of one for four				

- 1st April, 2015			*16,000*	
			27,000	
Profit for the year(loss)	*14,000*	*30,000*	*7,000*	*4,000*
	30,000	*52,000*	*34,000*	*24,000*
Dividends	*8,000*	*9,000*	*6,000*	*Nil*
Balance carried forward	*22,000*	*43,000*	*28,000*	*24,000*

Solution

Amounts to be included in the Consolidated Balance Sheet of H Limited as on 31st March, 2017 in respect of W Limited:

Share Capital before bonus issue $\frac{80,000}{5} \times 4 =$ ₹ 64,000 or ₹ 80,000 – ₹ 16,000

(i) *(a) Goodwill / Cost of Control:*

	₹	₹
Cost of 48,000 shares on 1st June, 2014		75,000
Less: Dividends from pre-acquisition profits:		
$\frac{48}{64} \times 8,000$	6,000	
$\frac{48}{64} \times \frac{2}{12} \times 9,000$	1,125	(7,125)
Cost of Investment	(a)	67,875
Nominal value of shares		48,000
Proportion of pre-acquisition profit as at 31st March, 2014	22,000	
Earned in 2014-2015 less dividend $\left[\frac{2}{12} \times 21,000\right]$	3,500	
	25,500	
H Ltd.'s share ₹ 25,500 × $\frac{48}{64}$		19,125
	(b)	67,125
Goodwill ₹ (67,875 – 67,125)		750

(b) Consolidated Profit & Loss balance

	₹	₹	₹
Profit & Loss Account as per Balance Sheet			24,000
Minority Interest: $\frac{20}{80} \times 24,000$		6,000	
Capital Profit:			

Pre-acquisition profit	25,500		
Less: Capitalised for bonus issue	(16,000)		
	9,500		
Share of H Ltd.: $\frac{60}{80} \times 9,500$		7,125	13,125
Balances for Consolidation			10,875

(c) *Minority Interest*

Share Capital (1/4)	20,000
Profit & Loss Account	6,000
	26,000

This answer assumes that 2/12th of the dividends for 2014-2015 and capitalisation for the bonus issue both came from pre-acquisition profits.

(ii) (a) *Cost of Control / Goodwill.*

	₹	₹
Cost of 40,000 shares - 31st March, 2015		60,000
Nominal value of shares purchased	40,000	
Pre-acquisition profits $\frac{40}{64} \times 43,000$	26,875	66,875
Capital Reserve		6,875
Shares held by the holding company after bonus issue will be 50,000.		
(b) Profits & Loss Account - as per Balance Sheet	24,000	
Minority Interest: $\frac{30}{80}$ x 24,000	9,000	
Pre-acquisition Profit: $\frac{50}{80} \times (43,000 - 16,000)$	16,875	
		25,875
Balance for Consolidation $\left[3,000 \times \frac{5}{8}\right]$		Dr. 1,875
(c) Minority Interest : $\frac{30}{80} \times 1,04,000$		39,000

(iii) Cost of Control/Goodwill

(a)	*Cost of 60,000 shares - 1st October, 2016*		80,000

	Nominal value of shares when purchased		60,000
	Pre-acquisition profit:		
	at 31st March, 2016	28,000	
	Less: $\frac{6}{12} \times 4{,}000$	(2,000)	
		26,000	
	H Ltd.'s shares : $\frac{60}{80} \times 26{,}000$	19,500	
			79,500
	Goodwill (80,000 – 79,500)		500
(b)	*Profit and Loss Account- as per Balance sheet*		24,000
	Minority Interest : $\frac{20}{80}$ x 24,000		6,000
	Pre-acquisition Profit		19,500
			25,500
	Balance for Consolidation		Dr.1,500
(c)	*Minority Interest:* $\frac{20}{80} \times 1{,}04{,}000$		26,000

Illustration 25

The Balance Sheet of A Ltd., B Ltd. and C Ltd. on 31st March, 2017 contained the following items relating to the profits and losses of the companies:

	A Ltd. ₹	*B Ltd.* ₹	*C Ltd.* ₹
Net Profit (or loss) for year	*800*	*1,800*	*Dr. 480*
Add : Balance forward	*1,500*	*Loss 800*	*Profit 1,920*
	2,300	*1,000*	*1,440*

A Ltd. acquired 75% of the share capital of B Ltd. on 1st November, 2015. B Ltd. was incorporated on 1st April, 2015.

A Ltd. acquired 10% of the share capital of C Ltd. on 1st March, 2017.

B Ltd. acquired 80% of the share capital of C Ltd. on 1st December, 2016.

Prepare draft schedule of consolidated profit and loss account of the group showing the amount to be transferred to other essential accounts to be included in the consolidated balance sheet, i.e., the credit total of ₹ 4,740.

Solution

(i) Analysis of profit of C Ltd.

	Capital Profit ₹	*Revenue Profit* ₹
Balance brought forward	1,920	
Profit/Loss for the year pre-post 8 : 4	–320	–160
	1,600	–160
Shares of Minority Interest (10%)	160	16
Balance	1,440	–144
Share of A Ltd.	160	16*
Share of B Ltd.	1,280	–128

(ii) Analysis of profit of B Ltd.

	Capital Profit ₹	*Revenue Profit* ₹
Balance brought forward		
divided in the ratio of 7:5		
i.e., Capital upto 31st October		
and Revenue from November	– 467	–333
Revenue loss from C Ltd.		–128
		–461
Profit for the year		1,800
	–467	1,339
Minority Interest (1/4)	117	335
Share of A Ltd.	–350	+1004

(iii) Capital Profits for Consolidation

B Ltd. in C Ltd.	1,280
A Ltd. in C Ltd. (160 – 12)	148
	1,428
A Ltd. in B Ltd.	–350
	1,078

* For A Ltd. this represents loss for December, January, February & March Loss upto 1st March is capital loss for A Ltd. Hence only ₹ 4 is Revenue loss; net capital profit for A Ltd. is ₹ 148.

(iv) *Minority Interest C Ltd.*

in Capital Profit	+160
in Revenue Profit	–16
	144
in B Ltd.: Capital Profit	–117
	27
Revenue Profit	335
	362

(v) Revenue Profit

A Ltd. in B Ltd.	1,004
Less: A Ltd. in C Ltd. (Loss of March)	(4)
	1,000

Illustration 26

As on 31st March, 2017 the draft balance sheets of the companies showed, the following position:

	Rock Ltd. ₹	King Ltd. ₹	Chair Ltd. ₹
Fixed assets	1,35,000	60,000	70,000
Investments at cost	1,60,000	1,50,000	10,000
	2,95,000	2,10,000	80,000
Current assets:			
Inventory	55,240	36,840	61,760
Trade Receivables	1,10,070	69,120	93,880
Balances at bank	1,31,290	16,540	52,610
	2,96,600	1,22,500	2,08,250
Less: Current liabilities:			
Trade payables	1,12,060	73,130	78,190
Taxation	30,000	—	22,000
Dividend	1,00,000	60,000	40,000
	2,42,060	1,33,130	1,40,190
Net current assets / (liabilities)	54,540	(10,630)	68,060
	3,49,540	1,99,370	1,48,060
Financed by:			
Issued ordinary shares of ₹ 10 each	2,00,000	1,50,000	80,000
Capital reserve	50,000	—	23,000
Revenue reserve	99,540	49,370	45,060
	3,49,540	1,99,370	1,48,060

You also obtain the following information:

(1) King Ltd. acquired 6,800 shares in Chair Ltd. at ₹ 22 per share in 2013-2014 when the balance on capital reserve was ₹ 15,000 and on revenue reserve ₹ 30,500 consolidated.

(2) Rock Ltd. purchased 8,000 shares in King Ltd. in 2013-2014 when the balance on the revenue reserve was ₹ 40,000. Rock Ltd. purchased a further 4,000 shares in King Ltd. in 2014-2015 when the balance on the revenue reserve was ₹ 45,000. Rock Ltd. held no other investments on 31st March, 2017.

(3) Dividend from subsidiary companies are included in the figure for Trade Receivables in the accounts of the parent companies.

Prepare the consolidated balance sheet of Rock Ltd. and its subsidiaries in vertical form as on 30th March, 2017, together with the consolidation schedules.

Solution

Rock Limited
Consolidated Balance Sheet as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	2,00,000
(b) Reserves and Surplus	2	1,71,044
(2) Minority Interest (W.N iv)		65,918
(3) Current Liabilities		
(a) Trade Payables (1,12,060+73,130+78,190)		2,63,380
(c) Short term Provisions	3	52,000
(b) Other current liabilities	4	1,18,000
Total		8,70,342
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets (1,35,000+60,000+70,000)		2,65,000
(ii) Intangible assets	5	49,592
(b) Non-current investment (W.N v)		10,400
(2) Current assets		
(a) Inventories (55,240+36,840+61,760)		1,53,840
(b) Trade Receivables (W.N vi)		1,91,070
(c) Cash & Cash equivalents (1,31,290+16,540+52,610)		2,00,440
Total		8,70,342

Notes to Accounts

			₹
1.	**Share Capital**		
	20,000 equity shares of ₹ 10 each		2,00,000
2.	**Reserves and Surplus**		
	Revenue Reserve (99,540+16,064)	1,15,604	
	Capital reserve (50,000+5,440)	55,440	1,71,044
3.	**Short term provisions**		
	Provision for Taxation (30,000 + 22,000)		52,000
4.	**Other current liabilities**		
	Dividend		
	Minority Shareholders	18,000	
	Holding Company	1,00,000	1,18,000
5.	**Intangible assets**		
	Goodwill (W.N iii)		49,592

Working Notes:

Analysis of profit

(i) Chair Ltd.

	Capital Profit ₹	*Capital Reserve* ₹	*Revenue Reserve* ₹
Capital Reserve in 2013-2014	15,000		
Increase in Capital Reserve		8,000	
Revenue Reserve in 2013-2014	30,500		
Increase in Revenue Reserve			14,560
	45,500	8,000	14,560
Minority Interest 15%	6,825	1,200	2,184
Share of King	38,675	6,800	12,376

(ii) King Ltd.

Revenue Reserve in 2013-2014	40,000		
Increase in Revenue Reserve			9,370
Share in Chair Ltd.		6,800	12,376
	40,000	6,800	21,746
Minority interest (20%)	8,000	1,360	4,349

	32,000	5,440	17,397
Less: $(5{,}000 \times \frac{4}{15})$ for second acquisition treated as capital	+1,333		–1,333
	33,333		16,064

(iii) Cost of Control / Goodwill

Cost of Investment in Chair		1,49,600	
Cost of Investment in king		1,60,000	
			3,09,600
Paid up value of shares			
in Chair		68,000	
in King		1,20,000	
Capital profits in			
Chair		38,675	
King		33,333	
			2,60,008
Goodwill			49,592

(iv) Minority Interest

	(20%) King Ltd.	(15%) Chair Ltd.
Capital	30,000	12,000
Capital Reserve	1,360	1,200
Revenue Reserve	4,349	2,184
Capital Profit	8,000	6,825
	43,709	22,209

(v) Investment

King Limited	1,50,000	
Less: Cost of Chair Limited (6,800 × ₹ 22)	(1,49,600)	
		400
Chair Limited	10,000	
		10,400

(vi) Trade Receivables

Rock Limited		1,10,070

Less: Dividend from King Limited		(48,000)
		62,070
King Limited	69,120	
Less: Dividend from Chair Limited	(34,000)	35,120
Chair Limited		93,880
		1,91,070

2.21 Disposal of a Subsidiary

The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship.

Calculation of gain or loss on disposal

On disposal of a subsidiary, the gain or loss on disposal is recognized in the consolidated statement of profit and loss, and is calculated as the aggregate of:

The difference between the proceeds of disposal of the subsidiary and the carrying amount of its assets less liabilities as of the date of disposal;

The cumulative amount of any exchange differences that relate to the subsidiary (non-integral operations) recognized in equity, in accordance with "AS 11 The Effect of Changes in Foreign Exchange Rates".

For the purposes of the disposal calculation, the carrying amount of the subsidiary would include any amount of goodwill carried on the balance sheet in respect of the subsidiary.

Partial disposals

When part of an investment in a subsidiary is sold during the reporting period, the status of the investment immediately after the disposal should determine the accounting. For example:

- If a parent sells a portion of its investment in a subsidiary but still retains a controlling interest, the consolidated financial statements at the end of the period should include the assets, liabilities and operations of the subsidiary and reflect the new minority interest from the date of the transaction: The profit or loss on disposal should be transferred to profit and loss account of holding company.
- If the parent sells a controlling interest in the subsidiary but still retains significant influence over the enterprise, that remaining investment should be reflected in the balance sheet at the end of the period as a single line item using the equity method in accordance with AS 23 Accounting for Investments in Associates in the Consolidated Financial Statements. The subsequent results of operations should also be reported using the equity method. If the disposal qualifies as discontinuing operation, presentation of the discontinuing operation should follow AS 24 Discontinuing Operations; and
- When almost all of a subsidiary is sold (except for an interest which does not allow the parent to exert significant influence over the subsidiary) and if the sale of the subsidiary

qualifies as a discontinuing operation, presentation of the discontinuing operation should follow AS 24 Discontinuing Operations.

In a parent's separate financial statement, an investment in subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments, from the date the enterprise ceases to be a subsidiary and does not become an associate*.

The carrying amount of the investment at the date it ceases to be a subsidiary is regarded as cost thereafter.

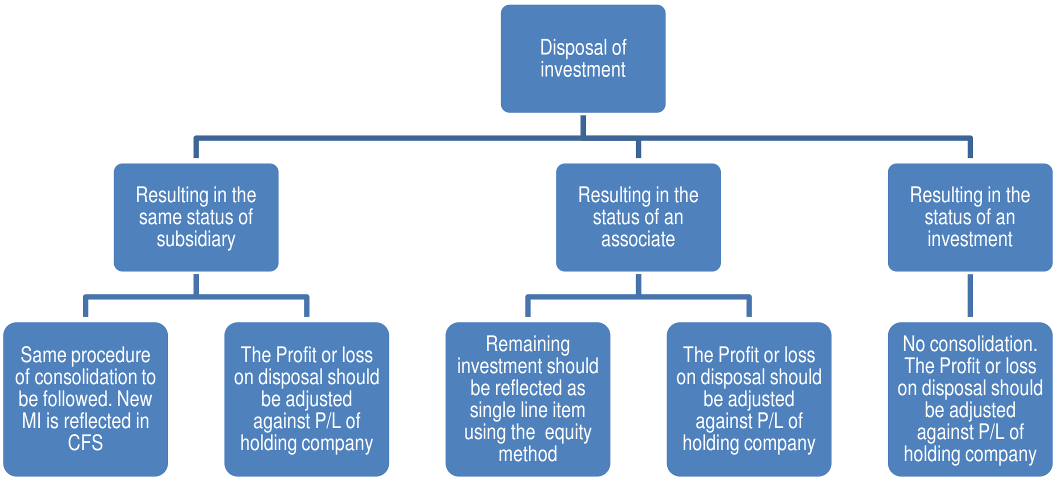


Illustration 27

From the following summarised Balance Sheets of A Ltd. and its subsidiary B Ltd., prepare a consolidated Balance Sheet as on 31st March, 2017.

Equity and Liabilities	*A Ltd. ₹*	*B Ltd. ₹*	*Assets*	*A Ltd. ₹*	*B Ltd. ₹*
Share Capital			*Sundry Assets*	*93,000*	*32,000*
Equity Shares			*Shares in B Ltd.*		
of ₹ 10 each	*1,00,000*	*20,000*	*1,200 shares at*		
Profit on sale of			*₹ 15 each*	*18,000*	
shares	*3,000*				
Profit and Loss A/c					

* Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', defines the term 'associate' and specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

Brought forward	*6,000*	*7,200*			
For the year	*2,000*	*4,800*			
	1,11,000	*32,000*		*1,11,000*	*32,000*

A Ltd. bought in earlier year 1,600 equity shares in B Ltd. @ 15 when the Profit and Loss Account balance in B Ltd. was ₹ 4,400. A sold 400 shares @ ₹ 22.50, credited the difference between the sale proceeds and cost to "Profit on sale of investment account" on 30th September, 2014 and crediting the balance to the investment account. Profit during the year accrued uniformly.

Solution:

Consolidated Balance Sheet of A Ltd., and its subsidiary B Ltd.
as at 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,00,000
(b) Reserves and Surplus	2	15,560
(2) Minority Interest (W.N iii)		12,800
Total		1,28,360
II. Assets		
(1) Non-current assets		
Fixed assets		
(i) Tangible assets (93,000+32,000)		1,25,000
(ii) Intangible assets	3	3,360
Total		1,28,360

Notes to Accounts

			₹
1.	**Share Capital**		
	10,000 equity shares of ₹ 10 each		1,00,000
2.	**Reserves and Surplus**		
	Profit & Loss Account (W.N iv)		15,560
3.	**Intangible assets**		
	Goodwill (W.N ii)		3,360

Working Notes:

(i) Analysis of Profit of B Ltd.

	Capital Profit ₹	*Revenue Profit* ₹
P/L A/c Balance on the date of acquisition	4,400	
Increase in the balance after acquisition		2,800
Profit for the year		4,800
	4,400	7,600
Less : Minority Interest (40 per cent)	1,760	3,040
Share of A Ltd	2,640	4,560

(ii) Cost of Control

Cost of Investments		18,000
Less : Paid-up value of shares	12,000	
Share of Capital Profits	2,640	(14,640)
Goodwill		3,360

(iii) Minority Interest (40 per cent)

Paid-up value of shares held	8,000
Share of Capital Profits	1,760
Share of Revenue Profits	3,040
	12,800

(iv) Consolidated Revenue Profit

Balance as per Profit and Loss A/c of A Ltd.	8,000
Add: Profit on sale of shares	3,000
	11,000
Share in Revenue Profit of B Ltd.	4,560
	15,560

(v) Investment in B Ltd.

Particulars	₹	*Particulars*	₹
To Balance b/d	24,000	By Bank	9,000
To Profit on Sale	3,000	By Balance c/d	18,000
	27,000		27,000

Illustration 28

H Ltd. purchased on 1.4.2014, 8,000 equity shares of ₹ 100 each in S Ltd. when S Ltd. had ₹ 10,00,000 *share capital.*

It sold 500 such shares on 1.4.2015 and purchased 1,000 shares on 1.4.2016.

S Ltd. paid 15% dividend each year in September and there was no change in Share Capital Account upto 31.3.2017. Profit and Loss Account balances in S Ltd. and Investments of H Ltd. in S Ltd. on different dates were as under:

	Profit and Loss Account balance of S Ltd. ₹	*Investments of H Ltd. in S Ltd.* ₹
1st April, 2014	*5,00,000*	*12,80,000*
31st March, 2015	*6,20,000*	*12,80,000*
31st March, 2016	*7,00,000*	*11,90,000*
31st March, 2017	*8,00,000*	*14,00,000*

The amounts shown as investments represent cost price as reduced by sales and increased by further purchase without making any adjustment for profit or loss on sale for dividend.

Prepare statements to show the relevant figures as on 31st March, 2015, 2016 and 2017 for preparation of Consolidated Accounts in respect of:

(a) Goodwill or Cost of Control

(b) Revenue Profit.

Solution

(a) Goodwill or Cost of Control:

	31.3.2015 ₹	*31.3.2016* ₹	*31.3.2017* ₹
Correct Cost of Investment as per Working Note no. (i)	11,60,000	10,87,500	12,82,500
Less: Paid up value of shares in hand	(8,00,000)	(7,50,000)	(8,50,000)
	3,60,000	3,37,500	4,32,500
Less : H Ltd.'s share of capital profits as per working Notes no (ii)	(2,80,000)	(2,62,500)	(3,17,500)
Goodwill or Cost of Control	80,000	75,000	1,15,000

(b) Revenue Profit

	31.3.2015 ₹	*31.3.2016* ₹
Balance of Profit & Loss Account	6,20,000	7,00,000
Less : Capital Profits		
Balance of Profit & Loss Account as on 1st April, 2014 after deducting dividend		

for the year 2013-2014 @ 15%	(3,50,000)	(3,50,000)
	2,70,000	3,50,000
Less : Minority Interest		
20% on 31.3.2015	(54,000)	
25% on 31.3.2016		(87,500)
H Ltd.'s share	2,16,000	2,62,500
		₹
Balance of Profit & Loss Account on 31.3.2017		8,00,000
Less : Capital Profits as mentioned above		(3,50,000)
		4,50,000
Less : Minority Interest @ 15%		(67,500)
		3,82,500
But for 10% shares acquired on 1.4.2016		
there are additional Capital Profits		
Balance of Profit & Loss Account	7,00,000	
as on 31.3.2016		
Less: Dividend for the year ended 31.3.2016 @ 15%	(1,50,000)	
	5,50,000	
Less : Capital Profit already taken into account above	(3,50,000)	
Additional Capital Profit	2,00,000	
H Ltd.'s share = ₹ 2,00,000 × 10/100		20,000
		3,62,500

Working Notes:

(i) Calculation of correct cost of investments

Investment in Shares in S Ltd. Account

2014		₹	*2015*		₹
April 1	To Bank (8,000 shares)	12,80,000	March 31	By Profit & Loss Account Rectification regarding pre-acquisition dividend – ₹ 8,00,000 × 15/100	1,20,000
				By Balance c/d (8,000 shares)	11,60,000
		12,80,000			12,80,000
2015		₹	*2015*		₹
April 1	To Balance b/d	11,60,000	April 1	By Bank	90,000

	(8,000 shares)			(Sale proceeds of 500 shares = ₹ 12,80,000 – ₹11,90,000)	
April 1	To Profit and Loss Account		2016 March 31	By Balance c/d	
	Profit on sale: ₹ 90,000 – (11,60,000 × 500/8,000)	17,500		(7,500 shares)	10,87,500
		11,77,500			11,77,500
2016		₹	*2017*		₹
April 1	To Balance b/d				
	(7,500 shares)	10,87,500	March 31	By Profit & Loss Account–	
	To Bank (1,000 shares purchased)	2,10,000		Rectification regarding pre acquisition dividend on 1,000 shares	15,000
				By Balance c/d (8,500 shares)	12,82,500
		12,97,500			12,97,500
2017					
April 1	To Balance b/d	12,82,500			

(ii) Capital Profits :

31st March 2015:	₹
Balance of Profit & Loss Account as on 31.3.2014	5,00,000
Less: Dividend on ₹ 10,00,000 @15%	(1,50,000)
	3,50,000
H Ltd.'s share = ₹ 3,50,000 × $\frac{8,000}{10,000}$ = 2,80,000	
31st March, 2016:	
As H Ltd. has sold 500 shares, its share of capital profits is reduced.	
H Ltd.'s share = $\frac{₹3,50,000 \times 7,500}{10,000}$ = ₹ 2,62,500	
31st March, 2017 :	
Balance of Profit & Loss Account as on 31.3.2016	7,00,000
Less: Dividend on ₹ 10,00,000 @ 15%	(1,50,000)
	5,50,000
H Ltd.'s share in respect of 1,000 shares purchased on 1.4.2016	

$= \frac{₹ 5,50,000 \times 1,000}{10,000}$	55,000
H Ltd.'s share of capital profits in respect of 7,500 shares purchased on 31.3.2014 as calculated above	2,62,500
Total	3,17,500

2.22 Foreign Subsidiaries

For consolidating foreign subsidiaries, the first step is to convert the figures of foreign subsidiary into reporting currency on the basis of rules as prescribed by AS 11 (revised 2003), "The Effects of Changes in Foreign Exchange Rates". The amount of exchange difference is calculated as the balancing figure, which is accounted for as post-acquisition profit/loss. After such conversion, the consolidation is done in usual manner.

UNIT 3: TREATMENT OF INVESTMENT IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

3.1 Meaning of Associates

As per Accounting Standard 23, an associate is an enterprise in which an investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. 'Significant influence' means the power to participate in the financial and operating policy decisions of the investee, but the investor does not have control over those policies.

However, Section 2(6) of the Companies Act, 2013 states that 'associate company', in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and not includes a joint venture company. 'Significant influence' means control of atleast twenty percent of total share capital (paid-up equity share capital and convertible preference share capital), or of business decisions under an agreement.

Indicators of significant influence

Significant influence may be gained by the investor by virtue of share ownership, statute or agreement.

When an investor exercises significant influence over the investee, one or more of the following indicators is usually present:

- representation on the board of directors or corresponding governing body of the investee;
- participation in policy making processes;
- material transactions between the investor and the investee;
- interchange of managerial personnel; or
- provision of essential technical information.

Significant Influence - Holding 20% or more of voting power

As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee.

As with the classification of any investment, the substance of the arrangement in each case will need to be considered. If it can be clearly demonstrated that an investor holding 20% or more of the voting power of the investee does not have significant influence, the investment will not be accounted for as an associate.

As substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

If the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. The presence of one or more of the indicators as above may indicate that an investor has significant influence over a less than 20% owned corporate investee.

Similarly, the definition of an associate in the 2013 Act is based on control of business decisions as compared to the concept of power to participate under AS 23. The 2013 Act sets a threshold of 20 percent ownership of total share capital and hence does not consider influence over voting power, or any other manner in which significant influence may be established. AS 23 envisages situations in which significant influence may be demonstrated without meeting the 20 percent threshold which are not addressed in the 2013 Act.

3.2 Accounting Method for Associates

AS 23 suggests equity method of accounting for investments in associates. Under equity method of accounting investment is initially recorded at cost, identifying any goodwill/ capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post-acquisition change in investor's share of net assets in the investee. Distributions received from the investee reduce the carrying amount of the investment. The investor's share in the operational result of the investee is reflected in the consolidated statement of profit and loss.

The following procedure should be followed:

- Investment is initially recorded at cost. Subsequently, the carrying amount is increased on the basis of share of profit or decreased on the basis of share of loss in the associate.
- Step (1): Find out value of investments on the basis of proportionate value of net assets of the investee;
- Step (2): Find out goodwill or capital reserve arising out of the purchase consideration. If the purchase price is above the value of investments determined in step (1) then there is goodwill and if the purchase price is less than the value of the investments determined in step (1) then there is capital reserve.
- Step (3): Goodwill or capital reserve as determined in step (2) should be included in the carrying amount of the investments with a separate disclosure. On the contrary, investments are recognised at purchase price as per AS 13 without disclosing goodwill/capital reserve.

  Goodwill/capital reserve can be disclosed within bracket below the "Investments in Associates" in the following style and accumulated income which was not earlier recognized should be added to value of investments for first time consolidation with corresponding credit to consolidated reserve.

Investments

Long Term Investments in Associates –	**...... ₹ at original cost**

[including ₹..... goodwill/capital reserve (previous year ₹.....)
arising on acquisition of associates]

Add: Accumulated income from Associates.

- Unrealised profit or loss resulting from transactions between the investor (and its consolidated subsidiary) and the associate should be eliminated to the extent of interest of the investor in the associate.

- The carrying amount of investment in an associate is reduced to recognise decline in the value of investments computed in terms of proportionate net assets of the investee.
- Applying the logic of consolidation unrealized profit arising out of intra-group transactions should be eliminated.

3.3 Non-application of Equity Method

The general rule is that investments in associates are accounted for using the equity method of accounting. If, however, any of the two conditions under-mentioned are fulfilled, the investment is not accounted for using the equity method but is accounted for in accordance with AS 13 'Accounting for Investments' with disclosure of the reasons for not applying the equity method in accounting for investments;

(1) when an investment is acquired for the purpose of disposal in the near future, i.e., as short term investments; and

(2) there is severe long term restriction on fund transfer by the associate to the investor.

3.4 Treatment of Change in Equity of Associate not arising out of Profit and Loss Account

The situation may arise that change in equity of the associate which are not through profit and loss account.

For example, the associate may revalue its fixed assets and create revaluation reserve. In such cases, increase/decrease in the value of investments should be directly added to/subtracted from the carrying amount of investments with corresponding credit/debit to the balance of the consolidated profit and loss account in the balance sheet. This adjustment should not be routed through consolidated profit and loss account.

Illustration 1

The draft consolidated balance sheet of Helpful Ltd. group as at 31.03.2017 is given below:

Liabilities	*₹ in 000*	*Assets*	*₹ in 000*
Share Capital	*1,200*	*Fixed Assets*	*3,000*
Capital Reserve	*30*	*Investment in Need Ltd.*	*180*
Profit & Loss A/c	*875*	*Investment in Desire Ltd.*	*375*
Minority Interest	*450*	*Current Assets*	*500*
Non- current liabilities	*900*		
Current Liabilities	*600*		
	4,055		*4,055*

Helpful Ltd. acquired 25% stake in Need Ltd. for ₹ 1.80 lakh and 40% stake in joint venture Desire Ltd. for ₹ 3.75 lakh on 01.01.2016. Profit & Loss A/c balances of Need Ltd. and Desire Ltd. on that date were ₹ 2 lakh and ₹ 3 lakh respectively.

Summarised balance Sheets of Need Ltd. and Desire Ltd. as at 31.12.2016 are given below:

Liabilities	*Need Ltd.* ₹ *in 000*	*Desire Ltd.* ₹ *in 000*	*Assets*	*Need Ltd.* ₹ *in 000*	*Desire Ltd.* ₹ *in 000*
Share Capital	*500*	*600*	*Fixed Assets*	*600*	*800*
Profit & Loss A/c	*300*	*400*	*Current Assets*	*400*	*700*
Non-current Liabilities	*100*	*150*			
Current Liabilities	*100*	*350*			
	1,000	*1,500*		*1,000*	*1,500*

Earnings of Need Ltd. for the first quarter 2017 was ₹ 32,000. There were no changes in long term assets and liabilities. Current assets and liabilities increased during the period by ₹ 27,000 and ₹ 18,000 respectively.

In first quarter of 2017, Desire Ltd. redeemed debentures of ₹ 1 lakh at par (standing in the books as non-current liability) and earned ₹ 40,000. Current assets and liabilities increased during the period by ₹ 38,000 and ₹ 25,000 respectively.

Adjust the draft consolidated balance sheet if necessary.

Solution

Consolidated Balance Sheet as at 31.03.2017

Particulars	*Note No.*	*(₹ in 000)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		1,200
(b) Reserves and Surplus	1	994
(2) **Minority Interest**		450
(3) **Non-Current Liabilities** (900 + 20)		920
(3) **Current Liabilities** (600 + 150)		750
Total		4,314
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets (3,000 + 320)		3,320
Intangible assets	2	20
(2) **Non- current Investment in Need Ltd.**		208
(3) **Current assets** (500 + 266)		766
Total		4,314

Notes to Accounts

		(₹)	(₹)
1.	Reserves and surplus		
	Capital Reserve		30
	Profit & Loss A/c		
	Helpful Ltd. and its subsidiary	875	
	Need Ltd. [25% of (332-200)]	33	
	Desire Ltd. [40% of (440-300)]	56	964
			994
2.	Intangible Assets		
	Goodwill (Need Ltd.)	5	
	Goodwill (Desire Ltd.)	15	20

Working Notes:

1. Draft Balance Sheets of Need Ltd. and Desire Ltd. as at 31.03.2017 are drawn below:

Liabilities	*Need Ltd. ₹ in 000*	*Desire Ltd. ₹ in 000*	*Assets*	*Need Ltd. ₹ in 000*	*Desire Ltd. ₹ in 000*
Share Capital	500	600	Fixed Assets	600	800
Profit & Loss A/c	332	440	Current Assets (Bal. fig.)	450	665
Non-Current Liabilities	100	50			
Sundry Liabilities	118	375			
	1,050	1,465		1,050	1,465

2. Closing equity (Need Ltd.) = 25% of (500 + 332) = ₹ 208 thousand

Pre-acquisition equity (Need Ltd.) = 25% of (500 + 200) = ₹ 175 thousand

Goodwill = 180 - 175 = ₹ 5 thousand

Adjustment under equity method for investment in associate Need Ltd.

		₹ in 000	*₹ in 000*	
Investment in Need Ltd.	Dr.	28		208 - 180
Goodwill	Dr.	5		180-175
To Profit and Loss A/c			33	208 - 175

3. Closing equity (Desire Ltd.) = [40% of (600 + 440)] = ₹ 416 thousand

Pre-acquisition equity (Desire Ltd.) = [40% of (600 + 300)] = ₹ 360 thousand

Goodwill = 375 – 360 = ₹ 15 thousand

Adjustment for proportionate consolidation in respect of Investment in Joint Venture- Desire Ltd.

		₹ *in 000*	₹ *in 000*	
Investment in Desire Ltd.	Dr.	41		416-375
Goodwill	Dr.	15		375 - 360
To Profit and Loss A/c			56	416 - 360
Fixed Assets A/c	Dr.	320		40% of 800
Current Assets A/c	Dr.	266		40% of 665
To Non-current Liabilities			20	40% of 50
To Current Liabilities			150	40% of 375
To Investment in Desire Ltd.			416	40% of 1,040

UNIT 4: TREATMENT OF INVESTMENT IN JOINT VENTURES IN CONSOLIDATED FINANCIAL STATEMENTS

Joint venture is defined as a contractual arrangement whereby **two or more parties undertake an economic activity, which is subject to joint control.**

Business entities, in their process to achieve improved performance and to provide value addition to stakeholders, exert themselves in establishing various forms of business relationships to have either access or control over the economic resources of other business entities. Joint ventures are one of such form of business relationship. Such relations are made either to promote trade, or to gain access to new markets.

Joint venture is controlled by two or more venturers. Additionally, there can also be investors who do not have control. By joint venture, its co-venturers who expect to achieve some common purpose or benefit. In India, Accounting Standard 27 on "Financial Reporting of interests in Joint Ventures" deals with both separate financial statements and also with consolidated financial statements.

4.1 Scope Under AS 27

AS 27 should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

The requirements relating to accounting for joint ventures in consolidated financial statements, contained in AS 27 are applicable only where consolidated financial statements are prepared and presented by the venturer.

4.2 Forms of Joint Venture

AS 27 identifies three broad types of Joint Ventures-

- jointly controlled operations,
- jointly controlled assets and
- jointly controlled entities.

4.2.1 Jointly Controlled Operations

No separate establishment: The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves.

Each venture uses its own assets and liabilities: Each venturer uses its own fixed assets and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations.

Own employees: The joint venture's activities may be carried out by the venturer's employees alongside the venturer's similar activities.

Sharing of common expenses and revenues: The joint venture agreement usually provides means by which the revenue from the jointly controlled operations and any expenses incurred in common are shared among the venturers.

An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute, jointly, a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers.

Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

4.2.2 Jointly Controlled Assets

Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture.

The assets are used to obtain economic benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

An example of a jointly controlled asset is an oil pipeline jointly controlled and operated by a number of oil production companies.

Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline.

Another example of a jointly controlled asset is when two enterprises jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

4.2.3 Jointly Controlled Entities

A jointly controlled entity is a joint venture which is established as a separate legal entity which can be in form of a corporation, partnership or other entity in which each venturer has an interest.

The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

4.3 Accounting Treatment

4.3.1 Jointly Controlled Operations

As per para 13 of AS 27, in respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

The only accounting issue that arises is that the output from the project is to be shared among the venturers and, therefore, there must be some mechanism for specifying the allocation of the proceeds and the sharing of any joint expenses.

4.3.2 Jointly Controlled Assets

As per para 19 of AS 27, in respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities which it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

4.3.3 Jointly Controlled Entities

A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements of AS 27 applicable to that jointly controlled entity.

Separate Financial Statements of a Venturer

In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

Consolidated Financial Statements of a Venturer

In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and

(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

An interesting feature of Schedule III (that provides general instructions for preparation of financial statements) is that it requires disclosure, for each joint venture, of amounts 'as per proportionate consolidation/investment as per the equity method', whereas AS 27 on Accounting for Joint Ventures does not permit accounting for jointly controlled entities as per equity method.

4.4 Proportionate Consolidation Method

Separate line Items: AS 27 defines proportionate consolidation as a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Balance sheet and profit & loss account to include share of venturer: The application of proportionate consolidation means that the balance sheet of the venture includes its share of the assets that it controls jointly, and its share of the liabilities for which it is jointly responsible. The statement of profit and loss of the venture includes its share of the income and expenses of the jointly controlled entity.

4.4.1 Steps for Proportionate Consolidation

All the steps are similar to those of consolidation of Subsidiary except that when Consolidated Balance sheet is prepared; the venturer's (Investor) proportionate share of each asset and liability is added.

Step 1: Ascertain the date of Investment of venturer in Jointly Controlled Entities (JCE).

Step 2: Ascertain venturer's share of Interest in the Jointly Controlled Entities.

Step 3: Analyse profits of the Jointly Controlled Entities as pre-acquisition and post-acquisition with reference to date of acquisition.

Step 4: Ascertain the venturer's share of both pre-acquisition and post-acquisition profits of Jointly Controlled Entities analysed above.

Step 5: Ascertain Goodwill/Capital Reserve

A)	Cost of Investment		
	Amount invested *Less:* Pre acquisition dividend	XXX XXX	 XXX
B)	*Less:* Venturer's share of net assets in JCE as at date of acquisition represented by venturer's share of: (i) Share Capital (ii) Pre acquisition profits	XXX XXX	 XXX
C)	Goodwill/Capital Reserve (Difference between A & B)		XXX

Steps 6: Elimination of Inter Company transactions.

Elimination of unrealized profit on unsold Inventory forming part of intra group transactions to be eliminated to the extent of venturer's stake.

Step 7: Reserves for Consolidated Balance Sheet

a)	Aggregate reserves for Consolidated Balance Sheet of holding company and subsidiaries as per AS 21 and AS 23 where applicable.	XXX
b)	*Add:* Venturer's share of post-acquisition profit (Step 4)	XXX
c)	*Less:* Venturer's share of unrealized profit (Step 6A)	(XXX)
		XXX

Step 8: Prepare Consolidated Balance Sheet

Liabilities

	Parents	*Subsidiary (Say 80%)₹*	*Associate*	*JCE (Say 50%)*	*Adj.*	*Consolidated*
Share Capital	100%	--	--	--	Cancel Cross holding only	XXX
Reserves						Step 7
Minority Interest	-	20%	-	-	-	XXX
Outside Liabilities (Individually)	100%	100%	-	50%	Cancel Inter Company Balances Subsidiary – 100% JCE – 50%	XXX
						XXX

Assets

	Parent	*Subsidiary (Say 80%)*	*Associate*	*JCE (Say 50%)*	*Adj.*	*Consolidated*
Fixed Assets	100%	100%		50%	Adjust for -Revaluation -Unamortised profit on Intra	XXX

					group transaction	
Investment	-	-	- Only Outside Investment and carrying amount of Investment in Associate as per Step 8			XXX
Current Assets Loans and Advances	100%	100%	-	50%	Adjust for -Unrealised profit on Intra group transaction	XXX
Miscellaneous Expenditure to the extent not written off	100%	-	-	-	-	XXX
						XXX
						XXX

4.5 Different Reporting Dates

- The financial statements of the jointly controlled entity used in applying proportionate consolidation are usually drawn up to the same date as the financial statements of the venturer.
- When the reporting dates are different, the jointly controlled entity often prepares, for applying proportionate consolidation, statements as at the same date as that of the venturer.
- When it is impracticable to do this, financial statements drawn up to different reporting dates - may be used provided the difference in reporting dates is not more than six months. In such a case, adjustments are made for the effects of significant transactions or other events that occur between the date of financial statements of the jointly controlled entity and the date of the venturer's financial statements.
- The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

4.6 Uniform Accounting Policies

- The venturer usually prepares consolidated financial statements **using uniform accounting policies** for the like transactions and events in similar circumstances.
- In case a jointly controlled entity uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, **appropriate adjustments are made** to the financial statements of the jointly controlled entity when they are used by the venturer in applying proportionate consolidation.
- If it is not practicable to do so, that **fact is disclosed** together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

4.7 Offsetting of Assets and Liabilities

While giving effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any income or expenses by the deduction of other expenses or income, unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

4.8 Goodwill or Capital Reserve

Any excess of the cost to the venturer of its interest in a jointly controlled entity over its share of net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, is recognised as goodwill, and separately disclosed in the consolidated financial statements. When the cost to the venturer of its interest in a jointly controlled entity is less than its share of the net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, the difference is treated as a capital reserve in the consolidated financial statements. Where the carrying amount of the venturer's interest in a jointly controlled entity is different from its cost, the carrying amount is considered for the purpose of above computations.

4.9 Discontinuance of Proportionate Consolidation Method

A venturer should discontinue the use of proportionate consolidation from the date that:

(a) it ceases to have joint control over a jointly controlled entity but retains, either in whole or in part, its interest in the entity; or

(b) the use of the proportionate consolidation is no longer appropriate because the jointly controlled entity operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

(a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and

(b) in all other cases, as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments, or in accordance with Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate. For this purpose, cost of the investment should be determined as under:

    (i) the venturer's share in the net assets of the jointly controlled entity as at the date of discontinuance of proportionate consolidation should be ascertained, and

(ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve (see paragraph 37) as at the date of discontinuance of proportionate consolidation.

4.10 Joint Venture cum Subsidiary

When an enterprise establishes joint control over an Entity, which is also a subsidiary of that enterprise as per AS 21, such entity is treated as subsidiary company as per AS 21 and should be accounted accordingly. However, the consolidation of such entity does not preclude other venturers from treating such entity as a Joint Venture under AS 27.

Illustration 1

Consolidated data of X Ltd., and its 100% subsidiary Y Ltd. and also information of Z Ltd. relating to the year end 31st March, 2017 is given below:

BALANCE SHEET

(₹ in thousand)

	CBS of X Ltd. and its 100% Subsidiary Y Ltd.	*Z Ltd.*
Issued ordinary share capital	2,000	1,000
Reserves	3,450	2,000
Debentures	2,000	1,500
Current liabilities	4,550	2,500
Total	12,000	7,000
Fixed assets (net)	6,500	4,000
Investment in Z Ltd. at cost	2,000	---
Current assets	3,500	3,000
Total	12,000	7,000

PROFIT AND LOSS ACCOUNT

	X Ltd and its 100% Subsidiary Y Ltd.	*Z Ltd.*
Sales	2000	1000
Expenses	(900)	(500)
Trading profit before tax	1,100	500
Dividend from Z Ltd.	100	----
Taxation	(600)	(200)
Profit after tax	600	300
Opening Balance	3150	1100
Dividends paid	(300)	(200)
Retained Profit	3450	1200

X Ltd. acquired 50% of the ordinary share capital of Z Ltd. on 1st April, 2016 for ₹ 2,000 thousands when its reserves were ₹ 1,900 thousands and sold this holding on 3rd April, 2017 for ₹ 2,050 thousands.

You are required to prepare the 'Group' Profit and Loss account (draft) and Balance Sheet (draft) on four bases as follows:

1. When Z Ltd. is treated as a subsidiary
2. When Z Ltd. is treated as an associated company
3. When Z Ltd. is treated as an investment
4. When Z Ltd. is treated as a Joint Venture.

Solution

	Particulars	*Subsidiary*	*Investment*	*Associate*	*Joint Venture*
a.	Accounting Standard Applicable	21	13	23	27
b.	Method	Full Consolidation	Cost method	Equity method	Proportionate Consolidation
c.	Date of Acquisition	1st April 2016	1st April 2016	1st April 2016	1st April 2016
d.	Shareholding	X Ltd – 50% Minority Int. – 50%	Not applicable	Extent of investment 50%.	Extent of financial interest 50%.
e.	Analysis of reserves	1) Opening balance 1900 thousands pre-acquisition 2) Current year retained profit 100 thousands post-acquisition	Not applicable	1) Opening balance 1900 thousands pre-acquisition 2) Current year retained profit 100 thousands post acquisition	1) Opening balance 1900 thousands pre-acquisition 2) Current year retained profit 100 thousand post acquisition.
f.	Apportionment of Profits 1) Pre-acquisition 2) Post-acquisition	1) X Ltd. – 950 thousands 2) Minority – 950 thousands 1) X Ltd. – 50 thousands 2) Minority – 50 thousands	Not applicable	1) X Ltd. – 950 thousands (Investing Co. Interest) 2) X Ltd. – 50 thousands	1) X Ltd. – 950 thousands (Venturer Interest). 2) X Ltd. – 50 thousands.
g.	Outsider's interest	Minority Interest 1) Share capital - 500 thousands	Not applicable		

		2) Pre-acquisition – 950 thousands 3) Post acquisition - 50 thousands Total 1500 thousands			
h.	Goodwill/Capital Reserve	1) Cost of Investment – 2000 thousands 2) Share of Net Assets on the date of investment - Share Capital 500 thousands - Capital Profits 950 thousands - 1450 thousands 3) Goodwill 550 thousands	Not applicable	1) Cost of investment 2000 thousands 2) Share of net assets on the date of investment - share capital 500 thousands - capital profits 950 thousands Total 1450 thousands - Goodwill 550 thousands	1) Cost of investment 2000 thousands 2) Share of net assets on the date of investment - Share capital 500 thousands - Capital profits 950 thousands Total 1450 thousands - Goodwill 550 thousands
i.	Inter Company Transactions 1) Inter company owings 2) Unrealised Profits	Eliminate in full Eliminate in full	Not applicable	Not applicable Eliminate to the extent of investing co's interest	Eliminate to the extent of venturer's interest
J.	Reserves for CBS	*	Not Applicable	*	*
k.	Carrying	Nil	2000	a) Amount Invested	Nil

	amount of Investment in CBS		thousands	i)Share of Net Assets 1450 thousands ii) Goodwill - 550 thousands 2000 thousands b) Add. Share of Post Acquisition profits 150 thousand c) Less: Dividend received 100 thousands Total 2050 thousands	

* Reserves for CBS

Draft Consolidated Profit and Loss A/c
as at 31.03.2017

₹ in thousands

Particulars	*Subsidiary*	*Investment*	*Associate*	*Joint Venture*
Sales	3,000	2,000	2,000	2,500
Expenses	(1,400)	(900)	(900)	(1,150)
Dividend	-	100	-	-
PBT	1,600	1,200	1,100	1,350
Tax	(800)	(600)	(600)	(700)
PAT	800	600	500	650
Share of profits from Associate	-	-	150	-
Opening Balance B/d	3,150	3,150	3,150	3,150
Dividend Paid	(300)	(300)	(300)	(300)
Share of Minority Interest	(150)	-	-	-
Balance carried forward to Balance Sheet	3,500	3,450	3,500	3,500

Draft Consolidated Balance Sheet
as at 31.03.2017

₹ in thousands

	If Subsidiary	*If Investment*	*If Associate*	*If Joint Venture*
Equity and Liabilities				
Share Capital	2,000	2,000	2,000	2,000
Reserves	3,500	3,450	3,500	3,500
Debentures	3,500	2,000	2,000	2,750
Current Liabilities	7,050	4,550	4,550	5,800
Minority Interest	1,500	-		-
Total	17,550	12,000	12,050	14,050
Assets				
Non-current assets				
Fixed Assets				
Tangible Assets	10,500	6,500	6,500	8,500
Intangible Assets	550	-	-	550
Investments	-	2,000	2,050 (Goodwill – ₹ 550 thousands)	-
Current Assets	6,500	3,500	3,500	5,000
Total	17,550	12,000	12,050	14,050

References :

AS 21 : Consolidated Financial Statements

AS 23 : Accounting for Investments in Associates

AS 27 : Financial Reporting of Interests in Joint Ventures

6

Accounting and Reporting of Financial Instruments

1. Introduction

During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are financial instruments whose values change in response to the change in an underlying which can be specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts.

The Institute of Chartered Accountants of India came out with the Accounting Standards 30, 31, 32 for recognition, measurement, presentation and disclosures of financial instruments in the year 2009. However, they were not notified by the Ministry of Corporate Affairs and hence not made mandatory. Earlier, these standards were to be made mandatory for Level I Entities only. Now, since the Ind ASs have been notified, the same would be applicable in respect of Level I Entities w.e.f 1.4.2016 and Level II entities w.e.f. 1.4.2017 and 1.4.2018, as the case may be. Consequently, AS 30, 31 and 32 are no longer relevant to corporate entities. For non-corporate entities also, the status of AS 30, 31 and 32 is only "encouraged to be followed". Therefore, AS 30, 31 and 32 had been removed from the syllabus and in place of it Ind AS 32, Ind AS 107 and Ind AS 109 have been made applicable.

Accordingly, this chapter has been revised on the basis of the provisions of Ind AS 32 "Financial Instruments: Presentation", Ind AS 107 "Financial Instruments: Disclosures" and Ind AS 109 "Financial Instruments".

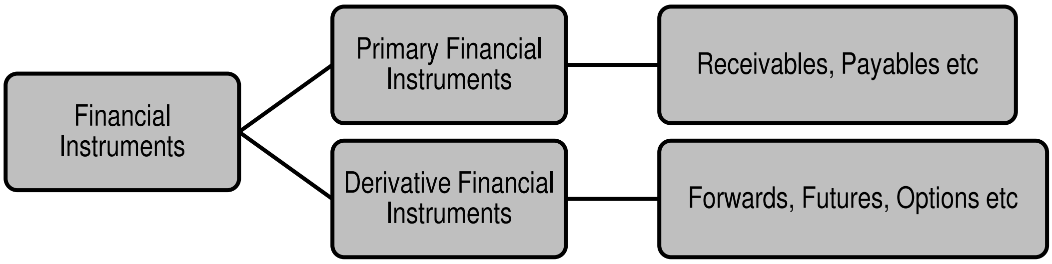
2. Meaning of Financial Instrument

A financial instrument is any ***contract*** that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

'Contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

Financial Instruments may be classified as primary and derivative financial instruments. The classifications can be shown as:



2.1 Meaning of Financial Asset

A financial asset is any asset that is:

(a) cash;

> 1. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements.
> 2. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

(b) an equity instrument of another entity;

(Example: Investment in equity shares of another company)

(c) a contractual right to:

(i) receive

- cash or
- another financial asset from another entity; or

> Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:
>
> (a) trade accounts receivable and payable;
>
> (b) notes receivable and payable;
>
> (c) loans receivable and payable; and
>
> (d) bonds receivable and payable.
>
> In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).
>
> Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. There can be chain of financial instruments that give right to receive financial asset. However, the chain

should always end with a financial asset that gives rise to contractual right to receive case to one party and contractual obligation to pay cash or issue equity to another party.

For example: A note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are ***potentially favourable*** to the entity; or

(d) a contract that ***will or may be*** settled in the entity's ***own equity instruments*** and is:

(i) a ***non-derivative*** for which the entity is or may be obliged to receive a ***variable number*** of the entity's own equity instruments; or

(ii) a ***derivative*** that will or may be settled ***other than by*** the exchange of a fixed amount of cash or another financial asset for a ***fixed number*** of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable financial instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments if such instruments are classified as equity instruments.

2.2 Meaning of Financial Liability

A financial liability is any liability that is:

(a) A contractual obligation:

(i) to deliver

- cash or
- **another financial asset** to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable** to the entity; or

(b) a contract that **will or may be** settled in the entity's own equity instruments and is:

i. a non-derivative for which the entity is or may be obliged to deliver a **variable** number of the entity's own equity instruments; or

ii. a **derivative** that will or may be settled **other than** by the exchange of a fixed amount of cash or another financial asset for a **fixed number** of the entity's own equity instruments.

For this purpose, it excludes rights, options or warrants used to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency since they are equity instruments if the entity offers the rights, options or warrants pro-rata to all of its existing owners of the same class of its own non-derivative equity instruments.

Points to remember

1. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument.
2. A ***chain*** of contractual rights or contractual obligations meets the definition of a financial instrument if it will ***ultimately lead to the receipt or payment of cash*** or to the acquisition or issue of an equity instrument.
3. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute or contingent on the occurrence of a future event.
4. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be insurance contracts within the scope of Ind AS 104.

For example: A financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. Here the financial guarantee may actualize in contingent circumstances therefore, it shall be constituted as financial instrument as per Ind AS 32.

Illustration 1 (Exchange of Financial Liability at Unfavourable terms)

A company borrowed ₹ 50 lacs @ 12% p.a. Tenure of the loan is 10 years. Interest is payable every year and the principal is repayable at the end of 10th year. The company defaulted in payment of interest for the year 4, 5 and 6.

A loan reschedule agreement took place at the end of 7th year. As per the agreement the company is required to pay ₹ 90 lacs at the end of 8th year. Calculate the additional amount to be paid on account of rescheduling and also the book value of loan at the end of 8th year when reschedule agreement took place.

Solution

Assumption: Interest is compounded in case of default.

Outstanding Amount at the end of 8th year = ₹ 50,00,000 x 1.12 x 1.12 x 1.12 x 1.12 x 1.12

= ₹ 88,11,708 (i.e. adding interest for 4th to 8th year)

Rescheduled amount to be paid at the end of the 8th year = ₹ 90,00,000

Additional amount to be paid on rescheduling = ₹ 90,00,000 - ₹ 88,11,7081 = ₹ 1,88,291

Illustration 2

Entity A holds an option to purchase equity shares in a listed entity B for ₹ 100 per share at the end of a 90 day period. Evaluate the contract whether a financial asset or a financial liability? What if the entity A has written the option and the price of the share on the expiry date is ₹ 120?

Solution

The above call option gives entity A, a contractual right to exchange cash of ` 100 for an equity share in another entity and will be exercised if the market value of the share exceeds `100 at the end of the 90 day period. If the market value of a share will be such that the entity A will gain on the exercise date, it will exercise the call option.

Since entity A stands to gain if the call option is exercised, the exchange is potentially favourable to the entity. Also, the determination of whether the option is a derivative is dependent on whether it satisfies all the following conditions as contained in the definition of derivative and not whether the contract is potentially favourable or unfavourable:

1. Its value changes on the basis of the change in some variable. If the variable is a non-financial variable, it is not specific to a party to the contract
2. It requires no or little initial net investment
3. It is settled at a future date.

Therefore, the option is a derivative financial asset from the time the entity becomes a party to the option contract.

On the other hand, if entity A writes an option under which the counterparty can force the entity to sell equity shares in the listed entity B for ` 100 per share at any time (if it is an American option*) in the next 90 days, then entity A will be said to have a contractual obligation to exchange its equity shares to another entity for cash of ₹ 100 per share on potentially unfavourable** terms i.e. if the holder exercises the option, on account of the market price per share being above the exercise price of ₹ 100 per share at the end of the 90 day period.

Since entity A, the writng party will have to buy shares from the market at ₹ 120 and sell those to the purchasing party at ₹ 100, it stands to lose if the option is exercised. Therefore, the exchange is potentially unfavourable and the option is a derivative financial liability from the time the entity becomes a party to the option contract.

Clarifications

1. 'Perpetual' debt instruments (such as 'perpetual' bonds, debentures and capital notes):

Perpetual debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either

* The purchase option is an example of european option where the exercise happens at the expiry date whereas the written option is an american option where the exercise can happen at any time before the expiry date.

** Whether a derivative is favourable or unfavourable is determined at the end of each reporting period. At the date the contract is entered into, it is neither favourable or unfavourable. It is neutral and therefore the premium paid for the option is its fair value as on that date.

with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

For example:

An entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of ₹ 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of ₹ 1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

2. **Leases under Ind AS 17:**

   A **finance lease** is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement.

   The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself.

   An **operating lease**, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract.

   Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable).

3. **Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks):**

   There is no contract existing for tangible assets recognised. Even if a contract is existing, the same is a contract to buy or sell non-financial item and hence not a financial instrument. Also, physical assets, leased assets and intangible assets are not financial assets because control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

4. **Assets (such as prepaid expenses):**

   Future economic benefit from prepaid expenses is the receipt of goods or services, rather than the right to receive cash or another financial asset. Therefore, such prepaid expenses shall not be considered as financial assets.

   Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

5. **Liabilities or assets that are not contractual:**

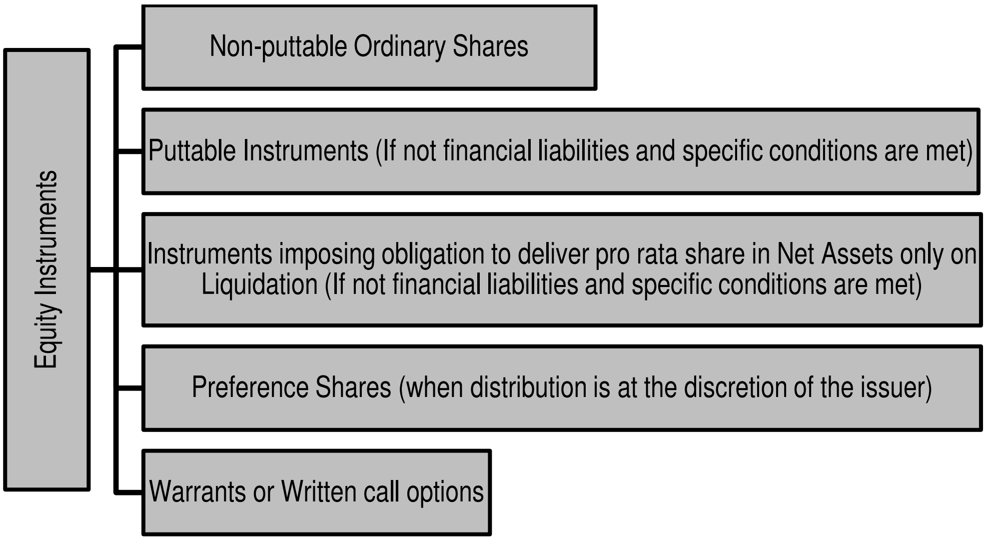
Non contractual liabilities or assets are not financial liabilities or financial assets. Income taxes that are created as a result of statutory requirements imposed by Governments are accounted in accordance with Ind AS 12.

Similarly, constructive obligations, as defined in Ind AS 37, "Provisions, Contingent Liabilities and Contingent Assets", do not arise from contracts and hence are not financial liabilities.

2.3 Meaning of Equity Instrument

An equity instrument is any contract that evidences a ***residual interest*** in the assets of an entity after deducting all of its liabilities.

Examples of equity instruments:

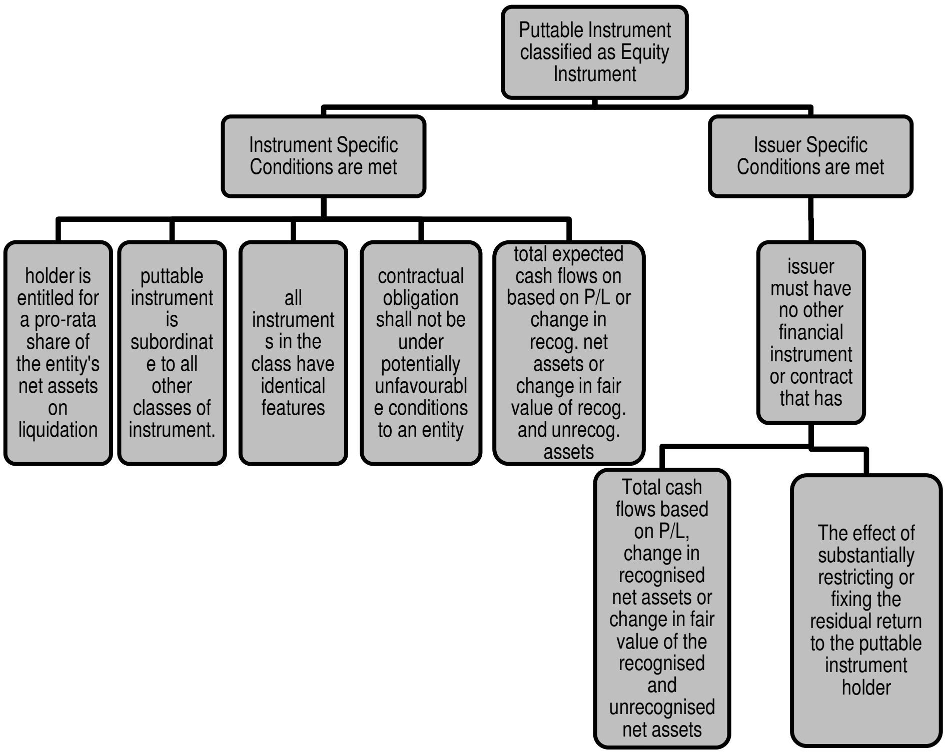


2.3.1 Criteria for Classification of Equity Instruments

1. **Puttable Financial Instrument**:

A puttable financial instrument includes a **contractual obligation for the issuer** to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. Therefore, it is a financial liability.

However, as an **exception,** such an instrument is classified as an equity instrument if it has all the following features:



Instrument specific conditions

(a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets.

A pro rata share is determined by:

$$\frac{\text{Entity's net assets on liquidation}}{\text{Number of units}} \times \text{Number of the units held by the financial instrument holder}$$

(b) The instrument is in the class of instruments that is **subordinate to all other classes of instruments.**

The following conditions must be fulfilled to be in such a class the instrument:

(i) Has no priority over other claims to the assets of the entity on liquidation, and

(ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments shall **have identical features.**

For example:

They must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument **does not include any contractual obligation** to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity**, and** it is **not a contract that will or may be settled in the entity's own equity instruments.**

(e) The **total expected cash flows** attributable to the instrument over the life of the instrument are based substantially on:

(i) The profit or loss

(ii) The change in the recognised net assets or

(iii) The change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument)

Issuer Specific Conditions

I**n addition to the instrument having all the above features,** the issuer must have no other financial instrument or contract that has:

(a) Total **cash flows based substantially on**

(i) The profit or loss

(ii) The change in the recognised net assets or

(iii) The change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract)

(b) The **effect of substantially restricting or fixing the residual return** to the puttable instrument holders

In case an Entity cannot carry out the above 2 tests, the puttable instrument is classified as a Financial Liability an if all the above conditions are satisfied than it will be treated as an equity instrument.

2. Instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

An instrument that includes such an obligation is classified as an equity instrument if it has all the following features:

Instrument Specific Conditions

(a) It entitles the holder to a pro rata share of the entity's **net assets in the event of the entity's liquidation.** The entity's net assets are those assets that remain after deducting all other claims on its assets.

A pro rata share is determined by:

$$\frac{\text{Entity's net assets on liquidation}}{\text{Number of units}} \times \text{Number of the units held by the financial instrument holder}$$

(b) The instrument is in the class of instruments that is **subordinate to all other classes of instruments.**

To be in such a class the instrument:

(i) Has no priority over other claims to the assets of the entity on liquidation, and

(ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an **identical contractual obligation** for the issuing entity to deliver a pro rata share of its net assets on liquidation.

Issuer Specific Conditions

In addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) Total cash flows based substantially on

(i) The profit or loss

(ii) The change in the recognised net assets or

(iii) The change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract)

(b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

If all the conditions stated above are satisfied then instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation will be treated as an equity instrument.

3. Preference Shares

Preference shares may be issued with various rights.

In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability.

Preference share is the name given to any share that has some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. These preferential rights are of great variety, but refer normally to the right to a fixed dividend, although they could also refer to the right on winding up to receive a fixed part of the capital or otherwise to participate in the distribution of the company's assets (share with such rights are often known as participating preference shares).

Redemption option:

1. A preference share that provides for redemption on a specific date or at the **option of the holder** contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share

   Note: The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.

2. An **option of the issuer** to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders.

   In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

   Note: When preference shares are **non-redeemable**, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

Distributions:

When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the **discretion of the issuer**, the shares are equity instruments. Also, if distributions to the holders of the preference shares is cumulative, the issuer has an obligation to distribute and if not distributed it accumulates. Where such accumulation is to be paid only on liquidation, then the preference shares could be classified as equity.

However, a question arises that whether the accumulation of dividend payable is off the books? If the obligation to accumulated dividend and pay on liquidation does not satisfy the exceptions specified in paragraphs 16C and 16D of Ind AS 32 for classifying an instrument that is payable only on liquidation as an equity. Therefore, the accumulation of dividend will always be recognised as liability. Such an instrument is a compound financial instrument.

4. Warrants or written call options:

Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.

Illustration 3 (Mandatorily Redeemable Preference Shares with Mandatory Fixed Dividends)

A Company has issued 6% mandatorily redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attaching to the instrument's principal and return components.

The instrument in this example provides for mandatory periodic fixed dividend payments and mandatory redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

Illustration 4 (Non-redeemable Preference Shares with Mandatory Fixed Dividends)

A Company issued non-redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

When preference shares are non-redeemable, the appropriate classification is determined by the other rights attached to them. Classification is based on an assessment of the contractual arrangement's substance and the definitions of a financial liability and an equity instrument.

It is necessary to examine the particular contractual rights attaching to the instrument's principal and return components. In this example, the shares are non-redeemable and thus the amount of the principal has equity characteristics, but the entity has a contractual obligation to pay dividends that provides the shareholders with a lender's return. This obligation is not negated if the entity is unable to pay the dividends because of lack of funds or insufficient distributable profits. Therefore, the obligation to pay the dividends meets the definition of a financial liability.

The overall classification is that the shares may be a compound instrument, which may require each component to be accounted for separately. It would be a compound instrument if the coupon was initially set at a rate other than the prevailing market rate or the terms specified payment of discretionary dividends in addition to the fixed coupon. If the coupon on the preference shares was set at market rates at the date of issue and there were no provisions for the payment of discretionary dividends, the entire instrument would be classified as a financial liability, because the stream of cash flows is in perpetuity.

Illustration 5 (Non-redeemable Preference Shares with Dividend Payments linked to Equity Shares)

A company issued Non-redeemable preference shares with dividend payments linked to equity shares. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

An entity issues a non-redeemable preference shares on which dividends are payable only if the entity also pays a dividend on its equity shares.

The dividend payments on the preference shares are discretionary and not contractual, because no dividends can be paid if no dividends are paid on the equity shares, which are an equity instrument. As the perpetual preference shares contain no contractual obligation ever to pay dividends and there is no obligation to repay the principal, they should be classified as equity in their entirety.

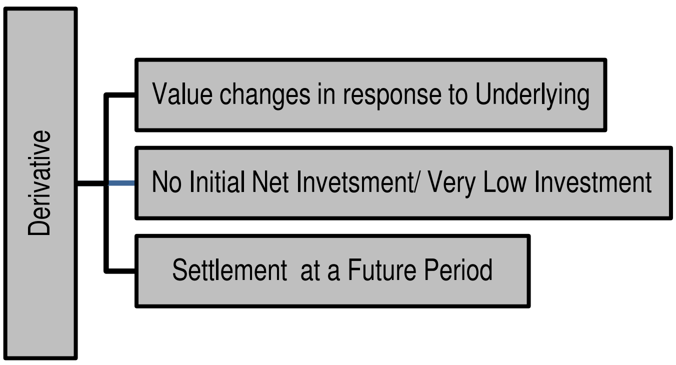
Where the dividend payments are also cumulative, that is, if no dividends are paid on the equity shares, the preference dividends are deferred, the perpetual shares will be classified as equity only if the dividends can be deferred indefinitely and the entity does not have any contractual obligations whatsoever to pay those dividends. This is an exception to the classification principle that certain instruments that are payable only on liquidation can be classified as equity (paragraphs 16C and 16D of Ind AS 32). However, generally, preference shares are not subordinate to all other classes of instruments. Hence, if the preference shares are cumulative, the accumulation is always a liability that should be recorded in books and not accumulated as an off balance sheet item.

A liability for the dividend payable would be recognised once the dividend is declared.

3. Derivatives

Financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

1. Its value changes in response to the change in an underlying which can be a specified interest rate, financial instrument price, commodity price, foreign exchange rate, prices of indices, credit rating or credit index, or other variable provided in the case of a non-financial variables.
2. It requires no initial or very less investment than it would be required otherwise to enter into a contract in normal course.
3. It is settled at a future period. The settlement can either by delivery of the underlying or cash settlement. In case of cash settlement no delivery of underlying takes place rather difference is settled in cash.



Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivatives that meet the conditions specified above are financial instruments and accordingly are within the scope of this standard.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract and even in some cases a transfer of underlying financial instrument/s necessarily may not take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative contract, as prices of underlying in financial markets change derivative contracts may become either favourable or unfavourable.

3.1 Forward Contracts

Forward Contract is the simplest form of a Derivatives Contract. Basically forward contract is a valid contract settled at some future point of time. For example, a forward contract involving settlement in six months' time in which one party (the purchaser) promises to purchase ₹ 1,000,000 face value of fixed interest rate government bonds, in exchange of ₹ 1,000,000 cash; and the other party (the seller) promises to deliver ₹ 1,000,000 face value of fixed rate government bonds in exchange for ₹ 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above ₹ 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below ₹ 1,000,000, the effect will be the opposite. However, both parties to a forward contract have an obligation to perform at the agreed time.

3.2 Option

As mentioned above both parties to a forward contract have an obligation to perform at the agreed time. However, under Option contract the option-holder has a right not an obligation to exchange the financial asset but the writer (seller) of the option has the obligation to exchange the financial asset upon exercise of the option. The nature of the holder's right and writer's obligation are not affected by the likelihood that the option will be exercised.

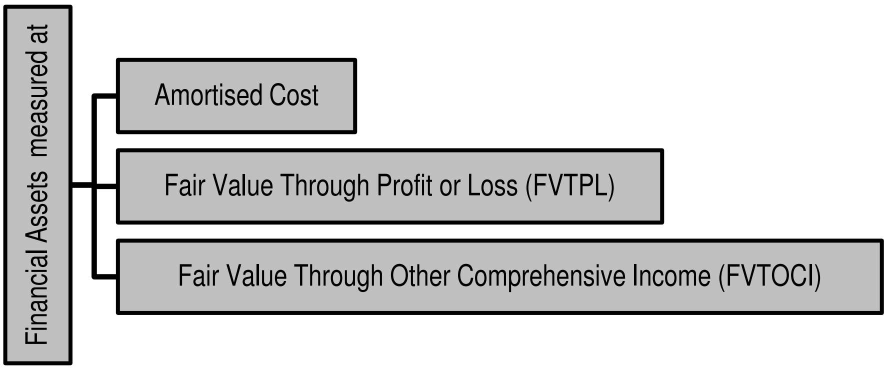
Thus, the purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

3.3 Others

Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments and note issuance facilities. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.

4. Classification of Financial Assets and Financial Liabilities

4.1 Classification of Financial Assets



An entity shall classify financial assets depending upon the ***following 2 criteria and options*** elected by the entity:

(a) the entity's **Business Model (BM)** for managing the financial assets and

(b) the Contractual Cash Flow Characteristics (CCFC) of the financial asset

A Business Model (BM) Test

Ind AS 109 requires an entity to classify financial assets on the basis of the entity's business model for managing the financial assets.

An entity assesses whether its financial assets meet the conditions on the basis of the business model as determined by the entity's key management personnel (As defined in Ind AS 24 Related Party Disclosures).

➢ An entity's business model is determined at a level that reflects **how groups of financial assets** are managed together to achieve a particular business objective.

The entity's business model **does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach** to classification and **should be determined on a higher level of aggregation**.

- An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

  That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, **this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios.**

  For example:

  If an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.

- If cash flows are realised in a way that is **different from the entity's expectations** at the date that the entity assessed the business model (For example: If the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements nor does it change the classification of the remaining financial assets held in that business model.

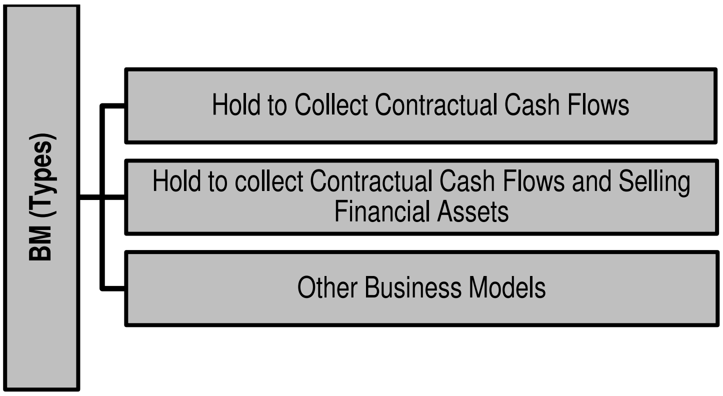
- However, when an entity assesses the business model for **newly originated or newly purchased financial assets,** it must consider information about how cash flows were realised in the past, along with all other relevant information.

- An entity's business model for managing financial assets is a **matter of fact and not merely an assertion.** It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

  a. how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

  b. the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and

  c. how managers of the business are compensated (For example: Whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).



Ind AS 109 elaborates these Models in the Application Guidance (AG) in Appendix B (B4.1.2C to B4.1.6)

Below given are various examples explaining Business Model (BM) Test:

Example 1: ABC Ltd. holds investments to collect their contractual cash flows. Funding needs of the Company are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs. The Company performs credit risk management activities with the objective of minimising credit losses.

In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the Company's documented investment policy.

In addition, infrequent sales have occurred as a result of unanticipated funding needs. Reports to Key Management Person focus on the credit quality of the financial assets and the contractual return. The Company also monitors fair values of the financial assets, among other information.

Analysis

Although the Company considers, among other information, the financial assets' fair values from a liquidity perspective (i.e. the cash amount that would be realised if the entity needs to sell assets), the Company's objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the Company's documented investment policy.

Infrequent sales resulting from unanticipated funding needs (eg. in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

Example 2: ABC Company anticipates capital expenditure in a few years. The Company invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the Company's anticipated investment period.

The Company will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Analysis

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The Company will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider a Company that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets.

When the investments mature, the Company reinvests the cash in new short-term financial assets.

The Company maintains this strategy until the funds are needed, at which time the Company uses the proceeds from the maturing financial assets to fund the capital expenditure.

Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk).

The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

Example 3: Entity B sells goods to customers on credit. Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. Entity B collects the cash in accordance with the contractual cash flows of the trade receivables and has no intention to dispose of the receivables.

Analysis

Entity B's objective is to collect the contractual cash flows from the trade receivables and, therefore, the trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

B Contractual Cash Flow Characteristic (CCFC) Test

Principal and Interest for SPPI TEST

Ind AS 109 requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity has to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a **basic lending arrangement**. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.

However, in such an arrangement, interest can also include consideration for other basic lending risks (For example, liquidity risk) and costs (For example, administrative costs) associated with holding the financial asset for a particular period of time.

In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- Principal is the fair value of the financial asset at initial recognition.

However, that principal amount may change over the life of the financial asset

For example:

If there are repayments of principal

- Interest consists of consideration for:
  - o The time value of money
  - o Credit risk associated with the principal amount outstanding during a particular period of time and
  - o For other basic lending risks and costs
  - o As well as a profit margin

Below given are various examples explaining Contractual Cash Flow Characteristic (CCFC) Test:

Example 1 Illustrating contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

There is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Analysis

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor's performance (e.g. the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that actual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

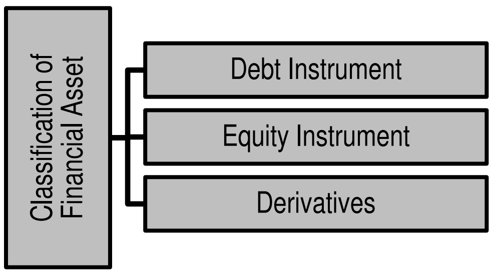
Example 2 Illustrating contractual cash flows that are not solely payments of principal and interest on the principal amount outstanding

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.

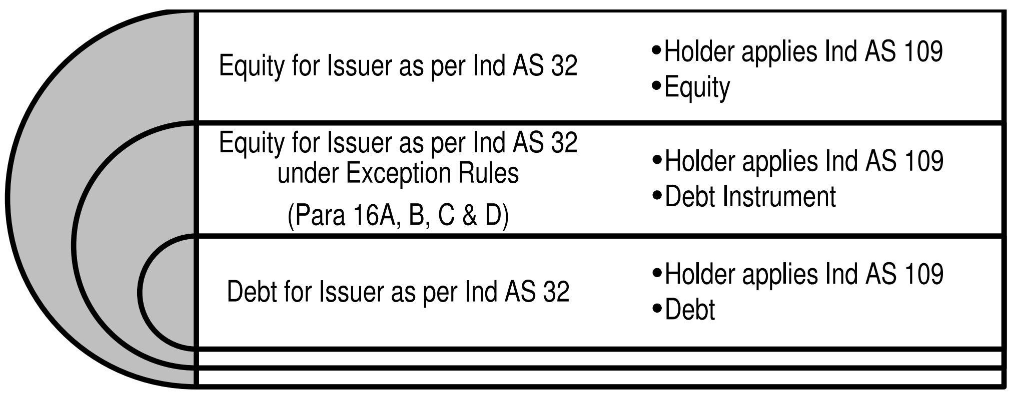
Analysis

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement i.e. the return is linked to the value of the equity of the issuer.

Ind AS 109 elaborates the SSPI Test in the Application Guidance (AG) in Appendix B (B4.1.7 to B4.1.26)

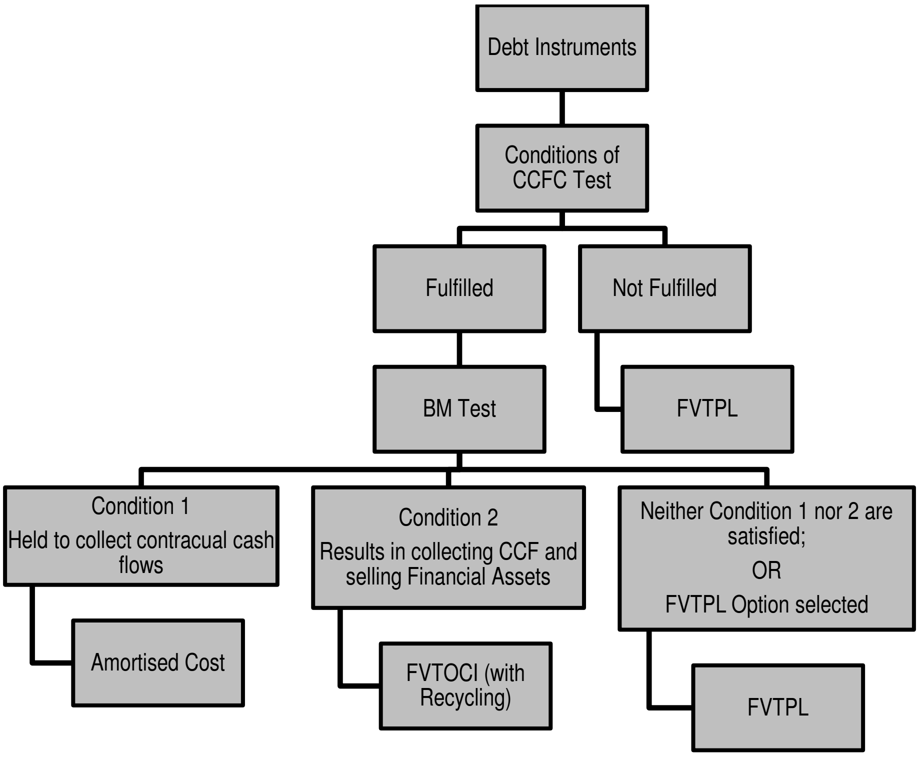


To decide whether a Financial Asset is a Debt Instrument or an Equity Instrument the holder needs to look at the issuer classification.



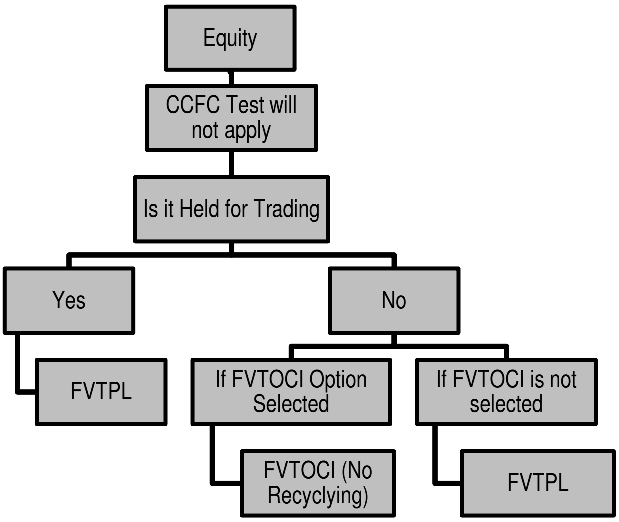
4.1.1 Classification of Debt Instruments (Financial Assets)

Classification of Debt Instruments has been explained by way of following flowchart:



4.1.2 Classification of Equity (Financial Asset)

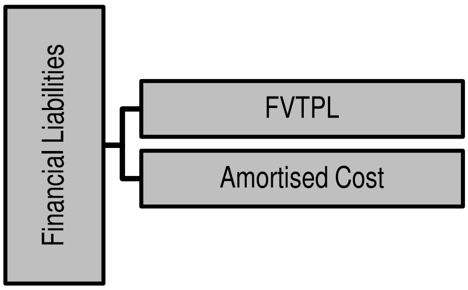
Classification of Equity which is a Financial Asset has been explained as follows:



4.1.3 Classification of Derivatives (Financial Asset)

Derivative classified as financial asset would be measured at Fair Value Through Profit and Loss (FVTPL) only. The classification of derivatives is only as per one basis i.e. Fair Value Through Profit and Loss (FVTPL)

4.2 Classification of Financial Liabilities



Financial Liabilities are classified as financial liability measured at fair value through profit or loss and financial liability measured at amortised cost.

4.3 Held for Trading

A financial asset or financial liability that:

1. Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
2. On initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
3. Is a derivative (**Except** for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

A Table showing classification of various items into Financial Asset or Financial Liability

S.No.	Items	Financial Instrument Whether Financial Asset (FA) or Financial Liability (FL)
1.	Cash	FA
2.	Cash Equivalents	FA
3.	Bank Balance	FA
4.	Deposits given	FA
5.	Deposits received	FL
6.	Trade and other Receivables	FA

7.	Trade and other Payables	FL
8.	Bills Receivable	FA
9.	Bills Payable	FL
10.	Loans including Bank Loan	FL
11.	Investments in Equity Shares	FA
12.	Investment in Debentures	FA
13.	Promissory Note to receive Government bonds	FA
14.	Promissory Note payable in Government Bonds	FL
15.	Perpetual Debt instrument held	FA
16.	Prepaid Expenses	Not a Financial Instrument
17.	Inventory	Not a Financial Instrument
18.	Property, Plant and Equipment	Not a Financial Instrument
19.	Intangible Assets	Not a Financial Instrument
20.	Advances given for goods and services	Not a Financial Instrument
21.	Advances received for goods and services	Not a Financial Instrument
22.	Deferred Revenue	Not a Financial Instrument
23.	Warranty obligations	Not a Financial Instrument
24.	Income Taxes	Not a Financial Instrument
25.	Financial Guarantee received	FA
26.	Financial Guarantee given	FL
27.	Finance Lease – Lessor	FA
28.	Finance Lease – Lessee	FL
29.	Operating Lease – Lessor	Not a Financial Instrument
30.	Operating Lease – Lessee	Not a Financial Instrument
31.	Gold	Not a Financial Instrument
32.	Gold bond held	FA

5. Recognition of Financial Instrument

Initial recognition

An entity shall recognise a financial asset or a financial liability in its balance sheet **when, and only when**, the entity becomes party to the contractual provisions of the instrument.

The above principle will be applied on the following:

5.1 Receivables and Payables

Unconditional receivables and payables are recognised as financial assets or financial liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

5.2 Firm Commitment to Purchase or Sell Goods or Services

Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement.

For example: An entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered.

5.3 Forward Contract

A forward contract that is within the scope of this Standard is recognised as a financial asset or a financial liability on the commitment date, instead of on the date on which settlement takes place.

When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

5.4 Option Contracts

Option contracts that are within the scope of this Standard are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

5.5 Planned Future Transactions

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

5.6 Regular Way Purchase or Sale of Financial Assets

A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame is established generally by regulation or convention in the market place concerned.

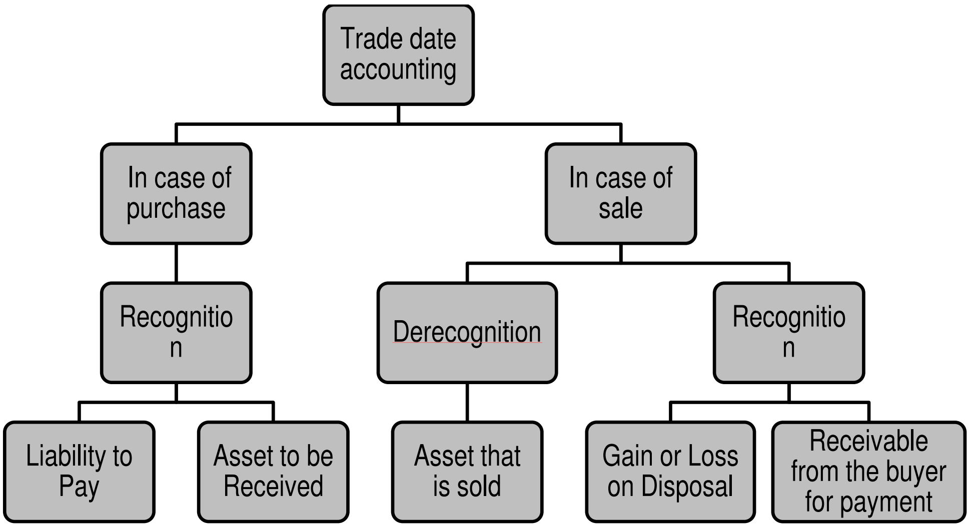
A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting.

Note: A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

6. Trade Date

The trade date is the date that an entity **commits itself to purchase or sell an asset.**

Trade date Accounting:

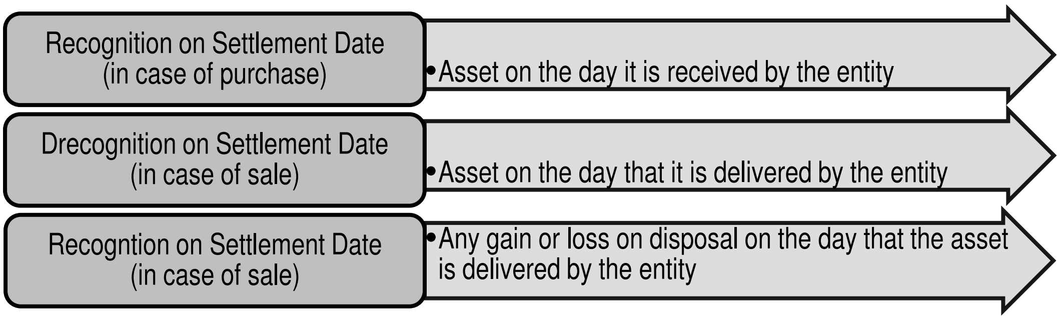


Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

7. Settlement Date

The settlement date is the date that an **asset is delivered to or by an entity.**

Settlement date Accounting:



When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in profit or loss for assets classified as financial assets measured at fair value through profit or loss; and it is recognised in other comprehensive income for financial assets measured at fair value through other comprehensive income.

Illustration 6

Let us say on 30th March 2015 an entity enters into an agreement to purchase a Financial Asset for ₹ 100 which is the Fair Value on that date.

On Balance Sheet date i.e. 31/3/2015 the Fair Value is 102 and on Settlement date i.e. 2/4/2015 Fair Value is 103.

Pass necessary Journal entries on trade date and settlement date when the asset acquired is measured at

(a) Amortised cost

(b) FVTPL

(c) FVTOCI

Solution

Financial Asset at Amortised Cost – Trade Date Accounting

Dates	Journal Entry	Amount	Amount
30/3/2015	Financial Asset Dr.	100	
	To Payables		100
31/3/2015	No Entry		
2/4/2015	Payables Dr.	100	
	To Cash		100

Financial Asset at Amortised Cost – Settlement Date Accounting

Dates	Journal Entry	Amount	Amount
30/3/2015	No Entry		
31/3/2015	No Entry		
2/4/2015	Financial Asset Dr.	100	
	To Cash		100

Financial Asset at FVTPL – Trade Date Accounting

Dates	Journal Entry	Amount	Amount
30/3/2015	Financial Asset Dr.	100	
	To Payables		100
31/3/2015	Financial Asset Dr.	2	
	To P&L		2
2/4/2015	Financial Asset Dr.	1	
	To P&L		1
	Payables Dr.	100	
	To Cash		100

Financial Asset at FVTPL– Settlement Date Accounting

Dates	Journal Entry		Amount	Amount
30/3/2015	No Entry			
31/3/2015	Fair Value Change	Dr.	2	
	To P&L			2
2/4/2015	Fair Value Change	Dr.	1	
	To P&L			1
	Financial Asset	Dr.	103	
	To Cash			100
	To Fair Value Change			3

Financial Asset at FVTOCI – Trade Date Accounting

Dates	Journal Entry		Amount	Amount
30/3/2015	Financial Asset	Dr.	100	
	To Payables			100
31/3/2015	Financial Asset	Dr.	2	
	To OCI			2
2/4/2015	Financial Asset	Dr.	1	
	To OCI			1
	Payables	Dr.	100	
	To Cash			100

Financial Asset at FVTOCI – Settlement Date Accounting

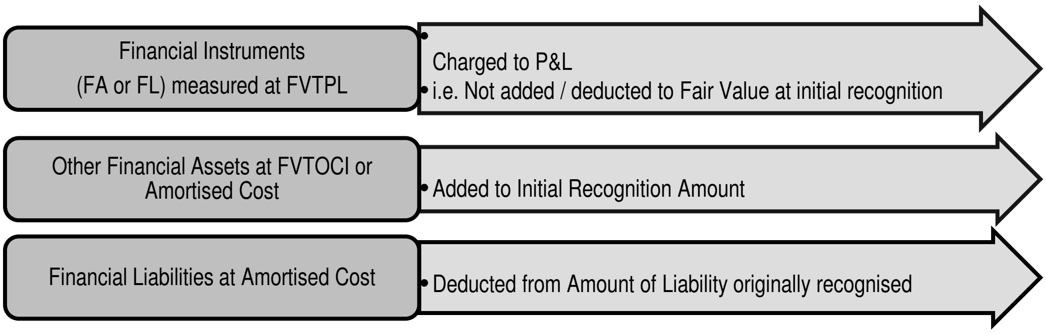
Dates	Journal Entry		Amount	Amount
30/3/2015	No Entry			
31/3/2015	Fair Value Change	Dr.	2	
	To OCI			2
2/4/2015	Fair Value Change	Dr.	1	
	To OCI			1
	Financial Asset	Dr.	103	
	To Cash			100
	To Fair Value Change			3

8. Measurement of Financial Instruments

8.1 Initial measurement

At **initial recognition**, an entity shall measure a financial asset or financial liability at its **fair value plus or minus**, in the case of a financial asset or financial liability not subsequently measured at Fair Value Through Profit or Loss, **transaction costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Transaction Costs for Initial Recognition



Transaction Costs on Disposal or Transfer are not included in measurement of all categories of Financial Assets and Financial Liabilities. These are charged to Profit and Loss.

If the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply as under:

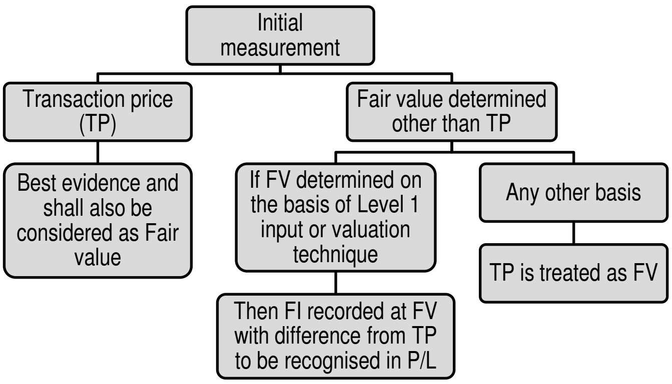
The best evidence of the fair value of a financial instrument at **initial recognition is normally the transaction price** (i.e. the fair value of the consideration given or received - Ind AS 113, Fair Value Measurements).

If an entity determines that the **fair value at initial recognition which differs from the transaction price** as mentioned above, the entity shall account for that instrument at that date as follows:

a. At the measurement if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. Level 1 input) or based on a valuation technique that uses only data from observable markets.

An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

b. In all other cases, Fair Value is adjusted to defer the difference between the fair value at initial recognition and the transaction price. i.e. Transaction Price is treated as Fair Value.



8.2 Subsequent Measurement of Financial Assets

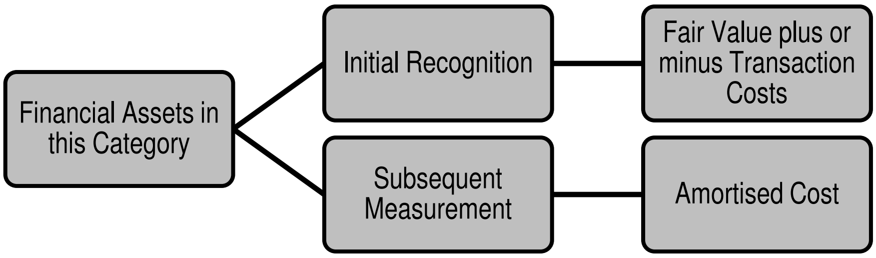
8.2.1 Financial Asset Subsequently Measured at Amortised Cost

A financial asset shall be measured at amortised cost **if both of the following conditions are met**:

A. The financial asset is held within a **business model** whose objective is to hold financial assets in order to **collect contractual cash flows**

And

B. The contractual terms of the financial asset give rise on specified dates to cash flows that are **solely payments of principal and interest (SPPI) on the principal amount outstanding**



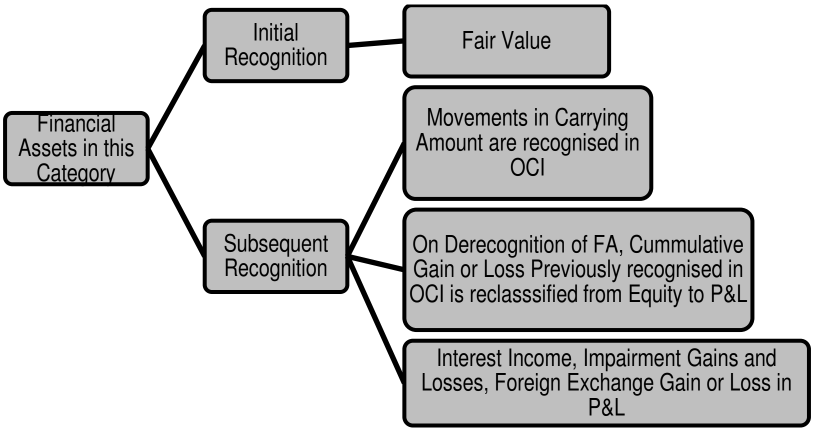
8.2.2 A Financial Asset Subsequently Measured at Fair Value Through Other Comprehensive Income (FVTOCI)

(Applicable to Debt and Equity Instruments both)

A financial asset shall be measured at fair value through other comprehensive **income if both of the following conditions are met:**

(i) The financial asset is held within a business model whose objective is achieved by **both collecting contractual cash flows and selling financial assets;** and

(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are **solely payments of principal and interest (SPPI) on the principal amount outstanding**



8.2.3 A Financial Asset Subsequently Measured At Fair Value Through Profit or Loss

(Residuary Category)

A financial asset shall be measured at fair value through profit or loss **unless** it is measured at amortised cost or at fair value through other comprehensive income.

However, an entity may make an **irrevocable selection at initial recognition** for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income.

8.2.4 Option to designate a Financial Asset at Fair Value Through Profit or Loss

An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different basis.

Illustration 7 (Financial Asset Accounted as FVTPL)

A Company invested in Equity shares of another entity on 15th March for ₹ 10,000. Transaction Cost = ₹ 200 (not included in ₹ 10,000)

Fair Value on Balance Sheet date i.e. 31st March 2015 = ₹ 12,000. Pass necessary Journal Entries

Solution

Date	Particulars	Dr	Cr
15/3/2015	Investment A/c Dr. Transaction Cost A/c Dr. To Bank	10,000 200	 10,200
31/3/2015	Investment A/c Dr. To Fair Value Gain A/c	2,000	 2,000
31/3/2015	P&L A/c Dr. To Transaction Cost A/c	200	 200
31/3/2015	Fair Value Gain A/c Dr. To P&L A/c	2,000	 2,000

Illustration 8 (Financial Asset Accounted as FVTOCI)

A Company invested in Equity shares of another entity on 15th March for ₹ 10,000. Transaction Cost = ₹ 200 (not included in ₹ 10,000). Fair Value on Balance Sheet date i.e. 31st March 2015 = ₹ 12,000. Pass necessary Journal entries.

Solution

Date	Particulars	Dr	Cr
15/3/2015	Investment A/c Dr. To Bank	10,200	 10,200

31/3/2015	Investment A/c Dr. To Fair Value Gain A/c	1,800	 1,800
31/3/2015	Fair Value Gain A/c Dr. To OCI A/c	1,800	 1,800
31/3/2015	OCI A/c Dr. To Fair Value Reserve A/c	1,800	 1,800

Illustration 9 (Financial Asset Accounted as Amortised Cost)

A Company lends ₹ 100 lacs to another company @ 12% p.a. interest on 1/4/2015.

It incurs ₹ 40,000 incremental costs for documentation.

Loan tenure = 5 years with Interest charged annually.

Fair Value of Loan = 99,40,000 (100 lacs – 1 lac + 40,000). Pass necessary Journal entries.

Solution

This is based on the assumption that interest rate is based on market rate of interest.

Date	Particulars	Dr	Cr
1/4/2015	Loan A/c To Bank A/c	100 lacs	 100 lacs
1/4/2015	Loan Processing Expense A/c To Bank A/c	40,000	 40,000
1/4/2015	Loan A/c To Loan Processing Expense A/c	40,000	 40,000

Subsequent entries would be explained under subsequent measurement basis.

8.3 Subsequent Measurement of Financial Liabilities

8.3.1 Financial Liabilities Subsequently Measured at Amortised Cost

An entity shall classify **all financial liabilities** as subsequently measured at amortised cost **except as discussed below.**

8.3.2 Financial Liabilities Subsequently Measured at Fair Value Through Profit or Loss (FVTPL)

a. Financial liabilities at fair value through profit or loss.

   Such liabilities, including **derivatives** that are liabilities, shall be subsequently measured at fair value.

b. Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the involvement approach applies.

c. Financial guarantee contracts.

d. Commitments to provide a loan at a below-market interest rate.

e. Contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

8.3.3 Option to Designate a Financial Liability at Fair Value Through Profit or Loss

An entity may, at initial recognition, **irrevocably designate a financial liability** as measured at fair value through profit or loss when permitted, or when doing so results in more relevant information, because either:

a. it **eliminates or significantly reduces a measurement or recognition inconsistency** (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

b. a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a **documented risk management or investment strategy,** and information about the group is provided internally on that basis to the entity's key management personnel (as defined in Ind AS 24 Related Party Disclosures).

   For example: The entity's board of directors and chief executive officer.

Illustration 10

An entity is about to purchase a portfolio of fixed rate assets that will be financed by fixed rate debentures. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Comment?

Solution

In the absence of the fair value option, the entity may have classified the fixed rate assets as FVTOCI with gains and losses on changes in fair value recognised in other comprehensive income and the fixed rate debentures at amortised cost. Reporting both the assets and the liabilities at fair value through profit and loss i.e. FVTPL corrects the measurement inconsistency and produces more relevant information.

FVTOCI Category for Debt Instrument and Equity – Significant Differences

There are significant differences between Debt and Equity being classified as FVTOCI.

FVTOCI Categorisation	• For Debt compulsory if conditions met • For Equity it is Optional if not held for Trading
Recognition of Interest Income, Impairment Gain/loss & Foreign Exchange Gain/Loss	• For Debt Recognised in P&L • For Equity only dividend income is recognised in P&l. All other gains or losses are recognised in OCI.
On Derecognition of FA, Cummulative Gains/Losses recognised in OCI are recycled from Equity to P&L	• For Debt - Yes • For Equity - No

An Overview for Measurement of Financial Assets

S.No.	Particulars	Amortised Cost	FVTOCI (Debt)	FVTPL	FVTOCI (Equity)
1.	Debt	Yes	Yes	Yes	No
2.	Equity	No	No	Yes	Yes
3.	Derivatives	No	No	Yes	No
4.	On Balance sheet date	Amortised cost	Fair Value	Fair Value	Fair Value
5.	Transaction Cost on Initial Recognition	Added	Added	Charged to P&L	Added
6.	Transaction Cost on Subsequent Accounting	Indirectly amortised to P&L	Transferred to OCI and amortised to P&L	NA	Transferred to OCI
7.	Revaluation on Balance Sheet (Changes in Fair Value)	No	Yes through OCI	Yes through P&L	Yes Through OCI
8.	Interest and Dividends	P&L	P&L	NA	P&L
9.	Impairment Losses	P&L	P&L	NA	OCI
10.	Foreign Exchange Gain or Loss	P&L	P&L	NA	OCI
11.	Gain or loss on de-recognition	P&L	Transferred from OCI to P&L	NA	OCI (Recycling not allowed)

An Overview for Measurement of Financial Liabilities

S.No.	Particulars	Amortised Cost	Held for Trading	Designated as FVTPL
1.	On Balance Sheet Date	Amortised Cost	Fair Value	Fair Value
2.	Transaction Cost – on Initial Recognition	Deducted	Charged to P&L	Charged to P&L
3.	Transaction Cost – On Subsequent Accounting	Amortised to P&L	NA	NA

4.	Gain or loss due to changes in own credit risk	NA	P&L	OCI
5.	Other gain or loss	NA	P&L	P&L
6.	Interest	P&L	NA	NA
7.	Foreign Exchange Gain or Loss	P&L	NA	NA

9. Reclassification of Financial Assets and Liabilities

When, and only when, an entity **changes its business model for managing** financial assets it shall reclassify all affected financial assets.

Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties.

Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations;

For example:

When the entity has acquired, disposed of or terminated a business line.

Examples of a change in business model include the following:

a. An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

b. A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

The following are not changes in business model:

a. A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

b. The temporary disappearance of a particular market for financial assets.

c. A transfer of financial assets between parts of the entity with different business models.

An entity shall not reclassify any financial liability.

Reclassification of Financial Asset

If an entity reclassifies financial assets, it shall apply the reclassification **prospectively** from the reclassification date.

The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

From Amortised Cost to	•FVTPL •FVTOCI
From FVTPL to	•Amortsied Cost •FVTOCI
From FVTOCI to	•Amortised Cost •FVTPL

CASE I

AMORTISED COST TO FVTPL

- Its fair value is measured at the reclassification date.
- Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Example:

Bonds for ₹ 1,25,000 reclassified as FVTPL

Fair Value on reclassification ₹ 90,000

Bonds (FVTPL) A/c	Dr.	90,000	
P&L A/c	Dr.	35,000	
To Bonds (Amortised Cost) A/c			1,25,000

CASE II

AMORTISED COST TO FVTOCI

- Its fair value is measured at the reclassification date.
- Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income.
- The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.

Example:

Bonds for ₹ 1,25,000 reclassified as FVTOCI

Fair Value on reclassification ₹ 90,000

Bonds (FVTOCI) A/c	Dr.	90,000	
OCI A/c	Dr.	35,000	
To Bonds (Amortised Cost) A/c			1,25,000

CASE III

FVTPL TO AMORTISED COST

- Its fair value at the reclassification date becomes its new gross carrying amount.
- Effective Interest rate is calculated based on the new gross carrying amount.

Example:

Bonds for ₹ 1,25,000 reclassified as FVTPL

Fair Value on reclassification ₹ 90,000

Bonds (Amortised Cost) A/c	Dr.	90,000	
P&L A/c	Dr.	35,000	
To Bonds (FVTPL) A/c			1,25,000

CASE IV

FVTPL TO FVTOCI

- The financial asset continues to be measured at fair value.
- The effective interest rate is determined on the basis of the fair value of the asset at the reclassification date.

Example:

Bonds for ₹ 1,25,000 reclassified as FVTOCI

Fair Value on reclassification ₹ 90,000

Bonds (FVTOCI) A/c	Dr.	90,000	
OCI A/c	Dr.	35,000	
To Bonds (Amortised Cost) A/c			1,25,000

CASE V

FVTOCI TO AMORTISED COST

- The financial asset is reclassified at its fair value at the reclassification date.
- However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date.
- As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment.
- The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.

Example:

Bonds for ₹ 1,25,000 reclassified as Amortised Cost

Fair Value on reclassification ₹ 90,000

Bonds (Amortised Cost) A/c	Dr.	90,000	
OCI A/c	Dr.	35,000	
To Bonds (FVTOCI) A/c			1,25,000

CASE VI

FVTOCI TO FVTPL

- The financial asset continues to be measured at fair value.
- The cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

Example:

Bonds for ₹ 1,25,000 reclassified as FVTPL

Fair Value on reclassification ₹ 90,000

Bonds (FVTPL) A/c	Dr.	90,000	
OCI A/c	Dr.	35,000	
To Bonds (FVTOCI) A/c			1,25,000

10. Derecognition of Financial Instruments

10.1 Derecognition of Financial Assets

An entity shall derecognise a financial asset **when, and only when:**

a) the contractual rights to the cash flows from the financial asset expire, or

b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6 of Ind AS 109.

On derecognition of a financial asset in its entirety, the difference between:

a) the carrying amount (measured at the date of derecognition) and

b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

10.2 Derecognition of Financial Liabilities

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expired.

NOTE:

1. An **exchange between an existing borrower and lender of debt instruments with substantially different terms** shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
2. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, **shall be recognised in profit or loss.**

Illustration 11

Sea Ltd. has lent a sum of ₹ 10 lakhs @ 18% per annum for 10 years. The loan had a Fair Value of ₹ 12,23,960 at the effective interest rate of 13%. To mitigate prepayment risks but at the same time retaining control over the loan, Sea Ltd. transferred its right to receive the Principal amount of the loan on its maturity with interest, after retaining rights over 10% of principal and 4% interest that carries Fair Value of ₹ 29,000 and ₹ 1,84,620 respectively. The consideration for the transaction was ₹ 9,90,000. The interest component retained included a 2% fee towards collection of principal and interest that has a Fair Value of ₹ 65,160. Defaults, if any, are deductible to a maximum extent of the company's claim on Principal portion. You are required to show the Journal Entries to record derecognition of the Loan.

Solution:

(i) Calculation of securitized component of loan

		₹	₹
Fair Value			12,23,960
Less: Principal strip receivable (fair value)		29,000	
Less: Interest strip receivable (fair value)	1,19,460		
Less: Value of service asset (fair value)	65,160	1,84,620	(2,13,620)
			10,10,340

(ii) Apportionment of carrying amount in the ratio of fair values

	Fair value (₹)		Apportionment (₹)
Securitized component of loan	10,10,340	$\frac{10,10,340 \times 10,00,000}{12,23,960}$	8,25,468
Principal strip receivable	29,000	$\frac{29,000 \times 10,00,000}{12,23,960}$	23,694
Interest strip receivable	1,19,460	$\frac{1,19,460 \times 10,00,000}{12,23,960}$	97,601

Servicing asset	65,160	$\frac{65,160 \times 10,00,000}{12,23,960}$	53,237

(iii) Entries to record the derecognition of the Loan

	₹	₹	₹
Bank A/c	Dr.	9,90,000	
To Loan A/c			8,25,468
To Profit & Loss A/c			1,64,532
(Being entry for securitization of 90% principal with 14% interest)			
Interest strip A/c	Dr.	97,601	
Servicing asset A/c	Dr.	53,237	
Principal strip A/c	Dr.	23,694	
To Loan A/c			1,74,532
(Being entry for interest, servicing asset and principal strips received)			

Illustration 12 (Factoring with / without recourse)

Entity A (the transferor) holds a portfolio of receivables with a carrying value of ₹ 1,000,000. It enters into a factoring arrangement with entity B (the transferee) under which it transfers the portfolio to entity B in exchange for ₹ 900,000 of cash.

Entity B will service the loans after their transfer and debtors will pay amounts due directly to entity B. Entity A has no obligations whatsoever to repay any sums received from the factor and has no rights to any additional sums regardless of the timing or the level of collection from the underlying debts. Comment.

Solution

Entity A has transferred its rights to receive the cash flows from the asset via an assignment to entity B. Furthermore, as entity B has no recourse to entity A for either late payment risk or credit risk, entity A has transferred substantially all the risks and rewards of ownership of the portfolio.

Hence, entity A derecognises the entire portfolio. The difference between the carrying value of ₹ 1,000,000 and cash received of ₹ 900,000 i.e. ₹ 100,000 is recognised immediately as a loss on derecognition of assets classified at amortised cost in profit or loss.

Had Entity A not transferred its rights to receive the cash flows from the asset or there would have been any credit default guarantee given by entity A, then it would have not led to complete transfer of risk and rewards and entity A could not derecognise the portfolio due to the same. Hence, the asset is recognised to the extent of continuing involvement.

11. Impairment of Financial Assets

11.1 Recognition of expected credit losses

An entity shall recognise a loss allowance for expected credit losses:

- On a financial asset that is measured at Amortised Cost or FVTOCI
- A lease receivable
- A loan commitment and
- A financial guarantee contract to which the impairment requirements apply

11.2 Credit Loss

The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash short falls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (For example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

Measurement of expected credit losses

An entity shall measure expected credit losses of a financial instrument in a way that reflects:

a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

b) the time value of money; and

c) Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

CASE I

Credit Risk on that Financial Instrument has Increased Significantly since Initial Recognition

At each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the **lifetime expected credit losses** if the credit risk on that financial instrument has increased significantly since initial recognition.

CASE II

Credit Risk on a Financial Instrument has not Increased Significantly Since Initial Recognition

If, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to **12-month expected credit losses.**

12 MONTH EXPECTED CREDIT LOSS (ECL) MEASUREMENT - PROBABILITY OF DEFAULT (POD) APPROACH

Facts:

Entity as a lender – Single 10 year loan for ₹ 1 million

At initial recognition, the POD over the next 12 months is 0.5%

Loss given default (LGD) is determined to be 25% of gross carrying amount

Assessment:

At reporting date, no change in 12-month POD; and entity assesses that no significant increase in credit risk since initial recognition – therefore Lifetime ECL is not required to be recognised

Loan	₹ 1,000,000	A
LGD	25%	B
POD - 12 months	0.5%	C
Loss allowance (for 12-month ECL)	₹ 1,250	A x B x C

12 MONTH EXPECTED CREDIT LOSS (ECL) MEASUREMENT - LOSS RATE (LR) APPROACH

Facts:

Bank as a lender – 2,000 bullet loans with total gross carrying amount of ₹ 5,00,000

Portfolio segmented into borrower groups (X and Y) based on shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a GCV per client of ₹ 200, for a total GCV of ₹ 200,000. Similarly, the GCV per client is ₹ 300 and the total GCV is ₹ 3,00,000 for Y.

Historical defaults per 1000 loans sample: 4 defaults (Grp X) and 2 defaults (Grp Y)

Assessment:

Bank considers forward looking information and expects an increase in defaults over the next 12 months compared to the historical rate: 5 defaults (Grp X) and 3 defaults (Grp Y)

At reporting date, the entity assesses that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios – therefore Lifetime ECL is not considered.

Group	Client in sample	Estimated GCV per client	Expected defaults	Estimated GCV at default	PV of Observed Loss (note)	Loss Rate
	A	B	C	D = BxC	E	E /BXA
	1000	200	5	1000	750	0.375%
	1000	300	3	900	675	0.225%

These Loss rates are then used to estimate 12 month ECL on new loans in Group X and Group Y that originated during the year and for which the credit risk has not increased significantly since initial recognition.

Note: In accordance with the standard, expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.

LIFETIME EXPECTED CREDIT LOSS (LECL) MEASUREMENT - PROVISION MATRIX FOR SHORT TERM TRADE RECEIVABLES

Facts:

Manufacturer M with a portfolio of short term trade receivables (no financing component) from a large number of small clients

Assessment:

Loss allowance at an amount equal to Lifetime ECL (simplified approach for trade receivables)

Entity creates a provision matrix that is based on its historical observed default rates over the expected life of trade receivables and adjusts it for forward looking estimates.

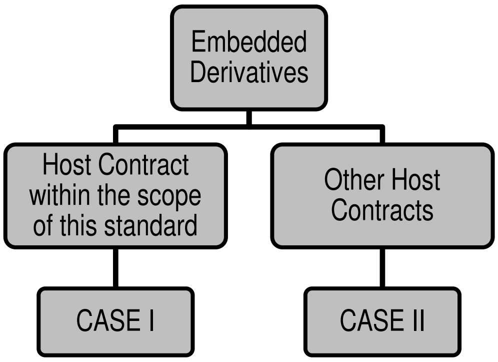
Age	Default Rate (A)	Gross Carrying Amount (B)	LECL Allowance (AxB)
Current	0.3%	150,00,000	45,000
1-30 days	1.6%	75,00,000	1,20,000
31- 60 days	3.6%	40,00,000	1,44,000
61- 90 days	6.6%	25,00,000	1,65,000
90 + days	10.6%	10,00,000	1,06,000
		300,00,000	5,80,000

12. Embedded Derivatives

An embedded derivative is a component of a hybrid contract that also includes a **non-derivative host**—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

12.1 Accounting Treatment of Embedded Derivatives



CASE I

If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements of classification and measurement rules to the entire hybrid contract.

CASE II

If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard **if, and only if**:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

   1. If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

   2. If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

13. Non-financial Contracts

Contracts to buy or sell non-financial items **do not meet the definition of a financial instrument** because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.

For example: Contracts that provide for settlement only by the receipt or delivery of a non-financial item (Example: An option, futures or forward contract on silver) are not financial instruments.

Many commodity contracts are of this type.

For example: A commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the **underlying commodity**.

The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument.

Nevertheless, **some contracts** to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments.

This Standard shall be applied to those contracts to buy or sell a non-financial item (Property, Plant and Equipment or Inventories) that can be as if the contracts were financial instruments

Exception: Contracts that were entered into and continue to be **held for the purpose of the receipt or delivery of a non-financial item** in accordance with the entity's expected purchase, sale or usage requirements.

This Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with Ind AS 109, Financial Instruments.

Illustration 13

Entity XYZ enters into a fixed price forward contract to purchase 10,00,000 kilograms of copper in accordance with its expected usage requirements.

The contract permits XYZ to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract covered under Financial Instruments standard?

Solution

The above contract needs to be evaluated to determine whether it falls within the scope of the financial instruments standards.

The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper and it is to be settled at a future date.

However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash, or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under Ind AS 109.

Instead, it is accounted for as an executory contract and if it becomes onerous then Ind AS 37 would apply.

14. Compound Financial Instruments

IND AS 32 applies only to issuers of non-derivative compound financial instruments.

It does not deal with compound financial instruments from the **perspective of holders**.

Ind AS 109 deals with the **classification and measurement** of financial assets that are compound financial instruments from the holder's perspective.

The **issuer of a non-derivative financial instrument** shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component.

An entity recognises separately the components of a financial instrument that

(a) creates a financial liability of the entity and

(b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

For example: A bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument.

From the perspective of the entity, such an instrument comprises two components:

- A financial liability (a contractual arrangement to deliver cash or another financial asset) and
- An equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

Accordingly, in all cases, the entity presents the liability and equity components separately in its balance sheet.

Accounting treatment:

Initial recognition:

The issuer of a bond convertible into ordinary shares:

Step I

Determines the carrying amount of the liability component by measuring the fair value of a similar liability that does not have an associated equity component

Explanation:

On initial recognition, the fair value of the liability component is the **present value** of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

Step II

The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by **deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole**

Subsequent Recognition:

On conversion of a convertible instrument **at maturity**, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

Illustration 14

On 1 April, 2015, Delta Ltd. issued ₹ 30,00,000, 6 % convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.19 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

Being compound financial instrument, ***you are required*** *to separate equity and debt portion as on 01.04.15.*

Solution:

Computation of Equity and Debt Component of Convertible Debentures as on 1.4.15

Present value of the principal repayable after four years	22,44,000
[30,00,000 x 1.10 x 0.680 at 10% Discount factor]	
Add: Present value of Interest	5,70,600
[1,80,000 x 3.17 (4 years cumulative 10% discount factor)]	
Value of debt component	28,14,600
Value of equity component	1,85,400
Proceeds of the issue	30,00,000

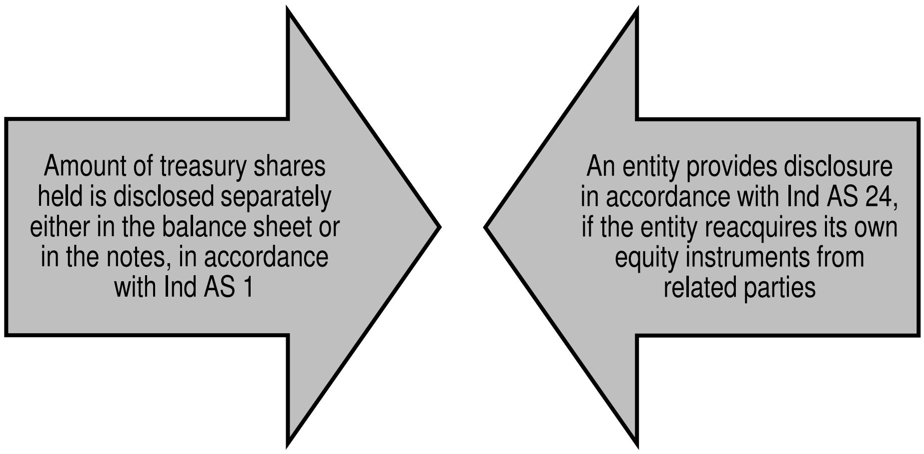
15. Treasury Shares (Entity's Own Equity Instruments)

An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.

However, when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

- If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity.

- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.
- Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.



Example:

A Limited buys back 1,00,000 of its own equity shares in the market for ₹ 5 per share. The shares will be held as treasury shares to enable A Limited to satisfy its obligations under its employee share option scheme. The following entry will be made to recognise the purchase of the treasury shares as a deduction from equity:

Dr Equity	₹ 5,00,000	
Cr Cash		₹ 5,00,000

16. Interest, Dividends, Losses and Gains

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.
- Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.
- Transaction costs of an equity transaction shall be accounted for as a deduction from equity.
- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12, Income Taxes.

The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.

Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond.

- An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
- Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.
- Dividends classified as an expense may be presented in the statement of profit and loss either with interest on other liabilities or as a separate item.

  {In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement of profit and loss. Disclosures of the tax effects are made in accordance with Ind AS 12.}
- Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

Illustration 15

Entity B places its privately held ordinary shares that are classified as equity with a stock exchange and simultaneously raises new capital by issuing new ordinary shares on the stock exchange.

Transaction costs are incurred in respect of both transactions. Determine the treatment of the incurred transactions costs?

Solution

Since the issue of new shares is the issue of an equity instrument, but the placing of the existing equity instruments with the exchange is not, the transaction costs will need to be allocated between the two transactions.

Transaction costs in respect of the new shares issued will be recognised in equity whereas the transaction costs incurred in placing the existing shares with the stock exchange will be recognised in profit or loss.

Illustration 16

An entity issues a non-redeemable callable subordinated bond with a fixed 6% coupon. The coupon can be deferred in perpetuity at the issuer's option. The issuer has a history of paying the coupon each year and the current bond price is predicated on the holder's expectation that the coupon will continue to be *paid each year. In addition, the stated policy of the issuer is that the coupon will be paid each year, which has been publicly communicated. Evaluate?*

Solution

Although there is both pressure on the issuer to pay the coupon, to maintain the bond price, and a constructive obligation to pay the coupon, there is no contractual obligation to do so. Therefore, the bond is classified as an equity instrument.

Illustration 17

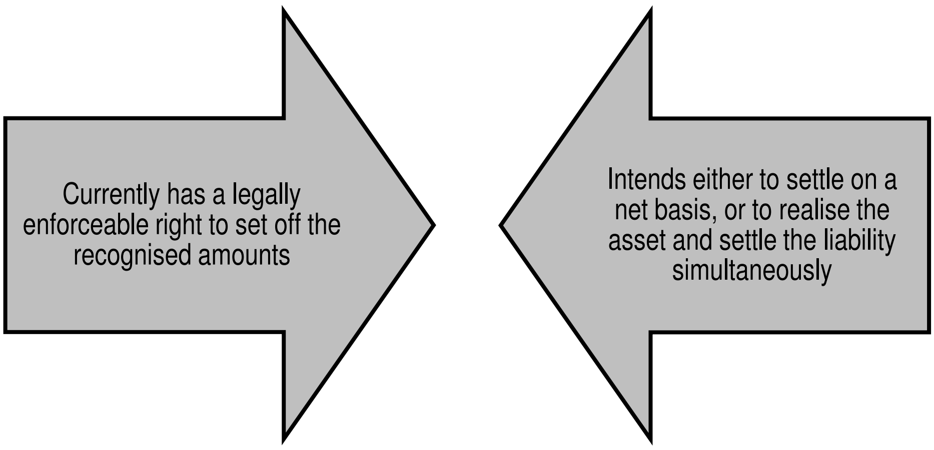
A zero coupon bond is an instrument where no interest is payable during the instrument's life and that is normally issued at a deep discount to the value at which it will be redeemed. Evaluate?

Solution

Although there are no mandatory periodic interest payments, the instrument provides for mandatory redemption by the issuer for a determinable amount at a fixed or determinable future date. Since there is a contractual obligation to deliver cash for the value at which the bond will be redeemed, the instrument is classified as a financial liability.

17. Offsetting a Financial Asset and a Financial Liability

A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:



Example: Company X owes Company Y Rs.20 million at the end of 31 March. As part of another contract, Company Y owes Company X Rs.15 million at 31 March. Company X has the legal right to set off the asset and liability but historically, Company X has settled one month after Company Y settles.

Can Company X offset the asset and liability?

No, since Company X cannot demonstrate the intention to settle net or simultaneously for all payments.

18. Analysis of Scope of Ind AS 32 and 109

Financial Instrument	Whether out of Scope?		Which Ind AS is Applicable
	Ind AS 109	Ind AS 32	
Subsidiaries	Yes	Yes	110/27
Associates	Yes	Yes	28/27
Joint Ventures	Yes	Yes	28/27
Rights and Obligations under Leases	Yes	No	17
Employers Rights and obligations under Employee Benefit Plans	Yes	Yes	19
Financial Instruments that meet the definition of equity Instrument			
Issuer point of view	Yes	No	32
Holders point of view	No	Yes	109
Rights and Obligations under an Insurance Contract	Yes	Yes	104
Financial Guarantee Contracts	No	No	32/109
Forward contract to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 *Business Combinations* at a future date	Yes	No	103
Loan commitments	Yes	No	37
Financial Instruments, Contracts and obligations under share based payment transactions	Yes	Yes	102
Reimbursement rights in respect of Provisions	Yes	No	37
Rights and obligations	Yes	No	115
Commodity Contracts to buy or sell Non-Financial Items net			
For expected purchase, sale or usage requirement	Yes	Yes	37
Not for Expected purchase, sale or usage requirement	No	No	32/109

19. HEDGE ACCOUNTING

19.1 Objective and Scope of Hedge Accounting

The objective of hedge accounting is to represent, in the financial statements, the **effect of an entity's risk management activities** that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

For the purpose of Hedge Accounting, an Entity should:

Identifies and designates Hedged Item	
Paragraph 6.3	Paragraph B6.3.1 to B6.3.25

↓

Designates Hedging Instruments	
Paragraph 6.2	Paragraph B6.2.1to B6.2.6

↓

Verifies whether Hedging satisfies Qualifying Criteria for Hedge Accounting	
Paragraph 6.4	Paragraph B6.4.1 to B6.4.19

Accounts for Qualifying Hedging Relationships	
Paragraph 6.5	Paragraph B6.5.1 to B6.5.39

↓

Consider whether it is a Hedge of a Group of Items i.e. Hedging Net Position	
Paragraph 6.6	Paragraph B6.6.1 to B6.6.16

↓

Evaluates the option to designate a credit exposure as measured at FVTPL
Paragraph 6.7

Identifies and designates Hedged Item

A hedged item can be:

- A Recognised Asset or Liability
- An Unrecognised Firm Commitment
- A Forecast Transaction
- A Net Investment in a Foreign Operation

The hedged item can be:

- a single item; or
- a group of items

NOTE:

1. The hedged item must be reliably measurable.
2. If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

19.2 Designation of Hedging Instruments

A derivative measured at fair value through profit or loss may be designated as a hedging instrument, **except for some written options** (Refer Paragraph B6.2.4).

A non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.

For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.

NOTE: For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e. external to the group or individual entity that is being reported on) can be designated as hedging instruments.

19.3 Qualifying Criteria For Hedge Accounting

A hedging relationship qualifies for hedge accounting ***only if all of the following criteria are met***:

a) The hedging relationship consists **only of eligible hedging instruments and eligible hedged items.**

b) At the inception of the hedging relationship there is **formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.** That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

c) The hedging relationship meets ***all of the following hedge effectiveness requirements***:

(i) there is an economic relationship between the hedged item and the hedging instrument (Refer Paragraphs B6.4.4– B6.4.6);

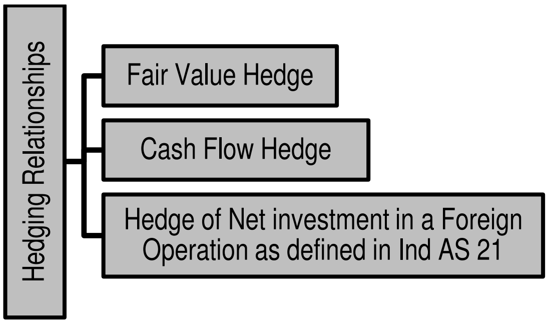
(ii) the effect of credit risk does not dominate the value changes that result from that economic relationship (Refer Paragraphs B6.4.7–B6.4.8); and

(iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (Refer Paragraphs B6.4.9–B6.4.11).

19.4 Types of Hedging Relationships

An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.

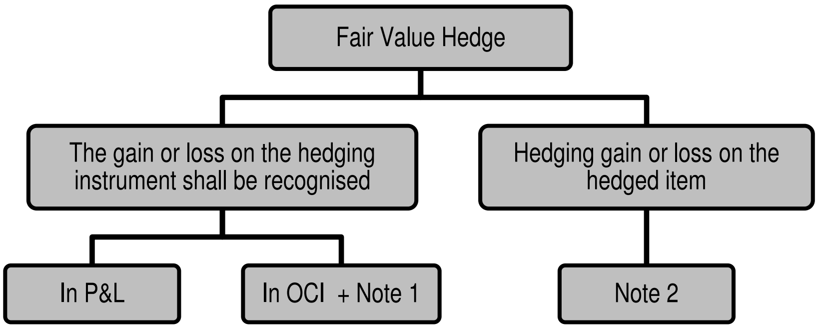
There are three types of hedging relationships:



19.4.1 Fair value hedge

A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

If a fair value hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:



Note:

1. If the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in OCI
2. Adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss.

   If the hedged item is a financial asset (or a component thereof) that is measured at FVTOCI, the hedging gain or loss on the hedged item shall be recognised in profit or loss.

   If the hedged item is an equity instrument for which an entity has elected to present changes in FVTOCI, those amounts shall remain in other comprehensive income.

   When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

19.4.2 Cash flow hedge

A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

As long as a cash flow hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:

a) **the separate component of equity associated with the hedged item** (CASH FLOW HEDGE RESERVE) is adjusted to the ***lower*** of the following (in absolute amounts):
   (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
   (ii) the cumulative change in fair value (present value) of the hedged item (i.e. the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

b) **the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge** (i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

(a) **any remaining gain or loss on the hedging instrument** (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is **hedge ineffectiveness** that shall be recognised in profit or loss.

(b) the amount that has been **accumulated in the cash flow hedge reserve in accordance with (a)** shall be accounted for as follows:
   (i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair

value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability.

[This is not a reclassification adjustment and hence it does not affect other comprehensive income.]

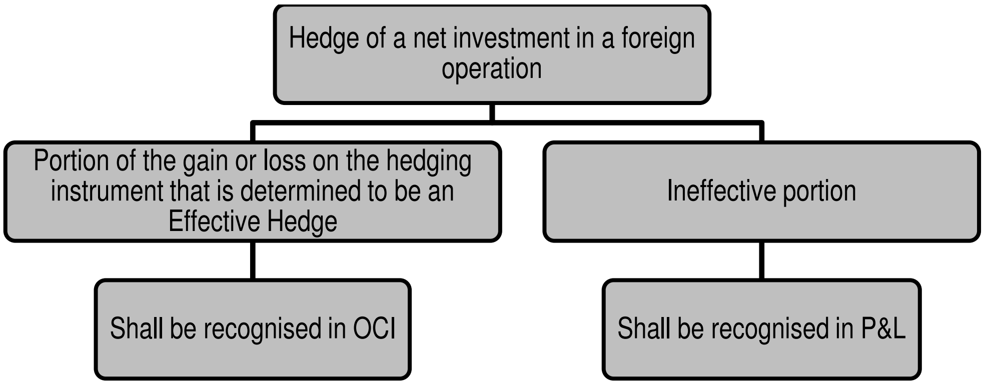
(ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss

For example: In the periods that interest income or interest expense is recognised or when a forecast sale occurs.

(iii) however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

19.5 Hedge of a Net Investment in a Foreign Operation as Defined in Ind AS 21

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (Refer Ind AS 21), shall be accounted for similarly to cash flow hedges:

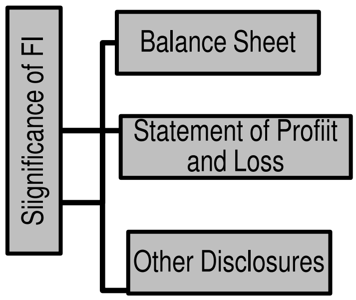


The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment (Refer Ind AS 1) in accordance with Ind AS 21 on the disposal or partial disposal of the foreign operation.

20. Disclosures

20.1 Significance of Financial Instruments for Financial Position and Performance

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.



20.2 Balance Sheet

<u>20.2.1 Categories of financial assets and financial liabilities</u>

The carrying amounts of each of the following categories, as specified in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

(a) financial assets measured at fair value through profit or loss, showing separately

- (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
- (ii) those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.

(b) financial liabilities at fair value through profit or loss, showing separately

- (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
- (ii) those that meet the definition of held for trading in Ind AS 109.

(c) financial assets measured at amortised cost.

(d) financial liabilities measured at amortised cost.

(e) financial assets measured at fair value through other comprehensive income, showing separately

- (i) financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109; and
- (ii) investment in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.

20.2.2 Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

(a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

  (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

  (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

20.2.3 Investments in equity instruments designated at fair value through other comprehensive income

If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by Ind AS 109, it shall disclose:

(a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

(b) the reasons for using this presentation alternative.

(c) the fair value of each such investment at the end of the reporting period.

(d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.

(e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

20.2.4 Reclassification

An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose:

(a) the date of reclassification.

(b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

(c) the amount reclassified into and out of each category.

20.2.5 Collateral

An entity shall disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and

(b) the terms and conditions relating to its pledge.

20.2.6 Allowance account for credit losses

The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the balance sheet as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

20.2.7 Compound financial instruments with multiple embedded derivatives

If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

20.2.8 Defaults and breaches

For loans payable recognised at the end of the reporting period, an entity shall disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

(b) the carrying amount of the loans payable in default at the end of the reporting period; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were approved for issue.

20.3 Statement of Profit and Loss

20.3.1 Items of Income, Expense, Gains or Losses

An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (e.g. financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

(ii) financial liabilities measured at amortised cost.

(iii) financial assets measured at amortised cost.

(iv) investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS 109.

(v) financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets and financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

20.4 Other Disclosures

20.4.1 Accounting policies

In accordance with Ind AS 1 Presentation of Financial Statements, an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

20.4.2 Hedge accounting

An entity shall apply the disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

(i) an entity's risk management strategy and how it is applied to manage risk;

(ii) how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(iii) The effect that hedge accounting has had on the entity's balance sheet, statement of profit and loss and statement of changes in equity.

20.4.3 Fair value

For each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

(b) For a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably.

20.4.4 Nature and Extent of Risks Arising from Financial Instruments

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Qualitative disclosures

For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) Any changes in (a) or (b) from the previous period.

Quantitative disclosures

For each type of risk arising from financial instruments, an entity shall disclose:

(a) Summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in Ind AS 24, Related Party Disclosures), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in accordance with (a).

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

21. Miscellaneous Illustrations

Illustration 18

XYZ Ltd. grants loans to its employees at 4% amounting to ₹ 10,00,000 at the beginning of 2015-16. The principal amount is repaid over a period of 5 years whereas the accumulated interest computed on reducing balance at simple interest is collected in 2 equal annual instalments after collection of the principal amount.

Assume the benchmark interest rate is 8%.

Show the accounting entries on 1-4-2015 and 31-3-2016.

Solution

Computation of Fair Value at Initial Recognition

Year	Estimated Cash Flows	PVIF @8%	Present Value
	₹		₹
1/4/2015		1	Nil
31/3/2016	2,00,000	0.9259	1,85,185
31/3/2017	2,00,000	0.8573	1,71,468
31/3/2018	2,00,000	0.7938	1,58,766
31/3/2019	2,00,000	0.7350	1,47,006
31/3/2020	2,00,000	0.6806	1,36,117
31/3/2021	60,000 See Working note	0.6302	37,810
31/3/2022	60,000 See Working note	0.5835	35,009
Fair Value of Loan			8,71,361

Working Notes:

Computation of Interest to be paid on 31/3/2021 and 31/3/2022

Year	Cash Flows	Principal outstanding	Interest	Cumulative Interest
	₹	₹	₹	₹
31/3/2016	2,00,000	8,00,000	40,000	40,000
31/3/2017	2,00,000	6,00,000	32,000	72,000
31/3/2018	2,00,000	4,00,000	24,000	96,000
31/3/2019	2,00,000	2,00,000	16,000	1,12,000
31/3/2020	2,00,000	Nil	8,000	1,20,000
31/3/2021	60,000			

	(1,20,000/2)			
31/3/2022	60,000 (1,20,000/2)			

Computation of Fair Value Loss

	₹
Fair Value of Loan	8,71,361
Loan Amount	10,00,000
Fair Value Loss	1,28,639

Journal Entry at Initial Recognition

Date	Particulars	Dr.	Cr.
		₹	₹
1/4/2015	Loans to Employee A/c Employee Benefits A/c To Bank A/c	8,71,361 1,28,639	 10,00,000

Note: The fair value measurement is of other than level 1. Therefore, as per paragraph B5.1.2A of Ind AS 109, an entity should defer the day 1 gain / loss over the term of the financial asset. Therefore, ₹ 1,28,369 will be amortised over a period of 7 years. There is no guidance on how to amortise the same. The simplest way is to amortise the difference in line with the interest accruals so that there is no impact on Profit or Loss.

Employee benefit is transferred to Statement of Profit and Loss.

Computation of Interest on Amortised Cost

Year	Opening Balance (1)	Interest @ 8% (2)	Repayment (3)	Closing Balance (1+2-3)
	₹	₹	₹	₹
1/4/2015				8,71,361
31/3/2016	8,71,361	69,709	2,00,000	7,41,070
31/3/2017	7,41,070	59,286	2,00,000	6,00,356
31/3/2018	6,00,356	48,028	2,00,000	4,48,384
31/3/2019	4,48,384	35,871	2,00,000	2,84,255
31/3/2020	2,84,255	22,740	2,00,000	1,06,995
31/3/2021	1,06,995	8,560	60,000	55,555
31/3/2022	55,555	4,445	60,000	Nil

Journal Entry on 31/3/2016

Date	Particulars	Dr.	Cr.
		₹	₹
31/3/2016	Loans to Employee A/c To Interest Accrued A/c	69,709	 69,709
31/3/2016	Bank A/c To Loan to Employees	2,00,000	 2,00,000

Note: Similar entries would be done at the end of each year.

Illustration 19

ABC Ltd. issued Debentures amounting to ₹ 100 lacs.

As per the terms of the issue it has been agreed to issue equity shares amounting to ₹ 150 lacs to redeem the debentures at the end of 3rd year.

Assume comparable market yield is 10% for year 0 and 1, and 10.5% for Year 2 end.

Show accounting entries.

Solution:

Value of Debentures to be recorded at initial year:

Present Value of 150 lacs at 10%

= 150 lacs x PVIF (10% at the end of 3rd year)

= 150 lacs x 0.7513

= 112,69,500

Journal Entries at Inception:

Date	Particulars	Dr.	Cr.
1st Year Beg	Bank A/c Dr. Profit & Loss A/c To Debentures	100,00,000 12,69,500	 112,69,500

Journal Entries at 1st Year End:

Date	Particulars	Dr.	Cr.
1st Year End	Interest A/c Dr. To Debentures A/c (10% of 112,69,500)	11,26,950	 11,26,950

Journal Entries at 2nd Year End:

Date	Particulars	Dr.	Cr.
2nd Year End	Interest A/c To Debentures A/c	11,78,550	 11,78,550

Working Note:

Present Value of 150 lacs at 10.5% compared to Book Value

i.e. 150 lacs x 0.905 = 135,75,000 compared to 123,96,450 = 11,78,550

Journal Entries at 3rd Year End:

Date	Particulars	Dr.	Cr.
3rd Year End	Interest A/c	14,25,000	
	To Debentures A/c		14,25,000

Working Note:

Present Value of 150 lacs at 10.5% compared to Book Value

i.e. 150 lacs x 1 = 150,00,000 compared to 135,75,000 = 14,25,000

On conversion to Equity Shares

Date	Particulars	Dr.	Cr.
3rd Year End	Debentures A/c	150,00,000	
	To Equity Share Capital		100,00,000
	To Securities Premium		50,00,000

Illustration 20

As point of staff welfare measures, Y Co. Ltd. has contracted to lend to its employees sums of money at 5 percent per annum rate of interest. The amounts lent are to be repaid alongwith the interest in five equal annual instalments. The market rate of interest is 10 per cent per annum.

Y lent ₹ 16,00,000 to its employees on 1st January, 2015.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31st December, 2015 for the transaction and also calculate the value of the loan initially to be recognized and the amortized cost for all the subsequent years.

For purposes of calculation, the following discount factors at interest rate of 10 percent may be adopted

At the end of year

1	*.909*
2	*.827*
3	*.751*
4	*.683*
5	*.620*

Solution:

(i) Calculation of initial recognition amount of loan to employees

Year end	Cash Inflow		Total	P.V. factor @10%	Present value
	Principal ₹	Interest @ 5% ₹	₹		₹
2015	3,20,000	80,000	4,00,000	0.909	3,63,600
2016	3,20,000	64,000	3,84,000	0.827	3,17,568
2017	3,20,000	48,000	3,68,000	0.751	2,76,368
2018	3,20,000	32,000	3,52,000	0.683	2,40,416
2019	3,20,000	16,000	3,36,000	0.620	2,08,320
Present value or Fair value					14,06,272

(ii) Calculation of amortised cost of loan to employees

Year	Amortised cost (Opening balance) [1] ₹	Interest to be recognised@10% [2] ₹	Repayment (including interest) [3] ₹	Amortised Cost (Closing balance) [4]=[1]+ [2]–[3] ₹
2015	14,06,272	1,40,627	4,00,000	11,46,899
2016	11,46,899	1,14,690	3,84,000	8,77,589
2017	8,77,589	87,759	3,68,000	5,97,348
2018	5,97,348	59,735	3,52,000	3,05,083
2019	3,05,083	30,917*	3,36,000	Nil

* ₹ 3,05,083 x 10% = ₹ 30,508. The difference of ₹ 409 (₹ 30,917 – ₹ 30,508) is due to approximation in computation.

(iii) Journal Entries in the books of Y Ltd.

For the year ended 31st December, 2015 (regarding loan to employees)

	Dr. Amount (₹)	Cr. Amount (₹)
Staff loan A/c Dr.	16,00,000	
To Bank A/c		16,00,000
(Being the disbursement of loans to staff)		
Staff cost A/c* ₹ (16,00,000 –14,06,272) [Refer part (ii)] Dr.	1,93,728	
To Staff loan A/c		1,93,728
(Being the write off of excess of loan balance over present value thereof in order to reflect the loan at its present value of ₹ 14,06,272)		

* This is a level 2 measurement and therefore should be deferred as per paragraph 5.1.2A instead of recognising on day 1.

Staff loan A/c	Dr.	1,40,627	
To Interest on staff loan A/c			1,40,627
(Being the charge of interest @ market rate of 10% on the loan)			
Bank A/c	Dr.	4,00,000	
To Staff loan A/c			4,00,000
(Being the repayment of first instalment with interest for the year)			
Interest on staff loan A/c	Dr.	1,40,627	
To Profit and loss A/c			1,40,627
(Being transfer of balance of staff loan Interest account to profit and loss account)			

Illustration 21

K Ltd. issued 5,00,000, 6% Convertible Debentures of ₹ 10 each on the 1st April 2015. The debentures are due for redemption on 31st March, 2019 at a premium of 10% convertible into equity shares to the extent of 50% and the balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%. You are required to separate the debt & equity components at the time of the issue and show the accounting entry in the company's books at initial recognition.

The following Present Values of ₹ 1 at 6% and at 10% are supplied to you.

Interest Rate	Year 1	Year 2	Year3	Year 4
6%	0.94	0.89	0.84	0.79
10%	0.91	0.83	0.75	0.68

Solution

Computation of Debt Component of Convertible Debentures as on 1.4.2015

Particulars	₹
Present value of the principal repayable after four years [50,00,000 x 50% × 1.10 × 0.68 (10% Discount factor)] (a)	18,70,000
Present value of Interest [3,00,000 x 3.17 (4 years cumulative 10% discount factor)] (b)	9,51,000
Total present Value of debt component (I) (a + b)	28,21,000
Issue proceeds from convertible debenture (II)	50,00,000
Value of equity component (II – I)	21,79,000

Journal entry at initial recognition

		Dr. (₹)	*Cr. (₹)*
Cash / Bank A/c	Dr.	50,00,000	
To 6% Debenture (Liability component) A/c			28,21,000
To 6% Debenture (Equity component) A/c			21,79,000
(Being the disbursement recorded at fair value)			

7

Share-Based Payments

<u>Reference:</u> The students are advised to refer the full text of the Guidance Note on Accounting for Employee Share-based Payments. This Guidance Note was issued in 2005 and deals with share-based payment to employees only.

Earlier Securities and Exchange Board of India (SEBI) issued Employees Stock Option Scheme and Employee Stock Purchase Scheme Guidelines (applicable for listed companies) in 1999 under section 11 of the Securities and Exchange Board of India Act, 1992. This guideline has now been replaced by the SEBI (Share Based Employee Benefits) Regulations, 2014 (applicable for listed companies). It covers the provisions regarding accounting policies, pricing, disclosures, administration and implementation process of various schemes and other issues relating to Employee Stock Option Scheme (ESOS), Employee Stock Purchase Scheme (ESPS), Stock Appreciation Rights Scheme (SRS), General Employee Benefits Scheme (GEBS) and Retirement Benefit Scheme (RBS). The Regulation stipulates to follow the requirements of the 'Guidance Note on Accounting for Employee Share Based Payments' or Accounting Standards as may be prescribed by the ICAI from time to time including the disclosure requirements prescribed therein.*

The International Accounting Standards Board (IASB) has also issued the International Financial Reporting Standard (IFRS) 2 on "Share-Based Payments". Based on this IFRS, the Ministry of Corporate Affairs of India have notified Ind AS 2 on "Share Based Payments". For details regarding, Ind AS 2, you may refer Chapter 2 of the Study Material Module 2 of Financial Reporting.

1. Introduction

Share plans and share option plans have become a common feature of remuneration packages for directors, senior executives and other employees in many countries. Shares and share options may also be used to pay suppliers (e.g. for professional services). Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

** SEBI (Share Based Employee Benefits) Regulations, 2014 has been issued on October 28, 2014 and is applicable from the even date.*

2. Definitions

Grant: Grant of the option means giving an option to the employees to subscribe to the shares of the company.

Vesting: It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in purchase of shares in pursuance of employee stock option scheme (ESOS).

Vesting Period*:* It is the time period during which the vesting of the option granted to the employee on pursuance of ESOS takes place.

Option*:* Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.

Exercise Period: It is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the ESOS.

Exercise Price: It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.

Intrinsic Value: It is the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).

Fair Value: It is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Share-based payment arrangement

An agreement between an entity (or another group entity or a shareholder of a group entity) and another party (including an employee) which entitles the other party to receive:

- Equity instruments (including shares or share options) of the entity (or another group entity); or
- Cash (or other assets) for amounts based on the price (or value) of equity instruments of the entity (or another group entity),

Provided specified vesting conditions (if any) are met.

"**Vest**" means to become an entitlement. A party's right to shares of an entity may be free or at a pre-arranged exercise price.

Share-based payment transaction

A transaction in a share based payment arrangement in which the entity:

- Receives goods or services from a supplier (including an employee); or
- incurs an obligation (to the supplier) when another group entity receives those goods or services.

Equity instrument: A contract that gives a residual interest in the assets of an entity after deducting all its liabilities.

Share option: A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed (or determinable) price for a specified period of time.

Vesting conditions: The conditions that must be satisfied for a person to become entitled to receive cash, other assets or equity instruments under a share-based payment arrangement.

Examples of vesting conditions include completion of a specified service period and meeting performance targets (e.g. a specified increase in revenue over a specified period of time).

3. Employee Share-Based Payments

Employee share-based payments are incentive payments to employees in form of shares. The expression employee share-based payments also include cash incentives to employees, the size of which is linked with value of shares. The payment in form of shares generally involve grant of options to employees to subscribe shares of employer's enterprise at a concessional price, called the exercise price.

The employees gain the excess of market price of share at the time of exercise over the specified exercise price. In case of employee share-based payments in form of cash incentive, the excess of market price on specified future date and a stated price is paid in cash. In either case, the value of incentive depends on increase in share value, which is the generally accepted indicator financial success of a business. By linking incentives with value of shares, the employee share-based payment plans effectively integrate personal goals of employees with that of the enterprise.

The day a share-based payment plan is announced and accepted by employees is called the grant date and the day, when the employees become entitled to such payments, is called the vesting date. The period between these two dates is called the vesting period. To qualify for the incentives, the employees put in their efforts during the vesting period to fulfill specified vesting conditions, e.g. reaching a specified sales/profit target. Exercise date is the date when an option is exercised by paying the exercise price.

The value of share-based payment depends on the market value of shares on vesting date/exercise date and hence cannot be known with certainty before these dates. Nevertheless, since the share-based payments are payments for services rendered by employees during the vesting period, the value of share-based payments should be recognised as expense during the vesting period, i.e. before value of such payments are known with certainty.

Two principal issues involved in accounting for employee share-based payments are

(i) problem of valuation of share-based payments before vesting date and

(ii) problem of allocation of the estimated value of share-based payment to a particular accounting period during the vesting period for recognition as expense.

4. Employee Share Based Payment Schemes

Employee share-based payment plans generally take the form of Employee Stock Option Schemes (ESOS), Employee Stock Purchase Schemes (ESPS), Stock Appreciation Rights

(SARS), ***General Employee Benefits Schemes (GEBS) and Retirement Benefit Schemes (RBS).***

The Employee Stock Option Schemes (ESOS) is a contract that gives the employees of an enterprise the right, but not obligation, for a specified period to purchase or subscribe to the specified number shares of the enterprise at a fixed or determinable price, called the exercise price.

The Employee Stock Purchase Plan (ESPS), is a plan under which the enterprise offers shares to its employees at a discounted price as part of public issue or otherwise.

The Stock Appreciation Rights (SAR) are rights that entitle the employees to receive cash or shares for an amount equivalent to the excess of market price on exercise date over a stated price.

The General Employee Benefits Schemes (GEBS) is the scheme dealing in the shares of the company or the shares of its listed holding company for the purpose of employee welfare including healthcare benefits, hospital care or benefits or benefits in the event of sickness, accident, disability, death or scholarship funds or such other benefit as specified by such company.

Retirement Benefit Schemes (RBS) is the scheme dealing in the shares of the company or the shares of its listed holding company for providing retirement benefits to the employees.

5. Types of Transactions

For accounting purposes, employee share-based payment plans are classified into the following three categories:

- Equity-settled share-based payment transactions;
- Cash-settled share-based payment transactions; and
- Share-based payment transactions with cash alternatives

Equity-settled

The entity receives services:

- As consideration for its own equity instruments; or
- Has no **obligation** to settle the transaction with the supplier.

Under these plans, the employees receive shares, e.g. ESOP

Cash-settled

Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares, e.g. Stock Appreciation Rights (SAR). The entity acquires services by incurring liabilities for amounts that are based on the price (or value) of equity instruments of the entity or another group entity.

Share-based payment transactions with cash alternatives

Where an entity has a choice of issuing shares or paying cash then the entity shall recognise a liability if it determines that it has an obligation to settle the liability in cash. If on settlement the entity issues shares rather than paying cash then the value of the liability should be transferred to equity.

The entitlements to share-based payments are based on satisfaction of specified conditions. The specified conditions are vesting conditions and the period taken to satisfy the vesting conditions is the vesting period. The share-based payments are incentives for services rendered by employees over the vesting period and hence are recognised as Employees' Compensation Expense over the vesting period.

The examples of vesting condition include, a sales target, a profit target, a target market price of shares or service conditions such as continuous employment during the vesting period. Market condition is a vesting condition related to market price of shares of the enterprise, e.g. a condition that the payments will be made provided the market price of shares increases by at least 40% over that on grant date, within a period of three years.

6. Equity Settled Employee Share-Based Payment Scheme

Payments under these plans are made in form of shares. Under these plans, the enterprise offers new shares issued by it to its employees. The issue price for the shares issued under these plans is the exercise price. At their option, the employees may pay the exercise price and become shareholders of the enterprise. The options are granted subject to fulfillment of specified vesting conditions. This form of plan is commonly called Employees Stock Option Plans (ESOP).

Under an ESOP, the employees gain the excess of market price of underlying share on exercise date over the exercise price. The option is not exercised if market price of underlying share on exercise date falls below the exercise price. For example, consider an option at exercise ₹ 45. If market price per share on exercise date is ₹ 50, an employee gains ₹ 5, by purchasing the share at exercise price is ₹ 45. The option is not exercised if market price falls below ₹ 45. Clearly, the ESOP is a call option held by the employees, which is settled by actual delivery of underlying shares. The employer is the writer of the option, but does not charge any option premium. The employer recognises the premium sacrificed, i.e. the value of call, as expense over the vesting period. The value of call for the purpose of accounting for share-based payments can be either the intrinsic value or fair value.

The fair value of an option is defined as the amount for which stock option granted can be exchanged between knowledgeable, willing parties in an arm's length transaction. This should be present value of expected gain of employees on exercise of the option. The expected gain is excess of expected market price at the time of exercise of option over the exercise price. The fair values of options depend on factors like, exercise price, current market price of underlying shares, expected volatility of return from the shares, risk-free rate of return, expected dividends, time allowed to exercise the option after vesting (i.e. life of option) and so on. Standard option pricing models, like Black-Scholes-Merton formula are modified suitably to ascertain fair value the options granted to employees.

Intrinsic value of an option is the excess of market price of the underlying share on the grant date over the exercise price. For example, if market price per share on grant date is ₹ 50 and the exercise of the option is 48, the intrinsic value of option on grant date is ₹ 2.

The value of an Employees Stock Option plan is initially based on fair value/intrinsic value per share on grant date. This is the minimum value of ESOP an enterprise must recognise as expense over vesting period. Where, after the grant date, the terms of an option are modified in a manner to increase its value, e.g. reduction of exercise price, the enterprise must also recognise the increased value of option as expense over vesting period remaining at the time of modification.

The aggregate value of option granted depends on the number of employees satisfying the vesting conditions and the number of options granted to each employee.

Suppose fair value of an option is ₹ 15 per share. If one option is granted per employee and if each option consists of 100 shares, the value of option granted to each employee is ₹ 1,500 (₹ 15 × 100). If the enterprise expects 200 employees to satisfy the vesting conditions at the end of vesting period, the fair value of option to be recognised as expense is ₹ 3 lakh (₹ 1,500 × 200). If vesting period is 5 years, the enterprise should recognise ₹ 60,000 (₹ 3 lakh / 5) as expense per year for 5 years.

Illustration 1

Ajanta grants 120 share options to each of its 460 employees. Each grant is conditional on the employee working for Ajanta over the next three years. Ajanta has estimated that the fair value of each share option is ₹ 12. Ajanta estimates that 25% of employees will leave during the three-year period and so forfeit their rights to the share options. Everything turns out exactly as expected.

Required:

Calculate the amounts to be recognized as expense during the vesting period.

Solution

Year	*Calculation*	*Expense for Period*	*Cumulative expense*
		₹	₹
1	55,200 options x 75% x ₹ 12 x 1/3 years	1,65,600	1,65,600
2	(55,200 options x 75% x ₹ 12 x 2/3 years) - ₹ 165,600	1,65,600	3,31,200
3	(55,200 options x 75% x ₹ 12 x 3/3 years) - ₹ 331,200	1,65,600	4,96,800

An enterprise should review all estimates taken in consideration for valuation of option. The value of options recognised as expense in an accounting period is the excess of cumulative expense as per latest estimates upto the current accounting period over total expense recognised upto the previous accounting period.

7. Accounting Procedure for ESOS

The amount recognised as expense in a period is debited to 'Employees' Compensation A/c' with a corresponding credit to an equity account called Stock Options Outstanding A/c'. The amount recognised as expense can be either the intrinsic value or fair value. The Stock

Options Outstanding A/c' is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve at the time of settlement. Till such transfer, the credit balance of Stock Options Outstanding A/c is shown in balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

The balance of Employees' Compensation A/c is transferred to the Profit & Loss A/c of the period. In case capitalization is justified, the balance of Employees' Compensation A/c is transferred to the concerned Asset A/c instead of the Profit & Loss A/c.

On exercise of the option, the enterprise issues shares on receipt of the exercise price. The consideration for such shares comprises of the exercise price and the aggregate value of option recognized as expense, standing to the credit of Stock Options Outstanding A/c. In a situation where the right to obtain shares or stock options expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to General Reserve. The illustrations given in this chapter have been given on the basis of the Guidance Note on Share based payments.

Illustration 2

Arihant Limited has its share capital divided into equity shares of ₹ 10 each. On 1-10-2016, it granted 20,000 employees' stock option at ₹ 50 per share, when the market price was ₹ 120 per share. The options were to be exercised between 10th December, 2016 and 31st March, 2017. The employees exercised their options for 16,000 shares only and the remaining options lapsed. The company closes its books on 31st March every year. Show Journal Entries (with narration) as would appear in the books of the company up to 31st March, 2017.

Solution

Journal Entries in the books of Arihant Ltd.

			₹	₹
10.12.16	Bank A/c (16,000 x 50)	Dr.	8,00,000	
to 31.3.17	Employee compensation expense A/c (16,000 x 70)	Dr.	11,20,000	
	To Equity share capital A/c (16,000 x 10)			1,60,000
	To Securities premium A/c (16,000 x 110)			17,60,000
	(Being shares issued to the employees against the options vested to them in pursuance of Employee Stock Option Plan)			
31.3.17	Profit and Loss A/c	Dr.	11,20,000	
	To Employee compensation expense A/c			11,20,000
	(Being transfer of employee compensation expenses to Profit and Loss Account)			

Illustration 3

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2013*
Number of employees covered	*525*
Number of options granted per employee	*100*
Vesting condition: Continuous employment for 3 years	
Nominal value per share (₹)	*100*
Exercise price per share (₹)	*125*
Market price per share on grant date (₹)	*149*
Vesting date	*March 31, 2016*
Exercise Date	*March 31, 2017*
Fair value of option on grant date (₹)	*30*

Position on 31/03/14

(a) Estimated annual rate of departure 2%

(b) Number of employees left = 15

Position on 31/03/15

(a) Estimated annual rate of departure 3%

(b) Number of employees left = 10

Position on 31/03/16

(a) Number of employees left = 8

(b) Number of employees entitled to exercise option = 492

Position on 31/03/17

(a) Number of employees exercising the option = 480

(b) Number of employees not exercising the option = 12

Compute expenses to recognise in each year by (i) fair value method (ii) intrinsic value method and show important accounts in books of the company by both of the methods.

Solution

Fair Value Method

Year 2013-14

Fair value of option per share = ₹ 30

Number of shares expected to vest under the scheme

= [(525 -15) x 0.98 × 0.98)] × 100 = 49,000 (round off)

Fair value = 49,000× ₹ 30 = ₹ 14,70,000

Vesting period = 3 years

Value of option recognised as expense in 2013-14 = ₹ 14,70,000/ 3 = ₹ 4,90,000

Year 2014-15

Fair value of option per share = ₹ 30

Number of shares expected to vest under the scheme = (525 – 15 – 10) × 0.97) × 100 = 48,500

Fair value = 48,500 × ₹ 30 = ₹ 14,55,000

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2013-14 and 2014-15

= (₹ 14,55,000/ 3) × 2 = ₹ 9,70,000

Value of option recognised as expense in 2014-15 = ₹ 9,70,000– ₹ 4,90,000= ₹ 4,80,000

Year 2015-16

Fair value of option per share = ₹ 30

Number of shares actually vested under the scheme = 492 × 100 = 49,200

Fair value = 49,200 x ₹ 30 = ₹ 14,76,000

Cumulative value of option to recognise as expense in 3 years = ₹ 14,76,000

Value of option recognised as expense in 2015-16 = ₹ 14,76,000 – ₹ 9,70,000 = ₹ 5,06,000

Year 2016-17

Fair value of option per share = ₹ 30

Number of shares not subscribed = (492 – 480) × 100 = 1,200

Value of option forfeited = 1,200 × 30 = ₹ 36,000

Employees' Compensation A/c

Year		₹	*Year*		₹
2013-14	To ESOP Outstanding A/c	4,90,000	2013-14	By Profit & Loss A/c	4,90,000
		4,90,000			4,90,000
2014-15	To ESOP Outstanding A/c	4,80,000	2014-15	By Profit & Loss A/c	4,80,000
		4,80,000			4,80,000
2015-16	To ESOP Outstanding A/c	5,06,000	2015-16	By Profit & Loss A/c	5,06,000
		5,06,000			5,06,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	4,90,000	2013-14	By Employees' Compensation A/c	4,90,000
		4,90,000			4,90,000

2014-15	To Balance c/d	9,70,000	2014-15	By Balance b/d	4,90,000
				By Employees' Compensation A/c	4,80,000
2015-16		9,70,000			9,70,000
	To Balance c/d	14,76,000	2015-16	By Balance b/d	9,70,000
				By Employees' Compensation A/c	5,06,000
		14,76,000			14,76,000
2016-17	To General Reserve (1,200 × 30)	36,000	2016-17	By Balance b/d (49,200 × 30)	14,76,000
	To Share Capital (48,000 × 100)	48,00,000		By Bank (48,000 × 125)	60,00,000
	To Securities Premium (48,000 × 55)	26,40,000			
		74,76,000			74,76,000

Note: Securities Premium

	₹
Exercise price received per share	125
Value of service received per share	30
Consideration received per share	155
Less: Nominal value per share	(100)
Securities premium per share	55

Intrinsic Value Method

Year 2013-14

Intrinsic value of option per share = ₹ 149 – ₹ 125 = ₹ 24

Number of shares expected to vest under the scheme

= [(525 -15) × 0.98 × 0.98] × 100 = 49,000 (round off)

Intrinsic value = 49,000× ₹ 24 = ₹ 11,76,000

Vesting period = 3 years

Value of option recognised as expense in 2013-14 = ₹ 11,76,000/ 3 = ₹ 3,92,000

Year 2014-15

Intrinsic value of option per share = ₹ 149 – ₹ 125 = ₹ 24

Number of shares expected to vest under the scheme = [(525 – 15 – 10) × 0.97] × 100 = 48,500

Intrinsic value = 48,500 × ₹ 24 = ₹ 11,64,000

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2013-14 and 2014-15

= (₹ 11,64,000/ 3) × 2 = ₹ 7,76,000

Value of option recognised as expense in 2014-15 = ₹ 7,76,000– ₹ 3,92,000= ₹ 3,84,000

Year 2015-16

Intrinsic value of option per share = ₹ 149 – ₹ 125 = ₹ 24

Number of shares actually vested under the scheme = 492 x 100 = 49,200

Intrinsic value = 49,200 × ₹ 24 = ₹ 11,80,800

Cumulative value of option to recognise as expense in 3 years = ₹ 11,80,800

Value of option recognised as expense in 2015-16 = ₹ 11,80,800 – ₹ 7,76,000= ₹ 4,04,800

Year 2016-17

Intrinsic value of option per share = ₹ 49 – ₹ 125 = ₹ 24

Number of shares not subscribed = (492 – 480) x 100 = 1,200

Value of option forfeited = 1,200 x 24 = ₹ 28,800

Employees' Compensation A/c

Year		₹	*Year*		₹
2013-14	To ESOP Outstanding A/c	3,92,000	2013-14	By Profit & Loss A/c	3,92,000
		3,92,000			3,92,000
2014-15	To ESOP Outstanding A/c	3,84,000	2014-15	By Profit & Loss A/c	3,84,000
		3,84,000			3,84,000
2015-16	To ESOP Outstanding A/c	4,04,800	2015-16	By Profit & Loss A/c	4,04,800
		4,04,800			4,04,800

ESOP Outstanding A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	3,92,000	2013-14	By Employees' Compensation A/c	3,92,000
		3,92,000			3,92,000
2014-15	To Balance c/d	7,76,000	2014-15	By Balance b/d	3,92,000
				By Employees' Compensation A/c	3,84,000
		7,76,000			7,76,000
2015-16	To Balance c/d	11,80,800	2015-16	By Balance b/d	7,76,000
				By Employees' Compensation A/c	4,04,800
		11,80,800			11,80,800
2016-17	To General Reserve (1,200 × 24)	28,800	2016-17	By Balance b/d (49,200 × 24)	11,80,800
	To Share Capital (48,000 × 100)	48,00,000		By Bank (48,000 × 125)	60,00,000

	To Securities Premium (48,000 × 49)	23,52,000			
		71,80,800			71,80,800

Note: Securities Premium

	₹
Exercise price received per share	125
Value of service received per share	24
Consideration received per share	149
Less: Nominal value per share	(100)
Securities premium per share	49

8. Variation in Vesting Period

The vesting period, i.e. the time taken to satisfy the vesting conditions can be uncertain. For example, if employees are granted ESOP subject condition that the enterprise achieves a 50% market share, the vesting period can be known only when the market share of the company actually reaches the specified 50% level. In these cases, allocation of option value for recognition as expense in a particular accounting period should be based on estimated vesting period. The initial estimate of vesting period on grant date should be reviewed and revised if necessary, at the end of each accounting period. In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, e.g. when an option is granted subject to condition that the market price of the share reaches a specified level, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

Illustration 4

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2014*
Number of employees covered	*500*
Number of options granted per employee	*100*
Fair value of option per share on grant date (₹)	*25*

The vesting period shall be determined as below:

(a) *If the company earns ₹ 120 crore or above after taxes in 2014-15, the options will vest on 31/03/15.*

(b) If condition (a) is not satisfied but the company earns ₹ 250 crores or above after taxes in aggregate in 2014-15 and 2015-16, the options will vest on 31/03/16.

(c) If conditions (a) and (b) are not satisfied but the company earns ₹ 400 crores or above after taxes in aggregate in 2014-15, 2015-16 and 2016-17, the options will vest on 31/03/17.

Position on 31/03/15

(a) The company earned ₹ 115 crore after taxes in 2014-15

(b) The company expects to earn ₹ 140 crores in 2015-16 after taxes

(c) Expected vesting date: March 31, 2016

(d) Number of employees expected to be entitled to option = 474

Position on 31/03/16

(a) The company earned ₹ 130 crore after taxes in 2015-16

(b) The company expects to earn ₹ 160 crores in 2016-17 after taxes

(c) Expected vesting date: March 31, 2017

(d) Number of employees expected to be entitled to option = 465

Position on 31/03/17

(a) The company earned ₹ 165 crore after taxes in 2016-17

(b) Number of employees on whom the option actually vested = 450

Compute expenses to recognise in each year.

Solution

Year 2014-15

Fair value of option per share = ₹ 25

Number of shares expected to vest under the scheme = 474 × 100 = 47,400

Fair value = 47,400 × ₹ 25 = ₹ 11,85,000

Expected vesting period = 2 years

Value of option recognised as expense in 2014-15 = ₹ 11,85,000 /2 = ₹ 5,92,500

Year 2015-16

Fair value of option per share = ₹ 25

Number of shares expected to vest under the scheme = 465 × 100 = 46,500

Fair value = 46,500 × ₹ 25 = ₹ 11,62,500

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2014-15 and 2015-16

= (₹ 11,62,500/ 3) × 2 = ₹ 7,75,000

Value of option recognised as expense in 2014-15 = ₹ 5,92,500

Value of option recognised as expense in 2015-16 = ₹ 7,75,000 – ₹ 5,92,500 = ₹ 1,82,500

Year 2016-17

Fair value of option per share = ₹ 25

Number of shares actually vested under the scheme = 450 × 100 = 45,000

Fair value = 45,000 × ₹ 25 = ₹ 11,25,000

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2014-15, 2015-16 and 2016-17 = ₹ 11,25,000

Value of option recognised as expense in 2014-15 and 2015-16 = ₹ 7,75,000

Value of option recognised as expense in 2016-17 = ₹ 11,25,000 – ₹ 7,75,000 = ₹ 3,50,000

Illustration 5

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2014*
Number of employees covered	*50*
Number options granted per employee	*1,000*
Fair value of option per share on grant date (₹)	*9*

The options will vest to employees serving continuously for 3 years from vesting date, provided the share price is ₹ 70 or above at the end of 2016-17.

The estimates of number employees satisfying the condition of continuous employment were 48 on 31/03/15, 47 on 31/03/16. The number of employees actually satisfying the condition of continuous employment was 45.

The share price at the end of 2016-17 was ₹ 68.

Compute expenses to recognise in each year and show important accounts in books of the company.

Solution

The vesting of options is subject to satisfaction of two conditions viz. service condition of continuous employment for 3 years and market condition that the share price at the end of 2016-17 is not less than ₹ 70. Since the share price on 31/03/14 was ₹ 68, the actual vesting as nil. Despite this, the company should recognise value of option over 3-year vesting period from 2014-15 to 2016-17.

Year 2014-15

Fair value of option per share = ₹ 9

Number of shares expected to vest under the scheme = 48 × 1,000 = 48,000

Fair value = 48,000 × ₹ 9 = ₹ 4,32,000

Expected vesting period = 3 years

Value of option recognised as expense in 2014-15 = ₹ 4,32,000 /3 = ₹ 1,44,000

Year 2015-16

Fair value of option per share = ₹ 9

Number of shares expected to vest under the scheme = 47 × 1,000 = 47,000

Fair value = 47,000 × ₹ 9 = ₹ 4,23,000

Expected vesting period = 3 years

Cumulative value of option to recognise as expense in 2014-15 and 2015-16

= (₹ 4,23,000/ 3) × 2 = ₹ 2,82,000

Value of option recognised as expense in 2014-15 = ₹ 1,44,000

Value of option recognised as expense in 2015-16 = ₹ 2,82,000 – ₹ 1,44,000 = ₹ 1,38,000

Year 2016-17

Fair value of option per share = ₹ 9

Number of shares actually vested under the scheme = 45 × 1,000 = 45,000

Fair value = 45,000 × ₹ 9 = ₹ 4,05,000

Vesting period = 3 years

Cumulative value of option to recognise as expense in 2014-15, 2015-16 and 2016-17 = ₹ 4,05,000

Value of option recognised as expense in 2014-15 and 2015-16 = ₹ 2,82,000

Value of option recognised as expense in 2016-17 = ₹ 4,05,000 – ₹ 2,82,000 = ₹ 1,23,000

Employees' Compensation A/c

Year		₹	*Year*		₹
2014-15	To ESOP Outstanding A/c	1,44,000	2014-15	By Profit & Loss A/c	1,44,000
		1,44,000			1,44,000
2015-16	To ESOP Outstanding A/c	1,38,000	2015-16	By Profit & Loss A/c	1,38,000
		1,38,000			1,38,000
2016-17	To ESOP Outstanding A/c	1,23,000	2016-17	By Profit & Loss A/c	1,23,000
		1,23,000			1,23,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2014-15	To Balance c/d	1,44,000	2014-15	By Employees' Compensation A/c	1,44,000
		1,44,000			1,44,000
2015-16	To Balance c/d	2,82,000	2015-16	By Balance b/d	1,44,000
				By Employees' Compensation A/c	1,38,000
		2,82,000			2,82,000

2016-17	To General Reserve	4,05,000	2016-17	By Balance b/d	2,82,000
				By Employees' Compensation A/c	1,23,000
		4,05,000			4,05,000

9. Graded Vesting

Graded vesting refers to a situation where options under a plan vest on different dates. For example, a plan may provide that shares offered to an employee shall vest in proportion of 2:3:5 in three years commencing from fourth year. Thus if an employee is offered 100 shares under the plan, 20 shares shall vest in year 4, 30 shares shall vest in year 5 and 50 shares shall vest in year 6. In these cases, based on vesting dates, the plan is segregated in into different groups. Each of these groups is then treated as a separate plan with specific vesting period and expected life.

Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

Intrinsic value of an option does not depend on its expected life. Intrinsic value of option per share shall therefore be same for each group. In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

Illustration 6

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2014*
Number of employees covered	*400*
Number of options granted per employee	*60*
Nominal value per share (₹)	*100*
Exercise price per share (₹)	*125*

Shares offered were put in three groups. Group 1 was for 20% of shares offered with vesting period one-year. Group II was for 40% of shares offered with vesting period two-years. Group III was for 40% of shares offered with vesting period three-years. Fair value of option per share on grant date was ₹ 10 for Group I, ₹ 12.50 for Group II and ₹ 14 for Group III.

Position on 31/03/15

(a) *Number of employees left = 40*

(b) *Estimate of number of employees to leave in 2015-16 = 36*

(c) *Estimate of number of employees to leave in 2016-17 = 34*

(d) *Number of employees exercising options in Group I = 350*

Position on 31/03/16

(a) Number of employees left = 35

(b) Estimate of number of employees to leave in 2016-17 = 30

(c) Number of employees exercising options in Group II = 319

Position on 31/03/17

(a) Number of employees left = 28

(b) Number of employees at the end of last vesting period = 297

(c) Number of employees exercising options in Group III = 295

Options not exercised immediately on vesting, were forfeited.

Compute expenses to recognise in each year and show important accounts in books of the company by both of the methods.

Solution

Expected vesting

Year	*Group*	*Number of employees expected to qualify*	*Number of shares vested to each employee*	*Total number of shares expected to vest*	*Fair value of option per share*	*Fair value of option*
2014-15	I	360	12	4,320	10.00	43,200
	II	324	24	7,776	12.50	97,200
	III	290	24	6,960	14.00	97,440
2015-16	II	325	24	7,800	12.50	97,500
	III	295	24	7,080	14.00	99,120
2016-17	III	297	24	7,128	14.00	99,792

Expense recognised in year 2014-15

	₹	
Group I	43,200	
Group II	48,600	97,200/2
Group III	32,480	97,440/3
	1,24,280	

Expense recognised in year 2015-16

	₹	
Group I	43,200	

Group II	97,500	
Group III	66,080	(99,120/3) × 2
Cumulative expense for 2014-15 and 2015-16	2,06,780	
Less: Expense recognised in 2014-15	(1,24,280)	
Expense recognised in 2015-16	82,500	

Expense recognised in year 2016-17

	₹
Group I	43,200
Group II	97,500
Group III	99,792
Cumulative expense for 2014-15 to 2016-17	2,40,492
Less: Expense recognised in 2014-15 and 2015-16	(2,06,780)
Expense recognised in 2015-16	33,712

Options Forfeited

	Group I *2014-15*	*Group II* *2015-16*	*Group III* *2016-17*
Number of employees qualifying	360	325	297
Less: Number of employees exercising	(350)	(319)	(295)
Number of employees not exercising	10	6	2
Number of options per employee	12	24	24
Number of options forfeited	120	144	48

Employees' Compensation A/c

Year		₹	*Year*		₹
2014-15	To ESOP Outstanding A/c	1,24,280	2014-15	By Profit & Loss A/c	1,24,280
		1,24,280			1,24,280
2015-16	To ESOP Outstanding A/c	82,500	2015-16	By Profit & Loss A/c	82,500
		82,500			82,500
2016-17	To ESOP Outstanding A/c	33,712	2016-17	By Profit & Loss A/c	33,712
		33,712			33,712

ESOP Outstanding A/c

Year		₹	*Year*		₹
2014-15	To General Reserve (120 × 10)	1,200	2014-15	By Employees' Compensation A/c	1,24,280
	To Share Capital (4,200 × 100)	4,20,000		By Bank (4,200 × 125)	5,25,000

	To Securities Premium (4,200 × 35)	1,47,000			
	To Balance c/d	81,080			
		6,49,280			6,49,280
2015-16	To General Reserve (144 × 12.50)	1,800	2015-16	By Balance b/d	81,080
	To Share Capital (7,656 × 100)	7,65,600		By Employees' Compensation A/c	82,500
	To Securities Premium (7,656 × 37.50)	2,87,100		By Bank (7,656 × 125)	9,57,000
	To Balance c/d	66,080			
		11,20,580			11,20,580
2016-17	To General Reserve (48 × 14)	672	2016-17	By Balance b/d	66,080
	To Share Capital (7,080 × 100)	7,08,000		By Employees' Compensation A/c	33712
	To Securities Premium (7,080 × 39)	2,76,120		By Bank (7,080 × 125)	8,85,000
		9,84,792			9,84,792

Securities Premium

	Group I *2014-15*	*Group II* *2015-16*	*Group III* *2016-17*
Exercise price received per share	125.00	125.00	125.00
Value of service received per share	10.00	12.50	14.00
Consideration received per share	135,00	137,50	139,00
Less: Nominal value per share	(100.00)	100.00)	(100.00)
Securities premium per share	35.00	37.50	39.00

10. Employees Stock Purchase Schemes (ESPS)

Under these plans, employees are given an option to subscribe to shares of employer in a public issue or otherwise. The exercise price is set at a specified rate of discount on the issue price/ market price on the date of exercise. For example, a company may offer specified number of shares to its employees at 20% discount on market price on grant date. ESPP with option features is treated as ESOP. For example, consider a case where shares are offered to employees at 80% of market price. If employees have the option to pay either 80% of market price of shares on grant date or to pay 80% of market price on date of purchase, the plan is treated as ESOP rather than ESPP. The fair value of ESPP can be less than the discount due to post-vesting restrictions on transfers and similar other factors. The fair value of ESPP is recognised over the vesting period in the same way as ESOP.

Illustration 7

On April 1, 2017, a company offered 100 shares to each of its 500 employees at ₹ 40 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is ₹ 50 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 48 per share.

On April 30, 2017, 400 employees accepted the offer and paid ₹ 40 per share purchased. Nominal value of each share is ₹ 10.

Record the issue of shares in book of the company under the aforesaid plan.

Solution

Intrinsic value of ESPP per share = ₹ 48 – ₹ 40 = ₹ 8

Number of share issued = 400 × 100 = 40,000

Fair value of ESPP = 40,000 × ₹ 8 = ₹ 3,20,000

Vesting period = One month

Expense recognised in 2017-18 = ₹ 3,20,000

Date		₹	₹	
April 30, 2017	Bank	16,00,000		40,000 × ₹ 40
	Employees' Compensation A/c	3,20,000		40,000 × ₹ 8
	To Share Capital		4,00,000	40,000 × ₹ 10
	To Securities Premium		15,20,000	40,000 × ₹ 38

11. Modifications

If the modification reduces the fair value of the options granted, the modification should be ignored. If the modification increases the fair value of the options granted (e.g., when exercise price is reduced), the incremental fair value is recognised as expense over the remaining vesting period. The incremental fair value is the difference between (i) fair value of the modified option estimated on the date of the modification and (ii) fair value of the original option estimated on the date of modification. If the modification occurs after the vesting date, the incremental fair value is recognised immediately, or over the additional vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to the options.

Illustration 8

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2013*
Number of employees covered	*600*

Number options granted per employee	*60*
Vesting condition: Continuous employment for 3 years	
Nominal value per share (₹)	*100*
Exercise price per share (₹)	*125*
Vesting date	*March 31, 2016*
Exercise Date	*March 31, 2017*
Fair value of option per share on grant date (₹)	*14*

Position on 31/03/14

(a) Number of employees left = 30

(b) Estimate of number of employees to leave in 2014-15 and 2015-16 = 70

(c) Exercise price was reduced to ₹ 120

(d) Fair value of original option on 31/03/14 = ₹ 13

(e) Fair value of option at reduced exercise price on 31/03/14 = ₹ 15

(f) Vesting date for modified option was March 31, 2016

Position on 31/03/15

(a) Number of employees left = 35

(b) Estimate of number of employees to leave in 2015-16 = 30

Position on 31/03/16

(a) Number of employees left = 28

(b) Number of employees entitled to exercise option = 507

Position on 31/03/17

(a) Number of employees exercising the option = 500

(b) Number of employees not exercising the option = 7

Compute the amount of expense the company should recognise in each of the years 2013-14, 2014-15 and 2015-16 and show important accounts in books of the company.

Solution

Year 2013-14

Fair value of option per share = ₹ 14

Number of shares expected to vest under the scheme = (600 – 100) × 60 = 30,000

Fair value = 30,000 × ₹ 14 = ₹ 4,20,000

Vesting period = 3 years

Value of option recognised as expense in 2013-14 = ₹ 4,20,000 / 3 = ₹ 1,40,000

Year 2014-15

Fair value of option per share = ₹ 14

Incremental fair value of option per share = ₹ 15 – ₹ 13 = ₹ 2

Number of shares expected to vest under the scheme = (600 – 95) × 60 = 30,300

Fair value of option = 30,300 × ₹ 14 = ₹ 4,24,200

Incremental fair value = 30,300 × ₹ 2 = ₹ 60,600

Vesting period = 3 years;

Remaining vesting period = 2 years (including current year)

Cumulative value of option to recognise as expense in 2013-14 and 2014-15

= (₹ 4,24,200/ 3) × 2 + ₹ 60,600/2 = ₹ 3,13,100

Value of option recognised as expense in 2013-14 = ₹ 1,40,000

Value of option recognised as expense in 2014-15 = ₹ 3,13,100 – ₹ 1,40,000 = ₹ 1,73,100

Year 2015-16

Fair value of option per share = ₹ 14

Number of shares actually vested under the scheme = 507 × 60 = 30,420

Fair value of option = 30,420 × ₹ 14 = ₹ 4,25,880

Incremental fair value = 30,420 × ₹ 2 = ₹ 60,840

Cumulative value of option to recognise as expense in 3 years

= ₹ 4,25,880 + ₹ 60,840 = ₹ 4,86,720

Value of option recognised as expense in 2013-14 and 2014-15 = ₹ 3,13,100

Value of option recognised as expense in 2015-16 = ₹ 4,86,720 – ₹ 3,13,100 = ₹ 1,73,620

Employees' Compensation A/c

Year		₹	*Year*		₹
2013-14	To ESOP Outstanding A/c	1,40,000	2013-14	By Profit & Loss A/c	1,40,000
		1,40,000			1,40,000
2014-15	To ESOP Outstanding A/c	1,73,100	2014-15	By Profit & Loss A/c	1,73,100
		1,73,100			1,73,100
2015-16	To ESOP Outstanding A/c	1,73,620	2015-16	By Profit & Loss A/c	1,73,620
		1,73,620			1,73,620

ESOP Outstanding A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	1,40,000	2013-14	By Employees' Compensation A/c	1,40,000
		1,40,000			1,40,000

2014-15	To Balance c/d	3,13,100	2014-15	By Balance b/d	1,40,000
				By Employees' Compensation A/c	1,73,100
		3,13,100			3,13,100
2015-16	To Balance c/d	4,86,720	2015-16	By Balance b/d	3,13,100
				By Employees' Compensation A/c	1,73,620
		4,86,720			4,86,720
2016-17	To General Reserve (420 × 16)	6,720	2016-17	By Balance b/d (30,420 × 16)	4,86,720
	To Share Capital (30,000 × 100)	30,00,000		By Bank (30,000 × 120)	36,00,000
	To Securities Premium (30,000 × 36)	10,80,000			
		40,86,720			40,86,720

Note: Securities Premium

	₹
Exercise price received per share	120
Value of service received per share	16
Consideration received per share	136
Less: Nominal value per share	(100)
Securities premium per share	36

12. Cancellation and Settlements during Vesting Period

If an enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) The entire amount of unamortised value of option should be recognised immediately.

(b) Payments made to the employees on cancellation or settlement should be debited to ESOP Outstanding A/c to the maximum extent of fair value of options granted, measured at the cancellation / settlement date. Any payment in excess of the fair value is recognised as an expense.

(c) If new options are granted to the employees in replacement for the cancelled options, the replacement is regarded as modification. The incremental fair value for the purpose is the difference between the fair value of replaced option and net fair value of cancelled option, as on the date of replacement. The net fair value of the cancelled option is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation that is debited to ESOP Outstanding A/c, in accordance with (b) above.

13. Dilution of Earnings per Share (EPS) due to ESOs Granted

Dilution of EPS is anticipated fall in EPS. Dilution occurs when expected proportionate increase in number of shares is more than expected proportionate increase in profit available to equity shareholders. For example, if number of shares increases from 10,000 to 11,000 (10% increase) and profit available to equity shareholders increases from ₹ 50,000 to ₹ 52,500 (5% increase) the EPS falls from ₹ 5 to ₹ 4.77. The Accounting Standard (AS) 20, Earning per Share, requires disclosure of basic and diluted EPS.

One factor contributing to dilution of EPS is issue of shares at less than fair value. This happens because issue of shares at less than fair value implies issue of certain number of shares for no consideration. For example, consider the case of a share warrant for 4,000 shares at exercise price ₹ 40. On exercise of the warrant, the issuer collects ₹ 1,60,000. If fair value of the shares is ₹ 50, the issue proceed is equivalent of price of 3,200. The issuer, by setting the exercise price at ₹ 40, instead of ₹ 50, allows the warrant holder to have 800 shares for no consideration. The shares issued for no consideration increase number of shares but do not increase resources available to the issuer and consequently, no increase in profit can be anticipated. These shares are taken in computation of diluted EPS as potential equity.

$$\text{Number of shares issued for consideration} = \frac{\text{Expected issue proceeds}}{\text{Fair value per share}}$$

Number of shares issued for no consideration

= Number of shares issued – Number of shares issued for consideration

Issue of shares under a scheme of share-based payment, increases the number of shares outstanding. Since the shares are issued at exercise price, which is lower than the fair value of shares issued, in the same way as share warrants, an ESOP gives rise to situation of dilution of EPS. In calculating the number of shares issued for no consideration, the expected proceeds from the exercise of option is taken as sum of (i) Exercise Price (ii) Value of services to be rendered by employees in future upto the vesting date. This value of services is measured as unamortised value of option.

Illustration 9

The following particulars in respect of stock options granted by a company are available:

Number of shares	*4,00,000*
Grant date	*April 1, 2013*
Number of employees covered	*600*
Number of options granted per employee	*100*
Vesting condition: Continuous employment for 3 years	
Nominal value per share (₹)	*10*
Exercise price per share (₹)	*45*
Vesting date	*March 31, 2016*

Exercise Date	*May 31, 2017*
Fair value of option per share on grant date (₹)	*15*

Position on 31/03/14

(a) Number of employees expected to satisfy service condition = 540

(b) Number of employees left = 15

(c) Profit before amortisation of ESOP cost = ₹ 11.90 lakh

(d) Fair value per share = ₹ 60

Position on 31/03/15

(a) Number of employees expected to satisfy service condition = 552

(b) Number of employees left = 20

(c) Profit before amortisation of ESOP cost = ₹ 12.62 lakh

(d) Fair value per share = ₹ 66

Position on 31/03/16

(a) Number of employees left = 11

(b) Number of employees entitled to exercise option = 554

(c) Profit before amortisation of ESOP cost = ₹ 13.79 lakh

(d) Fair value per share = ₹ 72

Position on 31/05/17

(a) Number of employees exercising the option = 550

(b) Number of employees not exercising the option = 4

Show Employees Compensation A/c, ESOP Outstanding A/c from 2013-14 to 2016-17.

Compute basic and diluted EPS for the years 2013-14 to 2015-16.

Solution

Year 2013-14

Fair value of option per share = ₹ 15

Number of options expected to vest under the scheme = 540 × 100 = 54,000

Fair value = 54,000 × ₹ 15 = ₹ 8,10,000

Vesting period = 3 years

Value of option recognised as expense in 2013-14 = ₹ 8,10,000 / 3 = ₹ 2,70,000

Year 2014-15

Fair value of option per share = ₹ 15

Number of options expected to vest under the scheme = 552 × 100 = 55,200

Fair value = 55,200 × ₹ 15 = ₹ 8,28,000

Vesting period = 3 years

Number of years expired = 2 years

Cumulative value of option to recognise as expense in 2013-14 and 2014-15

= (₹ 8,28,000/ 3) × 2 = ₹ 5,52,000

Value of option recognised as expense in 2014-15 = ₹ 5,52,000 – ₹ 2,70,000 = ₹ 2,82,000

Year 2015-16

Fair value of option per share = ₹ 15

Number of options actually vested under the scheme = 554 × 100 = 55,400

Fair value = 55,400 × ₹ 15 = ₹ 8,31,000

Cumulative value of option to recognise as expense in 3 years = ₹ 8,31,000

Value of option recognised as expense in 2013-14 = ₹ 8,31,000 – ₹ 5,52,000 = ₹ 2,79,000

Year 2016-17

Fair value of option per share = ₹ 15

Number of shares not subscribed = (554 – 550) × 100 = 400

Value of option forfeited = 400 × ₹ 15 = ₹ 6,000

Employees' Compensation A/c

Year		₹	*Year*		₹
2013-14	To ESOP Outstanding A/c	2,70,000	2013-14	By Profit & Loss A/c	2,70,000
		2,70,000			2,70,000
2014-15	To ESOP Outstanding A/c	2,82,000	2014-15	By Profit & Loss A/c	2,82,000
		2,82,000			2,82,000
2015-16	To ESOP Outstanding A/c	2,79,000	2015-16	By Profit & Loss A/c	2,79,000
		2,79,000			2,79,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	2,70,000	2013-14	By Employees' Compensation A/c	2,70,000
		2,70,000			2,70,000
2014-15	To Balance c/d	5,52,000	2014-15	By Balance b/d	2,70,000
				By Employees' Compensation A/c	2,82,000
		5,52,000			5,52,000
2015-16	To Balance c/d	8,31,000	2015-16	By Balance b/d	5,52,000
				By Employees'	

				Compensation A/c	2,79,000
		8,31,000			8,31,000
2016-17	To General Reserve 400 × 15)	6,000	2016-17	By Balance b/d (55,400 × 15)	8,31,000
	To Share Capital (55,000 × 10)	5,50,000		By Bank (55,000 × 45)	24,75,000
	To Securities Premium (55,000 × 50)	27,50,000			
		33,06,000			33,06,000

Note: Securities Premium

	₹
Exercise price received per share	45
Value of service received per share	15
Consideration received per share	60
Less: Nominal value per share	(10)
Securities premium per share	50

Computation of Basic EPS

	2013-14 *₹ 000*	*2014-15* *₹ 000*	*2015-16* *₹ 000*
Profit before amortisation of ESOP costs	1,190	1,262	1,379
Less: ESOP cost amortised	(270)	(282)	(279)
Net profit for shareholders	920	980	1,100
Number of shares outstanding ('000)	400	400	400
Basic EPS	2.30	2.45	2.75

Potential Equity

	2013-14	*2014-15*	*2015-16*
A. Actual number of employees	585	565	554
B. Option granted per employee	100	100	100
C. Number of options outstanding	58,500	56,500	55,400
D. Unamortised ESOP cost per option (₹)	10*	5**	Nil
E. Exercise Price (₹ 45)	45	45	45
F. Expected exercise price to be received (C x E): ₹ 000	2,632.5	2,542.5	2,493.0
G. Unamortised ESOP cost (C × D): ₹ 000	585.0	282.5	Nil
H. Total proceeds: ₹ 000	3,217.5	2,825.0	2,493.0
I. Fair value per share (₹)	60	66	72
J. Number of shares issued for consideration (H/I)	53,625	42,803	34,625
K. Potential Equity (C – J)	4,875	13,697	20,775

* [15-(15/3)] = 10

** [15-{(15/3) x 2}] = 5

Computation of Diluted EPS

	2013-14 ₹	2014-15 ₹	2015-16 ₹
Net profit for shareholders	9,20,000	9,80,000	11,00,000
Number of shares outstanding	4,00,000	4,00,000	4,00,000
Potential Equity	4,875	13,697	20,775
Total number of share	4,04,875	4,13,697	4,20,775
Diluted EPS	2.27	2.37	2.61

Illustration 10

PQ Ltd. grants 100 stock options to each of its 1,000 employees on 1-4-2013, conditional upon the employee remaining in the company for 2 years. The fair value of the option is ₹ 18 on the grant date and the exercise price is ₹ 55 per share. The other information is given as under:

(i) The no. of employees expected to satisfy service condition are 930 in the 1st year and 850 in the 2nd year.

(ii) 40 employees left the company in the 1st year of service and 880 employees have actually completed 2 year vesting period.

(iii) The profit of the enterprise before amortization of the compensation cost on account of ESOPs is as follows:

(A) ₹ 18,50,000

(B) ₹ 22,00,000

(iv) The fair value of share for these years was ₹ 80 and ₹ 88 respectively.

(v) The company has 6 lakhs shares of ₹ 10 each outstanding at the end of both years.

Compute basic and diluted EPS for both the years (ignore the tax impacts).

Solution

Calculation of Basic & Diluted EPS

	2013-14	2014-15
Profit before amortization of ESOP cost	18,50,000	22,00,000
Less: ESOP cost amortised	(8,37,000)	(7,47,000)
Net profit for shareholders	10,13,000	14,53,000
No. of shares outstanding	6,00,000	6,00,000
Basic EPS	1.69	2.42
Potential equity	19,200	33,000
Total no. of equity shares	6,19,200	6,33,000
Diluted EPS	1.64	2.30

Working Notes:

1. Calculation of Potential Equity

		2013-2014	2014-2015
a.	Actual no. of employees	960	880
b.	Options granted per employee	100	100
c.	No. of options outstanding	96,000	88,000
d.	Unamortised ESOP cost per option (₹)	(₹ 18-18/2)9	0
e.	Exercise price (₹)	55	55
f.	Expected exercise price to be received (c x e) (₹)	52,80,000	48,40,000
g.	Unamortised ESOP cost (c x d) (₹)	8,64,000	0
h.	Total proceeds (₹)	61,44,000	48,40,000
i.	Fair value per share	80	88
j.	No. of shares issued for consideration (h/i)	76,800	55,000
k.	Potential Equity (c-j)	19,200	33,000

2. Calculation of ESOP cost to be amortised

	2013-2014	2014-15
Fair value of options per share	₹ 18	₹ 18
No. of options expected to vest under the scheme	(930 x 100) 93,000	(880 x 100) 88,000
Fair value of options	16,74,000	₹ 15,84,000
Value of options recognized as expenses	(₹ 16,74,000 / 2) 8,37,000	(₹ 15,84,000 – ₹ 8,37,000) 7,47,000

14. Stock Appreciation Rights (SARs)

Stock Appreciation Rights (SAR) entitle the employees to claim cash payment to the extent of excess of market price of underlying shares on exercise date over the exercise price. Stock Appreciation Rights are not exercised if market price of underlying shares on exercise date is less than the exercise price. SAR is therefore a call option held by employees. The employer recognises the value of call as expense over the vesting period.

The accounting procedures for ESOP and SAR are similar except that: (i) The liability for SAR is recognised as Provision instead of ESOP Outstanding and (ii) value per option is reassessed at each reporting date.

Illustration 11

A company announced a Stock Appreciation Right on 01/04/13 for each of its 525 employees. The scheme gives the employees the right to claim cash payment equivalent to excess on market price of company's shares on exercise date over the exercise price ₹ 125 per share in respect of 100 shares, subject to condition of continuous employment for 3 years. The SAR is exercisable after 31/03/16 but before 30/06/16. The fair value of SAR was ₹ 21 in 2013-14, ₹ 23 in 2014-15 and ₹ 24 in 2015-16. In

2013-14 the company estimates that 2% of the employees shall leave the company annually. This was revised to 3% in 2014-15. Actually, 15 employees left the company in 2013-14, 10 left in 2014-15 and 8 left in 2015-16. The SAR therefore actually vested to 492 employees. On 30/06/16, when the SAR was exercised, the intrinsic value was ₹ 25 per share.

Show Provision for SAR A/c by fair value method.

Solution

Provision of SARs A/c (For 2013-14)

	₹		₹
To Balance c/d	3,42,860	By Employee Compensation Expense	3,42,860
	3,42,860		3,42,860
Provision of SARs A/c (For 2014-15)			
To Balance c/d	7,43,667	By Balance b/d	3,42,860
		By Employee Compensation Expenses	4,00,807
	7,43,667		7,43,667
Provision of SARs A/c (For 2016-17)			
To Balance c/d	11,80,800	By Balance b/d	7,43,667
		By Employee Compensation Expenses	4,37,133
	11,80,800		11,80,800
Provision of SARs A/c (For 2016-17)			
To Bank (49,200 x 25)	12,30,000	By Balance b/d	11,80,800
		By Employee Expenses	49,200
	12,30,000		12,30,000

The Provision for SAR is a liability as settlement of SAR is through cash payment equivalent to an excess of market price of company's shares on exercise date over the exercise price.

Working Notes:

Year 2013-14

Number of employees to whom SARs were announced = 525 employees

Total estimated SARs, to be vested at the end of the vesting period, as on 2013-14

= (525 -15 x 0.98 x 0.98) x 100 SARs = 48,980 SARs

Fair value of SARs = 48,980 SARs × ₹ 21 = ₹ 10,28,580

Vesting period = 3 years

Recognised as expense in 2013-14 = ₹ 10,28,580 / 3 years = ₹ 3,42,860

Year 2014-15

Total number of employees after three years, on the basis of the estimation in 2014-15

= [(525 – 15 - 10) x 0.97] x 100 SARs = 48,500 SARs

Fair value of SARs = 48,500 SARs × ₹ 23 = ₹ 11,15,500

Vesting period = 3 years

No. of years expired = 2 years

Cumulative value of SARs to recognize as expense = 11,15,500/3 × 2 = ₹ 7,43,667

SARs recognize as expense in 2014–15 = ₹ 7,43,667 – ₹ 3,42,860 = ₹ 4,00,807

Year 2015-16

Fair value of SARs = ₹ 24

SARs actually vested = 492 employees × 100 = 49,200 SARs

Fair value = 49,200 SARs × ₹ 24 = ₹ 11,80,800

Cumulative value to be recognized = ₹ 11,80,800

Value of SARs to be recognized as an expense = ₹ 11,80,800 – ₹ 7,43,667 = ₹ 4,37,133

Year 2016–17

Cash payment of SARs = 49,200 SARs × ₹ 25 = ₹ 12,30,000

Value of SARs to be recognized as an expense in 2013–14 = ₹ 12,30,000 – ₹ 11,80,800 = ₹ 49,200

15. Employee Share-based Payment Schemes with Cash Alternatives

These plans consist of two components viz., (i) liability, i.e., the employer's obligation to pay price differential in cash and (ii) equity, i.e., the employer's obligation to issue shares at exercise price. The company should first measure, on the grant date, fair value of the plan on the assumption that all employees will exercise their options in favour of (i) cash settlement (ii) equity settlement. The fair value of plan for cash settlement is the fair value of the liability component. The excess, if any, of fair value of plan for equity settlement over the liability component is the fair value of equity component. The accounting procedure for equity component is same as that for ESOP. The accounting procedure for liability component is same as that for SAR.

On the date of settlement, the company should re-measure the liability to its fair value. If the employees opt for shares, the amount of liability should be treated as the consideration for the shares issued. If the employees opt for cash settlement, the balance in ESOP Outstanding A/c should be transferred to general reserve.

Illustration 12

A company announced a share-based payment plan for its employees on 01/04/10, subject to a vesting period of 3 years. By the plan, the employees can (i) either claim difference between exercise price ₹ 150 per share and market price of those shares on vesting date in respect of 10,000 shares or (ii) can subscribe to 12,000 shares at exercise price ₹ 150 per share, subject to lock in period of 5 years. On 01/04/10, fair value of the option, without considering restrictions on transfers was ₹ 30 and that after considering restrictions on transfer was ₹ 27. The fair value estimates, without considering transfer restrictions were ₹ 31.50, ₹ 32.70 and ₹ 34 respectively, at the end of 2013-14, 2014-15 and 2015-16.

Show important accounts in books of the company if employees opt for (i) cash settlement (ii) equity settlement.

Solution

	₹	
Fair value under equity settlement = 12,000 × ₹ 27	3,24,000	
Less: Fair value under cash settlement =10,000 × ₹ 30	(3,00,000)	Liability component
	24,000	Equity component

Vesting period = 3 years

Expenses to be recognised each year for equity component = ₹ 24,000 / 3 = ₹ 8,000

Expenses recognised for liability component

2013-14

Number of shares = 10,000

Fair value = ₹ 31.50 per share

Fair value of liability component = 10,000 × ₹ 31.50 = ₹ 3,15,000

Vesting period = 3 years

Expense recognised = ₹ 3,15,000/3 = ₹ 1,05,000

2014-15

Number of shares = 10,000

Fair value = ₹ 32.70 per share

Fair value of liability component = 10,000 × ₹ 32.70 = ₹ 3,27,000

Vesting period = 3 years

Number of years expired = 2 years

Cumulative expense to be recognised upto 2014-15 = (₹ 3,27,000/3) × 2 = ₹ 2,18,000

Expense recognised in 2013-14 = ₹ 1,05,000

Expense recognised in 2014-15 = ₹ 2,18,000 – ₹ 1,05,000 = ₹ 1,13,000

2015-16

Number of shares = 10,000

Fair value = ₹ 34 per share

Fair value of liability component = 10,000 × ₹ 34 = ₹ 3,40,000

Vesting period = 3 years

Number of years expired = 3 years

Cumulative expense to be recognised upto 2015-16 = ₹ 3,40,000

Cumulative expense to be recognised upto 2014-15 = ₹ 2,18,000

Expense recognised in 2015-16 = ₹ 3,40,000 – ₹ 2,18,000 = ₹ 1,22,000

Employees' Compensation A/c

Year		₹	*Year*		₹
2013-14	To Provision for Liability	1,05,000	2013-14	By Profit & Loss A/c	1,13,000
	To ESOP Outstanding	8,000			
		1,13,000			1,13,000
2014-15	To Provision for Liability	1,13,000	2014-15	By Profit & Loss A/c	1,21,000
	To ESOP Outstanding	8,000			
		1,21,000			1,21,000
2015-16	To Provision for Liability	1,22,000	2015-16	By Profit & Loss A/c	1,30,000
	To ESOP Outstanding	8,000			
		1,30,000			1,30,000

Provision for Liability Component A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	1,05,000	2013-14	By Employees' Compensation A/c	1,05,000
		1,05,000			1,05,000
2014-15	To Balance c/d	2,18,000	2014-15	By Balance b/d	1,05,000
				By Employees' Compensation A/c	1,13,000
		2,18,000			2,18,000
2015-16	To Balance c/d	3,40,000	2015-16	By Balance b/d	2,18,000
				By Employees' Compensation A/c	1,22,000
		3,40,000			3,40,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2013-14	To Balance c/d	8,000	2013-14	By Employees' Compensation A/c	8,000
		8,000			8,000
2014-15	To Balance c/d	16,000	2014-15	By Balance b/d	8,000
				By Employees' Compensation A/c	8,000
		16,000			16,000
2015-16	To Balance c/d	24,000	2015-16	By Balance b/d	16,000
				By Employees' Compensation A/c	8,000
		24,000			24,000

Cash Settlement

Provision for Liability Component A/c

		₹			₹
2016-17	To Bank	3,40,000	2016-17	By Balance b/d	3,40,000
		3,40,000			3,40,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2016-17	To General Reserve	24,000	2016-17	By Balance b/d	24,000
		24,000			24,000

Equity Settlement

Provision for Liability Component A/c

		₹			₹
2016-17	To ESOP Outstanding A/c	3,40,000	2016-17	By Balance b/d	3,40,000
		3,40,000			3,40,000

ESOP Outstanding A/c

Year		₹	*Year*		₹
2016-17	To Share Capital	12,00,000	2016-17	By Balance b/d	24,000
	To Securities Premium	9,64,000		By Provision for Liability Component	3,40,000
				By Bank	18,00,000
		21,64,000			21,64,000

16. Disclosures

The Guidance Note on Accounting for Employee Share-based Payments issued by the Institute of Chartered Accountants of India requires enterprises to disclose the following in respect of such payments:

1. Method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS- both basic and diluted – for the accounting period, had the fair value method been used.
2. Information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period. In particular, it should disclose:
   (a) A description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan,

such as vesting requirement, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity).

(b) The number and weighted average exercise prices of stock options for each of the following groups of options:

(i) Outstanding at the beginning of the period:

(ii) Granted during the period;

(iii) Forfeited during the period;

(iv) Exercised during the period;

(v) Expired during the period;

(vi) Outstanding at the end of the period; and

(vii) Exercisable at the end of the period

(c) For stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.

(d) For stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

1. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:

(a) For stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:

(i) The option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

(ii) How expected volatility was determined, including an explanation of the extent to which expected volatility; and

(iii) Whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) For other instrument granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the granted date, and information on how that fair value was measured, including:

(i) If fair value was not measured on the basis of an observable market price, how it was determined;

(ii) Whether and how expected dividends were incorporated into the measured of fair value; and

(iii) Whether and how any other features of the instruments granted were incorporated into the measurement of fair value.

(c) For the employee share-based payment plants that were modified during the period:

(i) An explanation of those modifications;

(ii) The incremental fair value granted (as a result of those modifications); and

(iii) Information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

2. An enterprise should disclose the following information to enable users of the financial statement to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:

(a) The total expense recognized for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognized immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;

(b) For liability arising from employee share-based payment plans;

(i) The total carrying amount at the end of the period; and

(ii) The total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

As per the SEBI (Share Based Employee Benefits) Regulations, 2014, the Board of Directors of such a company shall also disclose the details of the scheme(s) being implemented, as specified by SEBI in this regard.

Illustration 14

The following particulars in respect of stock options granted by a company are available:

Grant date	*April 1, 2014*
Number of employees covered	*300*
Vesting condition: Continuous employment upto 31/03/14	*100*
Nominal value per share (₹)	*10*

Exercise price per share (₹)	*40*
Fair value of option per share on grant date (₹)	*20*
Exercise date	*July 31, 2017*

The number of options to vest per employee shall depend on company's average annual earnings after tax during vesting period as per the table below:

Average annual earnings after tax	*Number of options per employee*
Less than ₹ 100 crores	*Nil*
₹ 100 crores to less than ₹ 120 crores	*30*
₹ 120 crores to less than ₹ 150 crores	*45*
Above ₹ 150 crores	*60*

Position on 31/03/15

(a) The company expects to earn ₹ 115 crores after tax on average per year during vesting period.

(b) Number of employees expected to be entitled to option = 280

Position on 31/03/16

(a) The company expects to earn ₹ 130 crores after tax on average per year during vesting period.

(b) Number of employees expected to be entitled to option = 270

Position on 31/03/17

(a) The company earned ₹ 128 crores after tax on average per year during vesting period.

(b) Number of employees entitled to option = 275

Position on July 31, 2017

(a) Number of employees exercising option = 265

Compute expenses to be recognised in each year.

Solution

Calculation of expenses to be recognized in each year

Year	Calculation	Expense for Period (₹)	Cumulative expense (₹)
2014-15	(280 x 30) options x ₹ 20 x 1/3	56,000	56,000
2015-16	(270 x 45) options x ₹ 20 x 2/3 Less 56,000	1,06,000	1,62,000
2016-17	(275 x 45) options x ₹ 20 x 3/3 Less 1,62,000	85,500	2,47,500

Value of option forfeited as on July 31, 2017

Fair value of option per share= ₹ 20

Number of shares not subscribed = (275-265) x 45 = 450

Value of options forfeited = 450 x ₹ 20 = ₹ 9,000.

8

Financial Reporting for Financial Institutions

UNIT 1: MUTUAL FUNDS

Note: This chapter is also discussed in Paper 2: Strategic Financial Management of Final Course Study Material. In Financial Reporting Paper, students should emphasise upon accounting aspects of net present value and valuation only. Strategic Financial Management Paper deals with return aspect of mutual funds.

1.1 Definition

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them.

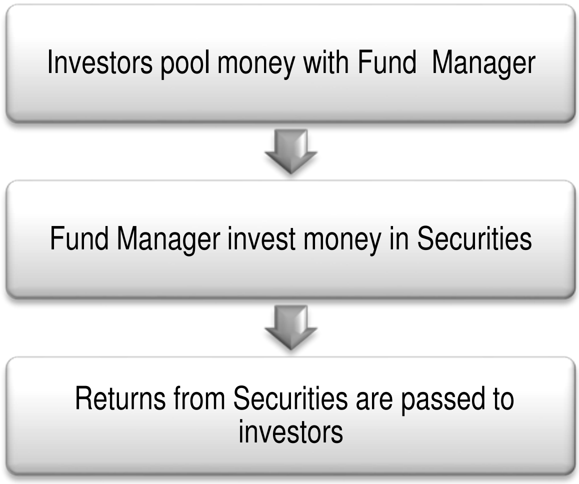
Different investment avenues are available to investors. Mutual funds also offer good investment opportunities to the investors. Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions.

Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders.

The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. A mutual fund is required to be registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public.

As per section 2(q) of Securities and Exchange Board of India (SEBI) (Mutual Funds) Regulations, 1996, "Mutual Fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets.

The following flow chart describes broadly the working of a mutual fund:



1.2 History of Mutual Funds in India and Role of SEBI in Mutual Funds Industry

Unit Trust of India was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up mutual funds. In the year 1992, Securities and exchange Board of India (SEBI) Act was passed. The objectives of SEBI are – to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

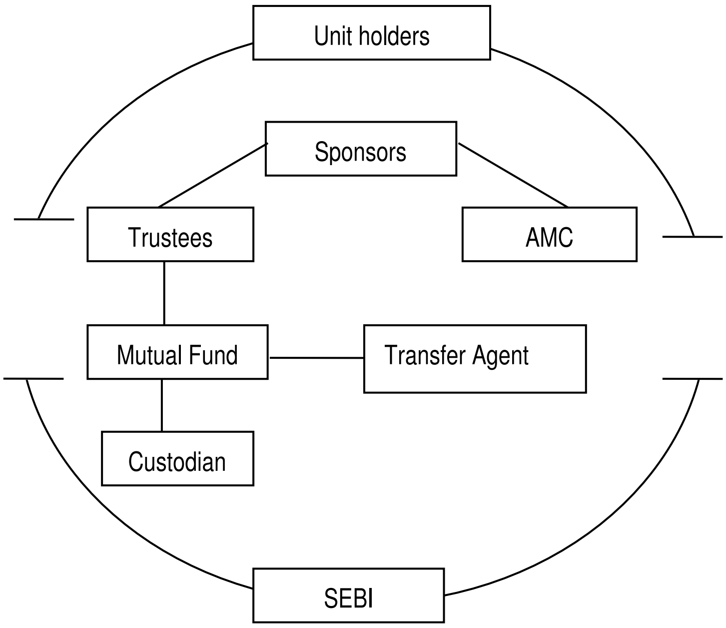
As far as mutual funds are concerned, SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

1.3 Organisation of Mutual Funds

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company (AMC) and custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unitholders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.



Here, “Asset management company” means a company formed and registered under the Companies Act, 1956 or 2013 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

“Unit” means the interest of the unit holders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme;

Money market instruments provide for borrowers' short-term needs and gives needed liquidity to lenders. Money market instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time.

1.4 Net Asset Value (NAV) of a Scheme

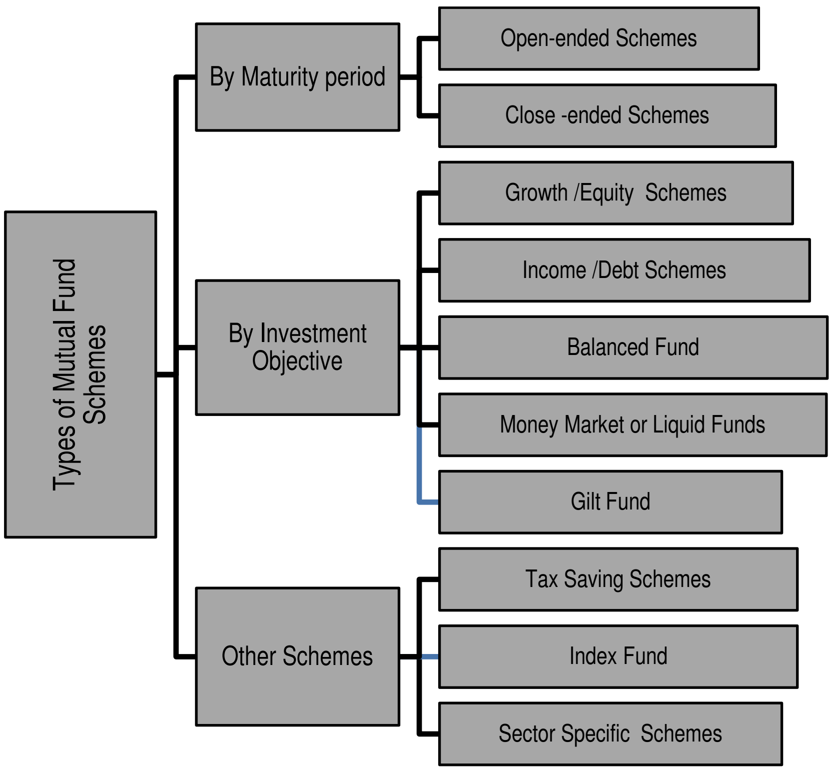
The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV).

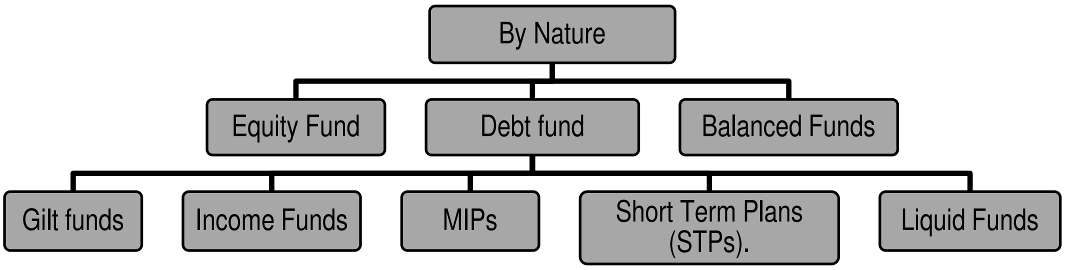
Mutual funds invest the money collected from the investors in securities markets. In simple words, Net Asset Value is the market value of the securities held by the scheme. Since market value of securities changes every day, NAV of a scheme also varies on day to day basis. The NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on any particular date.

For example, if the market value of securities of a mutual fund scheme is Rs. 200 lakhs and the mutual fund has issued 10 lakhs units of Rs. 10 each to the investors, then the NAV per unit of the fund is Rs.20. NAV is required to be disclosed by the mutual funds on a regular basis - daily or weekly - depending on the type of scheme.

1.5 Types of Mutual Fund Schemes

Wide variety of Mutual Fund Schemes exists to cater to the needs of the investors. There are over hundreds of mutual funds scheme to choose from. The charts given below will give an overview of existing types of schemes:





All the above mentioned schemes have been discussed in brief in the succeeding paragraphs.

By Maturity Period

A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period.

1. **Open - Ended Schemes:** An open-end fund is one that is available for subscription and repurchase all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.

2 **Close - Ended Schemes:** These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

3. **Interval Schemes:** Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

By Investment Objective

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

1. **Equity fund:** The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix. Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.

- **Income Schemes**: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.
- **Balanced Schemes:** Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).
- **Money Market Schemes**: Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

2. Debt funds: The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations. Debt funds are further classified as:

- **Income Funds**: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.
- **Monthly Income Plans (MIPs)**: Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.
- **Short Term Plans (STPs)**: Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

- **Liquid Funds**: Also known as Money Market Schemes, These funds provides easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

3. Balanced funds: As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

4. **Money Market or Liquid Fund:** These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

5. **Gilt Funds**: These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

By Other Schemes

1. **Tax Saving Schemes:** Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec. 80C (2) of the Income Tax Act, contributions made to any notified Equity Linked Savings Scheme (ELSS) are eligible for rebate. Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

2. **Index Schemes:** Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.

3. **Sector Specific Schemes:** These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are riskier compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time.

1.6 Fund of Funds (FoF) scheme

A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a FoF scheme. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

1.7 Load or No-load Fund

A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase to the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the performance track record and service standards of the mutual fund which are more important. Efficient funds may give higher returns in spite of loads.

A no-load fund is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and no additional charges are payable on purchase or sale of units.

1.8 Frequently Used Terms

Net Asset Value (NAV): Net asset value is the market value of the assets of the scheme minus its liabilities. The per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the valuation date.

Sale Price (SP): It is the price you pay when you invest in a scheme; also called offer price. It may include a sales load.

Repurchase Price: It is the price at which units under open-ended schemes are repurchased by the Mutual Fund. Such prices are NAV related.

Redemption Price: It is the price at which close-ended schemes redeem their units on maturity. Such prices are NAV related.

Sales Load: It is a charge collected by a scheme when it sells the units. Also called ‘Front-end’ load. Schemes that do not charge a load are called ‘No Load’ schemes.

Repurchase or ‘Back-end’ Load: It is a charge collected by a scheme when it buys back the units from the unit holders.

The Association of Mutual Funds in India (AMFI): The Association is dedicated to developing the Indian Mutual Fund Industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders.

1.9 SEBI Guidelines for Mutual Funds in India

Application for registration An application for registration of a mutual fund shall be made to the Board in Form A by the sponsor.

Furnishing information

The Board may require the sponsor to furnish such further information or clarification as may be required by it.

Eligibility criteria

(a) For the purpose of grant of a certificate of registration, the applicant has to fulfill the following, namely, the sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions;

Explanation: For the purposes of this clause "sound track record" shall mean the sponsor should,-

(i) be carrying on business in financial services for a period of not less than five years; and the net worth is positive in all the immediately preceding five years; and the net worth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and

(ii) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year.

(b) applicant is a fit and proper person.

(c) in the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by the Board;

(d) the sponsor has contributed or contributes at least 40% to the net worth of the asset management company;

Provided that any person who holds 40% or more of the net worth of an asset management company shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in these regulations;

(e) the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offense involving moral turpitude or has not been found guilty of any economic offence.

(f) appointment of trustees to act as trustees for the mutual fund in accordance with the provisions of the regulations;

(g) appointment of asset management company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations;

(h) Appointment of a custodian in order to keep custody of the securities and carry out the custodian activities as may be authorized by the trustees.

The Board may register the mutual fund and grant a certificate in Form B on the applicant paying the registration fee as specified in Second Schedule.

Trust Deed to be registered under the Registration Act

A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) executed by the sponsor in favour of the trustees named in such an instrument.

Approval of the Board for appointment of trustee

No trustee shall initially or any time thereafter be appointed without prior approval of the Board. The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the Board.

Rights and obligations of the trustees

The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement. The trustees shall ensure before the launch of any scheme that the asset management company has;-

(a) systems in place for its back office, dealing room and accounting;

(b) appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market with the trustees, within 15 days of their appointment;

(c) appointed auditors to audit its accounts;

(d) appointed a compliance officer to comply with regulatory requirement and to redress investor grievances;

(e) appointed registrars and laid down parameters for their supervision;

(f) prepared a compliance manual and designed internal control mechanisms including internal audit systems;

(g) specified norms for empanelment of brokers and marketing agents.

The trustees shall ensure that an asset management company has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.

Each trustee shall file the details of his transactions of dealing in securities with the Mutual Fund on a quarterly basis.

The trustees shall be accountable for, and be the custodian of, the funds and Trustees shall exercise due diligence as under:

1. The Trustees shall be discerning in the appointment of the directors on the Board of the asset management company.
2. The trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.
3. The trustee shall ensure that all service providers are holding appropriate registrations from the Board or concerned regulatory authority.

4. The Trustees shall arrange for test checks of service contracts.
5. Trustees shall immediately report to Board of any special developments in the mutual fund.
6. The Trustees shall: obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees.
7. Obtain compliance certificates at regular intervals from the asset management company.
8. Hold meeting of trustees more frequently to review the operation of the AMC function and auditor's report in order to take appropriate action.

1.10 Annual Report

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

As per Regulation 51, the financial year, for all the schemes, shall end as of March 31st of each year.

The scheme wise Annual Report of a mutual fund or an abridged summary thereof shall be mailed to all the unit holders as soon as may be but not later than four months from the date of closure of the relevant accounts year.

According to Eleventh Schedule, the annual report shall contain –

(i) Report of the board of Trustees on the operations of the various schemes of the fund and the fund as a whole during the year and the future outlook of the fund;

(ii) Balance Sheet and Revenue Account in accordance with paras 2, 3 and 4, respectively of this Schedule;

(iii) Auditor's Report in accordance with paragraph 5 of this Schedule;

(iv) Brief statement of the Board of Trustees on the following aspects, namely:-

   (a) Liabilities and responsibilities of the Trustees and the Settlor;

   (b) Investment objective of each scheme;

   (c) Basis and policy of investment underlying the scheme;

   (d) If the scheme permits investment partly or wholly in shares, bonds, debentures and other scrips or securities whose value can fluctuate, a statement on the following lines:

   "The price and redemption value of the units, and income from them, can go up as well as down with the fluctuations in the market value of its underlying investments in securities or fair value in underlying real estate asset, as the case may be."

   (e) Comments of the Trustees on the performance of the scheme, with full justification.

(v) Statement giving relevant perspective historical 'per unit' statistics in accordance with paragraph 6 of this Schedule;

(vi) Statement on the following lines:

"On written request, present and prospective unit holders /investors can obtain copy of the trust deed, the annual report [at a price] and the text of the relevant scheme."

1.11 Restriction on Investments

As per Seventh Schedule, a mutual fund scheme shall not invest more than ***10%*** of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorised to carry out such activity under the Act. Such investment limit may be extended to ***12%*** of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of asset management company. Provided that such limit shall not be applicable for investments in government securities and money market instruments.

1. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of asset management company.
2. No mutual fund under all its schemes should own more than ten per cent of any company's paid up capital carrying voting rights.
3. Transfers of investments from one scheme to another scheme in the same mutual fund shall be allowed only if, -
   (a) such transfers are done at the prevailing market price for quoted instruments on spot basis.

   [Explanation - "spot basis" shall have same meaning as specified by stock exchange for spot transactions.]

   (b) the securities so transferred shall be in conformity with the investment objective of the scheme to which such transfer has been made.
4. A scheme may invest in another scheme under the same asset management company or any other mutual fund without charging any fees, provided that aggregate inter scheme investment made by all schemes under the same management or in schemes under the management of any other asset management company shall not exceed 5% of the net asset value of the mutual fund.
5. Every mutual fund shall buy and sell securities on the basis of deliveries and shall in all cases of purchases, take delivery of relevant securities and in all cases of sale, deliver the securities.

   Provided that a mutual fund may engage in short selling of securities in accordance with the framework relating to short selling and securities lending and borrowing specified by the Board. Provided further that a mutual fund may enter into derivatives transactions in a recognized stock exchange, subject to the framework specified by the Board. Provided further that sale of government security already contracted for purchase shall be permitted in accordance with the guidelines issued by the Reserve Bank of India in this regard.

6. Every mutual fund shall, get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long term nature.
7. Pending deployment of funds of a scheme in securities in terms of investment objectives of the scheme a mutual fund may invest them in short term deposits of scheduled commercial banks.
8. No mutual fund [scheme] shall make any investment in;
   (a) any unlisted security of an associate or group company of the sponsor; or
   (b) any security issued by way of private placement by an associate or group company of the sponsor; or
   (c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.
9. No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company.

   Provided that, the limit of 10 per cent shall not be applicable for investments [in case of] index fund or sector or industry specific scheme.
10. A mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.
11. A fund of funds scheme shall be subject to the following investment restrictions:
    a. A fund of funds scheme shall not invest in any other fund or funds scheme;
    b. A fund of funds scheme shall not invest its assets other than in schemes of mutual funds, except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases or redemptions, as disclosed in the offer document of fund of funds scheme.

1.12 Cost of Investments

According to Ninth Schedule of SEBI (Mutual Fund) Regulations, 1996, cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments any front – end discount offered should be deducted from the cost of the investment.

As per the Eleventh Schedule of the SEBI Regulations, in respect of all interest – bearing investments, income must be accrued on a day-to-day basis as it is earned. Therefore, when such investments are purchased, interest paid for the period from the last interest due date upto the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly, interest received at the time of sale for the period from the last interest due date upto the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed. As per Regulation 51A, the exit load charged, if any, shall be credited to the scheme.

1.13 Investment Valuation Norms

Eight Schedule of the SEBI (Mutual Fund) Regulations, 1996 states the Investment Valuation Norms. NAV of a scheme as determined by dividing the net assets of the scheme by the number of outstanding units on the valuation date.

1. Traded Securities:-

(i) The securities shall be valued at the last quoted closing price on the stock exchange.

(ii) When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded. It would be left to the asset management company to select the appropriate stock exchange, but the reasons for the selection should be recorded in writing. There should however be no objection for all scrips being valued at the prices quoted on the stock exchange where a majority in value of the investments is principally traded.

(iii) Once a stock exchange has been selected for valuation of a particular security, reasons for change of the exchange shall be recorded in writing by the asset management company.

(iv) When on a particular valuation day, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

(v) When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than sixty days prior to the valuation date.

2. `Non-traded Securities':-

(i) When a security is not traded on any stock exchange for a period of thirty days prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.

(ii) Non-traded securities shall be valued "in-good faith" by the asset management company on the basis of appropriate valuation methods based on the principles approved by the Board of the asset management company. [For example, non-traded debt and money market securities of short term maturities, as may be specified by the Board from time to time, may be valued on amortization basis provided that such valuation shall be reflective of the fair value of the securities and all investors are treated fairly.] Such decision of the Board must be documented in the Board minute and the supporting data in respect of each security so valued must be preserved. The methods used to arrive at values "in-good faith" shall be periodically reviewed by the trustees and reported upon by the auditors as "fair and reasonable" in their report on the annual accounts of the fund. For the purpose of valuation of non-traded securities, the following principles should be adopted:-

(a) Equity instruments shall generally be valued on the basis of capitalization of earnings solely or in combination with the net asset value, using for the purposes of capitalization, the price or earning ratios of comparable traded securities and with an appropriate discount for lower liquidity;

(b) Debt instruments shall generally be valued on a yield to maturity basis, the capitalization factor being determined for comparable traded securities and with an appropriate discount for lower liquidity;

(c) Investments in call money, bills purchased under rediscounting scheme and short term deposits with banks shall be valued at cost plus accrual; other money market instruments shall be valued at the yield at which they are currently traded. For this purpose, non-traded instruments that is instruments not traded for a period of seven days will be valued at cost plus interest accrued till the beginning of the day plus the difference between the redemption value and the cost spread uniformly over the remaining maturity period of the instruments; Government securities will be valued at yield to maturity based on the prevailing market rate.

(d) In respect of convertible debentures and bonds, the non-convertible and convertible components shall be valued separately. The non-convertible component should be valued on the same basis as would be applicable to a debt instrument. The convertible component should be valued on the same basis as would be applicable to an equity instrument. If, after conversion the resultant equity instrument would be traded pari passu with an existing instrument which is traded, the value of the latter instrument can be adopted after an appropriate discount for the non-tradability of the instrument during the period preceding the conversion. While valuing such instruments, the fact whether the conversion is optional should also be factored in;

(e) In respect of warrants to subscribe for shares attached to instruments, the warrants can be valued at the value of the share which would be obtained on exercise of the warrant as reduced by the amount which would be payable on exercise of the warrant. A discount similar to the discount to be determined in respect of convertible debentures (as referred to in sub-paragraph (d) above) must be deducted to account for the period which must elapse before the warrant can be exercised;

(f) Where instruments have been bought on `repo' basis, the instrument must be valued at the resale price after deduction of applicable interest upto date of resale. Where an instrument has been sold on a `repo' basis, adjustment must be made for the difference between the repurchase price (after deduction of applicable interest upto date of repurchase) and the value of the instrument. If the repurchase price exceeds the value, the depreciation must be provided for and if the repurchase price is lower than the value, credit must be taken for the appreciation.

3. Until they are traded, the value of the "rights" shares should be calculated as:

$$Vr = \frac{n}{m} \times (Pex - Pof)$$

Where	Vr	=	Value of rights
	n	=	no. of rights offered
	m	=	no.of original shares held
	Pex	=	Ex-rights price
	Pof	=	Rights Offer Price

Where the rights are not treated pari passu with the existing shares, suitable adjustment should be made to the value of rights. Where it is decided not to subscribe for the rights but to renounce them and renunciations are being traded, the rights can be valued at the renunciation value.

Value of Gold:

The gold held by a gold exchange traded fund scheme shall be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand, subject to the following:

(a) adjustment for conversion to metric measure as per standard conversion rates;

(b) adjustment for conversion of US dollars into Indian rupees as per the RBI reference rate declared by the Foreign Exchange Dealers Association of India (FEDAI); and

(c) Addition of-

(i) transportation and other charges that may be normally incurred in bringing such gold from London to the place where it is actually stored on behalf of the mutual fund; and

(ii) notional customs duty and other applicable taxes and levies that may be normally incurred to bring the gold from the London to the place where it is actually stored on behalf of the mutual fund. Provided that the adjustment under clause (c) above may be made on the basis of a notional premium that is usually charged for delivery of gold to the place where it is stored on behalf of the mutual fund. Provided further that where the gold held by a gold exchange traded fund scheme has a greater fineness, the relevant LBMA prices of AM fixing shall be taken as the reference price under this sub-paragraph.

If the gold acquired by the gold exchange traded fund scheme is not in the form of standard bars, it shall be assayed and converted into standard bars which comply with the good delivery norms of the LBMA and thereafter valued in terms of sub-paragraph (1).

All expenses and incomes accrued upto the valuation date shall be considered for computation of net asset value. For this purpose, while major expenses like management fees and other periodic expenses should be accrued on a day to day basis, other minor expenses and income need not be so accrued, provided the non-accrual does not affect the NAV calculations by more than 1%.

Any changes in securities and in the number of units be recorded in the books not later than the first valuation date following the date of transaction. If this is not possible given the frequency of the Net Asset Value disclosure, the recording may be delayed upto a period of seven days following the date of the transaction, provided that as a result of the non-recording, the Net Asset Value calculations shall not be affected by more than ***1%***.

In case the Net Asset Value of a scheme differs by more than 1%, due to non-recording of the transactions, the investors or scheme/s as the case may be, shall be paid the difference in amount as follows:

(i) If the investors are allotted units at a price higher than Net Asset Value or are given a price lower than Net Asset Value at the time of sale of their units, they shall be paid the difference in amount by the scheme.

(ii) If the investors are charged lower Net Asset Value at the time of purchase of their units or are given higher Net Asset Value at the time of sale of their units, asset management company shall pay the difference in amount to the scheme. The asset management company may recover the difference from the investors.

Thinly traded securities as defined in the guidelines shall be valued in the manner as specified in the guidelines issued by the Board.

The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15 per cent of the total assets of the scheme and any illiquid securities held above 15 per cent of the total assets shall be valued in the manner as specified in the guidelines issued by Board.

1.14 Marking Investments to Market

For the purposes of the financial statements, mutual funds shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealized gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.

1.15 Pricing of Units

As per Regulation 49 of the Securities and Exchange Board of India Mutual Funds Regulations, 1996:

(1) The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.

(2) The mutual fund, in case of open ended scheme, shall at least once a week publish in a daily newspaper of all India circulation, the sale and repurchase price of units.

(3) While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than 93% of the Net Asset Value and the sale price is not higher than 107% of the Net Asset Value.

Provided that the repurchase price of the units of a close ended scheme shall not be lower than 95% of the Net Asset Value:

Provided further that the difference between the repurchase price and the sale price of the unit shall not exceed 7% calculated on the sale price.

(3A) Where a mutual fund repurchases units in a close ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 which fulfils the conditions mentioned in sub-regulation (3B), it shall deduct an amount representing proportionate initial issue expenses or part thereof remaining unamortized, from the repurchase proceeds.

Explanation:

The term —proportionate initial issue expenses or part thereof remaining unamortised refers to such proportion of the expenses of the scheme as are attributable to the units being repurchased.

(3B) The conditions referred to in sub-regulation (3A) are the following:

(a) the scheme is launched after the commencement of the Securities and Exchange Board of India (Mutual Funds) (Second Amendment) Regulations, 2006 and prior to commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2008;

(b) initial issue expenses in respect of the scheme are accounted in the books of accounts of the scheme in accordance with Tenth Schedule.

(3C) The amount recovered under sub-regulation (3A) shall be credited to the unamortized initial issue expenses of the scheme.

(4) The price of units shall be determined with reference to the last determined Net Asset Value as mentioned in sub-regulation (3) unless,

(a) the scheme announces the Net Asset Value on a daily basis; and

(b) the sale price is determined with or without a fixed premium added to the future net asset value which is declared in advance.

1.16 Limitation on Fees and Expenses on Issue of Schemes

As per Regulation 52, all expenses should be clearly identified and appropriated in the individual schemes. The asset management company may charge the scheme with investment and advisory fees which shall be fully disclosed in the offer document.

In addition to the above, the asset management company may charge the scheme with recurring expenses as mentioned in sub regulation 4.

Any other expense shall be borne by the asset management company or trustee or sponsors.

The total expenses of the scheme excluding issue or redemption expenses, whether initially borne by the mutual fund or by the asset management company, but including the investment management and advisory fee shall be subject to the following limits:—

(a) in case of a fund of funds scheme, the total expenses of the scheme including weighted average of charges levied by the underlying schemes shall not exceed 2.50 per cent of the daily net assets of the scheme.

(b) in case of an index fund scheme or exchange traded fund, the total expenses of the scheme including the investment and advisory fees shall not exceed one and one half percent (1.5%) of the daily net assets;

(c) in case of any other scheme-

(i) on the first ₹ 100 crores of the daily net assets 2.5%;

(ii) on the next ₹ 300 crores of the daily net assets 2.25%;

(iii) on the next ₹ 300 crores of the daily net assets 2.0%;

(iv) on the balance of the assets 1.75%:

In addition to the limits specified above, the following costs or expenses may be charged to the scheme, namely-

(a) brokerage and transaction costs which are incurred for the purpose of execution of trade and is included in the cost of investment, not exceeding 0.12 per cent in case of cash market transactions and 0.05 per cent in case of derivatives transactions;

(b) expenses not exceeding of 0.30 per cent of daily net assets, if the new inflows from such cities as specified by the Board from time to time are at least -

(i) 30 per cent of gross new inflows in the scheme, or;

(ii) 15 per cent of the average assets under management (year to date) of the scheme,

whichever is higher:

(c) additional expenses, incurred towards different heads mentioned under sub regulations (2) and (4), not exceeding 0.20 per cent of daily net assets of the scheme

Any expenditure in excess of the limits specified shall be borne by the asset management company or by the trustee or sponsors.

1.17 Accounting Policies For Investment in Securities

As per regulation 50(3) of SEBI (Mutual Funds) Regulations, 1996, the Asset Management Companies are required to follow the accounting policies and standards specified in the Ninth Schedule of the Regulations so as to provide appropriate details of the scheme-wise disposition of the assets of the fund at the relevant accounting date and the performance during that period together with information regarding distribution or accumulation of income accruing to the unitholder in a fair and true manner.

Following accounting policies shall be followed by Mutual Funds for the preparation of accounts:

a. For the purposes of the financial statements, mutual fund shall mark all investments to market and carry investments in the balance sheet at market value. However, since the unrealised gain arising out of appreciation on investments cannot be distributed, provision has to be made for exclusion of this item when arriving at distributable income.

b. Dividend income earned by a scheme should be recognised, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments which are not quoted on the stock exchange, dividend income must be recognised on the date of declaration.

c. In respect of all interest-bearing investments, income must be accrued on a day to day basis as it is earned. Therefore when such investments are purchased, interest paid for the period from the last interest due date up to the date of purchase must not be treated as a cost of purchase but must be debited to Interest Recoverable Account. Similarly, interest received at the time of sale for the period from the last interest due date up to the date of sale must not be treated as an addition to sale value but must be credited to Interest Recoverable Account.

d. In determining the holding cost of investments and the gains or loss on sale of investments, the "average cost" method must be followed.

e. Transactions for purchase or sale of investments should be recognised as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded, in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

f. Bonus shares to which the scheme becomes entitled should be recognised only when the original shares on which the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognised only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

g. Where income receivable on investments has accrued but has not been received for the period specified in the guidelines issued by the Board, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the Board.

h. When in the case of an open-ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative is debited to reserve, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

i. In the case of an open-ended scheme, when units are sold an appropriate part of the sale proceeds should be credited to an Equalization Account and when units are repurchased an appropriate amount should be debited to Equalization Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalization Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the distributable surplus. It should therefore be reflected in the Revenue Account only after the net income of the fund is determined.

j. In a close-ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

k. The cost of investments acquired or purchased should include brokerage, stamp charges and any charge customarily included in the broker's bought note. In respect of privately placed debt instruments any front-end discount offered should be reduced from the cost of the investment.

l. Underwriting commission should be recognised as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

m. In case of real estate mutual fund scheme, investments in unlisted equity shares shall be valued as per the norms specified in this regard.

1.18 Accounting Policies For Direct Investment in Real Estate Asset

A real estate asset that is held by a real estate mutual fund scheme shall be valued at fair value. Where a portion of the real estate asset is held to earn rentals or for capital appreciation and if the portions can be sold or leased separately, the real estate mutual fund scheme shall account for the portions separately.

Initial Recognition

A real estate mutual fund scheme shall recognise a real estate asset if (a) it is probable that the future economic benefits that are associated with the real estate asset will flow to the real estate mutual fund scheme; and (b) the cost of the asset can be measured reliably.

A real estate mutual fund scheme shall evaluate all its real estate asset costs including those incurred initially to acquire a real estate asset and those incurred subsequently to add to, replace part of, or service a real estate asset, at the time they are incurred. Provided that a real estate mutual fund scheme shall not recognise in the carrying amount of a real estate asset the costs of the day-to-day servicing of such an asset and such costs shall be recognised in the revenue account as incurred.

A real estate mutual fund scheme may acquire parts of real estate assets through replacement. For example, the interior walls may be replacements of original walls. Under the recognition principle, a real estate mutual fund scheme shall recognise in the carrying amount of a real estate asset, the cost of replacing part of an existing real estate asset at the time that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced shall be derecognised.

The real estate asset shall be recognized on the date of completion of the process of transfer of ownership i.e. the date on which the real estate mutual fund scheme obtains an enforceable right including all significant risks and rewards of ownership.

Measurement at Initial Recognition

A real estate asset shall be measured initially at cost. Such cost shall comprise purchase price and any other directly attributable expenditure such as professional fees for legal services, registration expenses and asset transfer taxes.

If the payment for a real estate asset is deferred, its cost is the cash price equivalent. A real estate mutual fund scheme shall recognise the difference between this amount and the total payments as interest expense over the period of credit.

A real estate mutual fund scheme may acquire one or more real estate assets in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such a real estate asset shall be measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired real estate asset shall be measured in this manner even if a real estate mutual fund scheme cannot immediately derecognize the asset given up. If the acquired real estate asset cannot be measured at fair value, its cost shall be measured at the carrying amount of the asset given up.

A real estate mutual fund scheme determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction.

For the purpose of determining whether an exchange transaction has commercial substance, the real estate mutual fund scheme-specific value of the portion of the real estate mutual fund scheme's operations affected by the transaction should reflect post-tax cash flows.

If the real estate mutual fund scheme is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Subsequent Measurement

After initial recognition, a real estate asset held by a real estate mutual fund scheme shall be measured at its fair value. A gain or loss arising from a change in the fair value of the real estate asset shall be recognised in the Revenue Account for the period in which it arises. The gain that arises from the appreciation in the value of real estate asset is an unrealised gain and thus the same cannot be distributed.

Where the fair value of the asset is not reliably determinable on a continuing basis, a real estate mutual fund scheme shall measure that real estate asset at cost as per AS 10. The residual value of the real estate asset shall be assumed to be zero. The real estate mutual fund scheme shall apply AS 10 until disposal of the investment asset. In determining the fair value of the real estate asset, it shall be ensured that there is no double-counting of assets or liabilities.

Explanation:

(a) equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the real estate asset, rather than recognised separately as asset, plant and equipment.

(b) if an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of real estate asset, a real estate mutual fund scheme shall not recognise that furniture as a separate asset.

(c) the fair value of real estate asset shall exclude prepaid or accrued operating lease income, because the real estate mutual fund scheme would recognise it as a separate liability or asset.

(d) The fair value of real estate asset held under a lease reflects expected cash flows (including contingent rent that is expected to become payable). Accordingly, if a valuation obtained for an asset is net of all payments expected to be made, it will be necessary to add back any recognised lease liability, to arrive at the fair value of the real estate asset for accounting purposes.

Where a real estate mutual fund scheme expects that the present value of its payments relating to a real estate asset (other than payments relating to recognised liabilities) will exceed the present value of the related cash receipts it shall apply AS 29, Provisions, Contingent Liabilities and Contingent Assets to determine whether to recognise a liability and, if so, how to measure it.

To determine the fair value of a real estate asset in accordance with the above-mentioned paragraphs, a real estate mutual fund scheme is required to use the services of two independent and approved valuers having recent experience in category of the real estate asset being valued and use the lower of the two valuations.

For accounting for rental income on real estate asset, AS 19, Leases, shall be followed. Such income shall be accrued on a daily basis, till the currency of the lease agreements.

Where the rental income receivable by a real estate mutual fund scheme in respect of real estate asset, has accrued but has not been received for the period specified by the Board. Further, provision shall be made by debiting to the revenue account the income so accrued in the manner as may be specified by the Board.

Derecognition of Real Estate Asset

A real estate mutual fund scheme shall derecognise a real estate asset on disposal or when the asset is permanently withdrawn from use and no future economic benefits are expected from its disposal.

In determining the date of disposal for real estate asset by way of sale, a real estate mutual fund scheme shall apply the criteria in AS 9, Revenue Recognition, for recognising revenue from the sale of goods and considers the related guidance in the Appendix to AS 9.

Gains or losses arising from the disposal or retirement of real estate asset shall be determined as the difference between the net disposal proceeds and the carrying amount of the real estate asset and shall be recognised in the Revenue Account in the period of the disposal or retirement.

The consideration receivable on disposal of a real estate asset is to be recognised initially at fair value. In particular, if payment for a real estate asset is deferred, the consideration received is recognized initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent should be recognised as interest revenue over the period of credit.

1.19 Contents of Balance Sheet and Revenue Account

The annual report of a mutual fund consists of (a) Balance Sheet (b) Revenue Account (c) Report of the Board of Trustees (d) Auditor's Report and (e) Statement of the Board of Trustees on specified matters.

Contents of Balance Sheet

(i) The Balance Sheet shall give scheme wise particulars of its assets and liabilities. It shall also disclose, *inter alia*, accounting policies relating to valuation of investments and other important areas.

(ii) If investments are carried at costs or written down cost, their aggregate market value shall be stated separately in respect of each type of investment, such as equity shares, preference shares, convertible debentures listed on recognized stock exchange, non-convertible debentures or bonds further differentiating between those listed on recognised stock exchange and those privately placed.

(iii) The Balance Sheet shall disclose under each type of investment the aggregate carrying value and market value of non-performing investments. An investment shall be regarded as non-performing if it has provided no returns in the form of dividend or interest for a period specified in the Guidelines issued by the Board.

(iv) The Balance Sheet shall indicate the extent of provision made in the Revenue Account for the depreciation/loss in the value of non-performing investments. However, if the investments are valued at marked to market, provisions for depreciation shall not be necessary.

(v) The Balance Sheet shall disclose the per-unit net asset value (NAV) as at the end of the accounting year.

(vi) As in case of companies, the Balance Sheet shall give against each item, the corresponding figures as at the end of the preceding accounting year.

(vii) The notes to the balance sheet should disclose the following information regarding investments:-

(a) all investments shall be grouped under the major classification given in the balance sheet;

(b) under each major classification, the total value of investments falling under each major industry group (which constitutes not less than 5% of the total investment in the major classification) shall be disclosed together with the percentage thereof in relation to the total investment within the classification;

(c) a full list of investments of the scheme shall be made available for inspection with the Asset Management Company;

(d) the basis on which management fees have been paid to the Asset Management Company and the computation thereof;

(e) if brokerage, custodial fees or any other payment for services are paid to or payable to any entity in which the Asset Management Company or its major shareholders have a substantial interest (being not less than 10% of the equity capital), the amounts debited to the revenue account or amounts treated as cost of investments in respect of such services shall be separately disclosed together with details of the interest of the Asset Management Company or its major shareholders;

(f) aggregate value of purchases and sales of investments during the year and expressed as a percentage of average weekly net asset value;

(g) where the non-traded investments which have been valued "in good faith" exceed 5% of the NAV at the end of the year, the aggregate value of such investments; and

(h) movement in unit capital should be stated.

An example of the manner in which the movement in unit capital may be disclosed is given below:

	No. of units	(₹ in lakhs)
Balance as on 1st April, 2016	1250,00,000	12,500.00
Units sold during the year	127,50,000	1,275.00
Units repurchased during the year	(15,40,000)	(154.00)
	1362,10,000	13,621.00

(i) the name of the company including the amount of investment made in each company of the group by each scheme and the aggregate investments made by all schemes in the group companies of the sponsor;

(j) if the investments are marked to market, the total income of the scheme shall include unrealised depreciation or appreciation on investment. There should be disclosure and unrealised appreciation deducted before arriving at the distributable income in the following manner, e.g.

	₹ in lakh	*₹ in lakh*
Net income as per Revenue Account	100	
Add: Balance of undistributed income		

as at 1st April, 2016 brought forward	20	120
Less: Unrealised appreciation on investments		
As on 31st March, 2017	30	
As on 1st April, 2016	15	(15)
		105
Less: Distributed to unit holders	80	
Transfer to reserve	5	(85)
		20

(viii) Provisions for doubtful deposits, doubtful debts and for doubtful outstandings and accrued income shall not be included under provisions on the liability side of the balance sheet, but shall be shown as a deduction from the aggregate value of the relevant asset.

(ix) Disclosure shall be made of all contingent liabilities showing separately underwriting commitments, uncalled liability on partly paid shares and other commitments with specifying details.

Contents of Revenue Account

(i) The Revenue Account shall give scheme wise particulars of the income, expenditure and surplus of the mutual fund. These particulars shall contain information enumerated in Annexure 2 of this Schedule.

(ii) If profit on sale of investments shown in the Revenue Account includes profit/loss on inter-scheme transfer of investments within the same mutual fund the aggregate of such profit recognised as realised, shall be disclosed separately without being clubbed with the profit/loss on sale of investments to third parties.

(iii) Unprovided depreciation in value of investments representing the difference between their aggregate market value and their carrying cost shall be disclosed by way of a note forming part of the Revenue Account. Conversely, unrealised profit on investment representing the difference between their aggregate market value and carrying cost, shall be disclosed by way of note to accounts. The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed. However, if investments are marked to market, depreciation may not be provided.

(iv) The Revenue Account shall indicate the appropriation of surplus by way of transfer to reserves and dividend distributed.

(v) The following disclosures shall also be made in the revenue accounts:

   (a) provision for aggregate value of doubtful deposits, debts and outstanding and accrued income;

   (b) profit or loss in sale and redemption of investment may be shown on a net basis;

   (c) custodian and registrar fees;

(d) total income and expenditure expressed as a percentage of average net assets, calculated on a weekly basis.

1.20 Evaluation of Mutual Funds

Mutual funds sell their shares to public and redeem them at current Net Assets Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings - All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. To illustrate this better, a simple example will help.

Scheme name	:	XYZ
Scheme size	:	₹ 50,00,00,000 (Rupees Fifty crores)
Face value of units	:	₹ 10
No. of units	:	5,00,00,000 $\frac{\text{Scheme size}}{\text{Face value of units}}$
Investments	:	In shares
Market value of shares	:	₹ 75,00,00,000 (Rupees seventy five crores)
	=	$\frac{\text{Market value of investments}}{\text{No. of units}} = \frac{₹\ 75,00,00,000}{5,00,00,000} = ₹\ 15$

Thus, each unit of ₹ 10 is worth ₹ 15.

Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and *vice versa*.

NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. The Net Asset Value (NAV) is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keep on changing with change in market value of portfolio under the scheme. The day of valuation of NAV is called the valuation day.

As per SEBI (Mutual Funds) Regulations, Regulation 48(2) states that the Net Asset Value of the scheme shall be calculated on daily basis.

Illustration 1

Sparrow Holdings is a SEBI Registered Mutual Fund which made its maiden N.F.O (New Fund Offer) on 10th April, 2016 ₹ 10 face value per unit. Subscription was received for 90 lakhs units. An underwriting arrangement was also entered into with Affinity Capital Markets Ltd., that agreed to underwrite the entire NFO of 100 lakh units on a commission of 1.5%.

Out of the monies received ₹ 892.50 lakhs was invested in various capital market instruments. The marketing expenses for the N.F.O amounted to ₹ 11.25 lakhs. During the financial year ended March

2013 the Fund sold securities having cost of ₹127.25 lakh (FV ₹ 54.36 lakhs) for ₹ 141.25 lakhs. The fund in turn purchased securities for ₹ 130 lakhs. The management expenses of the fund are regulated by SEBI stipulations which state that the same shall not exceed 0.25% of the average funds invested during the year. The actual amount spent towards management expenses was ₹ 2.47 lakhs of which ₹ 47,000 was in arrear. The dividends earned on the investments held amounted to ₹ 2.51 lakhs of which a sum of ₹ 25,000 is yet to be collected. The fund distributed 80% of realized earnings. The closing market value of the portfolio was ₹ 1120.23 lakhs.

You are required to determine the closing per unit NAV of the fund.

Solution

Calculation of Closing per unit of NAV of the fund

	₹ in lakhs
Net Assets of Sparrow holding	
Closing cash balance (W.N.2)	79.99
Closing Market Value of Investments	1,120.23
Accrued Dividends (collectable)	0.25
	1,200.47
Less: Current Liabilities	
Outstanding Management Fee (payable)	(0.47)
Closing Net Assets (A)	1,200.00
Units outstanding (in lakhs) (B)	100.00
NAV per unit (A/B)	12.00

Working Notes:

			₹ in lakhs
1.	**Computation of opening cash balance**		
	Proceeds of NFO in full including underwriters commitment		1000.00
	Less: Initial Purchase of Securities		(892.50)
			107.50
	Less: Underwriting Commission	15.00	
	Marketing Expenses	11.25	(26.25)
	Opening Cash Balance		81.25
2.	**Computation of Closing cash balance**		
	Opening bank balance (W.N.1)		81.25
	Add: Proceeds from sale of securities	141.25	
	Dividends received on investment	2.26	143.51
			224.76
	Less: Cost of Securities purchased	130.00	

	Management Expenses (W.N.3)	1.76	
	Capital Gains Distributed ₹ (141.25 - 127.25 x 80%)	11.20	
	Dividends Distributed ₹ (2.26 x 80%)	1.81	(144.77)
	Closing cash balance		79.99
3.	**Computation of Management Expenses Chargeable**		
	Actual Expense Incurred [A]		2.47
	Opening Investment Made	892.50	
	Closing Funds Invested (892.50 - 127.25 + 130)	895.25	
	Total	1,787.75	
	Average Funds Invested (1,787.75/2)	893.875	
	0.25% of Average Funds Invested [B]		2.23
	Lower of A or B		2.23
	Less: Amount unpaid		(0.47)
	Management expenses paid		1.76

Illustration 2

Calculate the year-end NAV of the Mutual Fund scheme on the basis of the information given below:

(i) *UTI launched a new Fund scheme for ₹ 6,000 crore.*

(ii) *Underwriting Commission is 1% of the fund shared equally by SBI, PNB, Syndicate Bank and UTI Bank.*

(iii) *The Fund was launched on 1.4.2016 with a face value of ₹ 1000 per unit.*

(iv) *Underwriting Commission was paid in full.*

(vi) *Management Expense was allowed by SEBI @ 1% of the Fund raised. However, during the year management expense was of ₹ 45 crore only. The management decided to defer the payment of ₹ 5 crore to the next financial year.*

(vii) *On 1.5.2016, the total fund received was invested after deduction of underwriting commission and ₹ 100 crore to meet the day to day management expenses. The investment fund received yielded 10% interest per annum. The interest was received for 3 quarters and the interest of last quarter is yet to receive. The interest realized in cash has been distributed to the unit holders @ 80%. The financial year runs from April to March. The quarter starts from the date of investment i.e. 1.5.2016.*

Solution

Calculation of Net Asset Value of a fund

		₹ in crores
Total Assets:		
Investment (6,000 - 60 -100)	5,840.00	
Add: Closing Cash Balance (Refer W.N.)	147.60	
Add: Interest for two months due to be received	97.33	6,084.93

$\left(5,840 \times 10\% \times \frac{2}{12}\right)$)			
Less: Outstanding Management Expenses			(5.00)
Total value of the fund			6,079.93

No. of Units = $\frac{₹\ 6,000\ \text{crore}}{1,000} = 6\ \text{crore units}$

NAV per unit = $\frac{₹\ 6079.93\ \text{crore}}{6\ \text{crore}}$ = ₹ 1,013.32 per unit

Working Note:

Calculation of year-end cash/bank balance of the fund

		₹ in crores
Cash received during the year for the fund		
Sale of units		6,000
Add: Interest for 3 quarters on investment $\left(5,840 \times 10\% \times \frac{9}{12}\right)$		438
		6,438
Less: Underwriting commission	60	
Management expenses paid in cash	40	
Investment	5,840	
Dividend paid (438 x 80%)	350.40	(6,290.40)
		147.60

1.21 Disposal of Investments

The profit/loss arising on the disposal of investment is the difference between the selling price and the cost. The profit arising on disposal of investment is recognised fully in the Revenue Account.

The loss on disposal of investment is recognised fully in the revenue account, if the investments are sold in the same year in which they are purchased. However, if an investment is sold in any year subsequent to year of purchase, loss on disposal is charged first against provision for depreciation to the extent of balance available, and the balance of loss, if any, should be charged directly to the Revenue Account.

Illustration 3

The investment portfolio for a mutual fund scheme includes 10,000 shares of A Ltd. and 8,000 shares of B Ltd. acquired on 30/10/2016. The cost of A Ltd. shares is ₹ 20 while that of B Ltd. shares is ₹ 30. The market values of these shares at the end of 2016-17 were ₹ 19 and ₹ 32 respectively. Show important accounting entries in books of the fund in the accounting year 2016-17.

Solution

	₹ 000	₹ 000
31.10.16 Investment in A Ltd. Shares Dr.	200	
Investment in B Ltd. Shares Dr.	240	
To Bank		440
(Being purchase of A Ltd., 10,000 shares @ ₹ 20 and 8000 shares of B Ltd., @ ₹ 30 each)		
31.3.17 Revenue A/c Dr.	10	
To Provision for Depreciation		10
(Being market value of A Ltd depreciated for ₹ 1 each for 10,000 shares)		
31.3.17 Investment in B Ltd. Shares Dr.	16	
To Unrealised Appreciation Reserve		16
(Being 8000 shares of B Ltd., appreciated @ ₹ 2 each per share on the closing date)		

Illustration 4

In the previous example, suppose that shares of both of the companies were disposed off on 31/05/16 realizing ₹ 18.50 per A Ltd. shares and ₹ 33.50 per B Ltd. shares. Show important accounting entries in books of the fund in the accounting year 2016-17.

Solution

Date	*Particulars*	*₹ 000*	*₹ 000*
1.4.16	Unrealised Appreciation Reserve Dr.	16	
	To Investment in B Ltd. Shares		16
	(Being 8,000 shares of B Ltd., appreciated @ ₹ 2 each per share on the closing date has been reversed at the beginning of the next year)		
31-5-16	Bank Account Dr.	185	
	Loss on disposal of Investment Dr.	15	
	To Investment in A Ltd. Shares		200
	(Being ₹ 2,00,000 of A Ltd., shares sold for ₹ 1,85,000 and Loss incurred ₹ 15,000)		
	Provision for Depreciation Dr.	10	
	Revenue A/c Dr.	5	
	To Loss on disposal of Investment		15
	(Earlier depreciation provision provided being reversed on disposal of total shares of A Ltd., and the balance amount debited to Revenue Account.)		

	Bank Account Dr.		268	
	To Investment in B Ltd. shares			256
	To Revenue A/c			12
	(Being 8,000 shares of B Ltd., sold @ ₹ 33.50 accounted on the trade date as per AS 30 since this is a regular transaction in the business)			

Illustration 5

A fund purchased 10,000 debentures of a company on June 1, 2016 for 10.7 lakh and further 5,000 debentures on November 1, 2016 for ₹ 5.45 lakh. The debentures carry fixed annual coupon of 12%, payable on every 31 March and 30 September. On February 28, 2017 the fund sold 6,000 of these debentures for ₹ 6.78 lakh. Nominal value per debenture is ₹ 100.

Show Investment in Debentures A/c in books of the fund.

Solution

Investment in Debentures A/c

		₹ Lakh			*₹ Lakh*
June 1, 2016	To Bank	10.70	June 1, 2016	By Interest Recoverable (Note 1)	0.20
Nov. 1, 2016	To Bank	5.45	Nov. 1, 2016	By Interest Recoverable (Note 2)	0.05
Feb. 28, 2017	To Interest Recoverable (Note 3)	0.30	Feb. 28, 2017	By Bank	6.78
Feb. 28, 2017	To Profit on disposal (Note 4)	0.12	March 31, 2017	By Balance c/d	9.54
		16.57			16.57

Working Notes:

Note 1: 10,000 x 100 x 12/100 x 2/12 = ₹ 0.20 Lakhs

Note 2: 5,000 x 100 x 12/100 x 1/12 = ₹ 0.05 Lakhs

Note 3: 6,000 x 100 x 12/100 x 5/12 = ₹ 0.30 Lakhs

Note 4: Cost of investments (per unit) = [(10,70,000 -20,000)+(5,45,000– 5,000)]/15,000 units

= [10,50,000+ 5,40,000]/15,000 = ₹ 106

Cost of investments sold = ₹ 106 x 6,000 = ₹ 6,36,000

Sale proceeds = ₹ 6,78,000 - ₹ 30,000(interest) = ₹ 6,48,000

Profit = ₹ 6,48,000 - ₹ 6,36,000 = ₹ 12,000

1.22 Recognition of Dividend Income

Dividend income earned by a scheme should be recognized, not on the date the dividend is declared, but on the date the share is quoted on an ex-dividend basis. For investments, which are not quoted on the stock exchange, dividend income must be recognized on the date of declaration.

Where income receivable on investments has accrued but has not been received for the period specified in the SEBI guidelines, the income accrued should be debited to Revenue A/c as provision.

Bonus shares to which the scheme becomes entitled should be recognized only when the original shares on which the bonus the bonus entitlement accrues are traded on the stock exchange on an ex-bonus basis. Similarly, rights entitlements should be recognized only when the original shares on which the right entitlement accrues are traded on the stock exchange on an ex-rights basis.

1.23 Date of Recognition of Transactions

For investments in securities

Transaction for purchase or sale of investments should be recognized as of the trade date and not as of the settlement date, so that the effect of all investments traded during a financial year are recorded and reflected in the financial statements for that year. Where investment transactions take place outside the stock market, for example, acquisitions through private placement or purchases or sales through private treaty, the transaction should be recorded in the event of a purchase, as of the date on which the scheme obtains in enforceable obligation to pay the price or, in the event of a sale, when the scheme obtains an enforceable right to collect the proceeds of sale or an enforceable obligation to deliver the instruments sold.

(a) When in the case of an open – ended scheme units are sold, the difference between the sale price and the face value of the unit, if positive, should be credited to reserves and if negative be debited to reserves, the face value being credited to Capital Account. Similarly, when in respect of such a scheme, units are repurchased, the difference between the purchase price and face value of the unit, if positive should be debited to reserves and, if negative, should be credited to reserves, the face value being debited to the capital account.

(b) In the case of an open – ended scheme, when units are sold an appropriate part of the sale proceeds should be credited to an Equalisation Account and when units are repurchased an appropriate amount should be debited to Equalisation Account. The net balance on this account should be credited or debited to the Revenue Account. The balance on the Equalisation Account debited or credited to the Revenue Account should not decrease or increase the net income of the fund but is only an adjustment to the distributable surplus. It should, therefore, be reflected in the Revenue Account only after the net income of the fund is determined.

(c) In a close – ended scheme which provide to the unit holders the option for an early redemption or repurchase their own units, the par value of the unit has to be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be credited to reserves and, if negative, should be debited to reserves. A proportionate part of the unamortized initial issue expenses should also be transferred to the reserves so that the balance carried forward on that account is proportional to the number of units remaining outstanding.

(d) Underwriting commission should be recognized as revenue only when there is no devolvement on the scheme. Where there is devolvement on the scheme, the full underwriting commission received and not merely the portion applicable to the devolvement should be reduced from the cost of the investment.

For investments in real estate assets

In a real estate mutual fund scheme which provides to the unit holders the option for an early redemption or repurchase their own units the par value of the unit shall be debited to Capital Account and the difference between the purchase price and the par value, if positive, should be debited to reserves and, if negative, shall be credited to reserves.

1.24 Dividend Equalisation

New investors are not entitled to any share of the income of a mutual fund scheme which arose before they bought their units. However, at the end of each distribution period the fund management allocates the same amount from the income of the fund to each unit. To compensate for this an equalisation payment is added to the cost of new units. This is the amount of income that has arisen up to the date of purchase of the unit. Because these payments are included in the amount available for distribution they are effectively repaid to the purchaser. The purchaser's dividend voucher at the end of the first distribution period should show the amount of the returned equalisation payment. This payment is not income. It should not be treated as capital distribution. It is a return of the initial price paid and it should therefore be deducted from the price paid when computing the chargeable gain on eventual disposal.

Illustration 6

On April 1, 2016 a mutual fund scheme had 9 lakh units of face value ₹ 10 outstanding. The scheme earned ₹ 81 lakh in 2016-17, out of which ₹ 45 lakh was earned in first half-year. 1 lakh units were sold on 30.09.16 at NAV ₹ 60. Show important accounting entries for sale of units and distribution of dividend at the end of 2016-17.

Solution

Allocation of earnings

	Old unit holders (9 lakh units) (₹ Lakh)	*New unit holders (1 lakh units) (₹ lakh)*	*Total earning (₹ Lakh)*
First half-year (₹ 5.00 per unit)	45.0	Nil	45.0

Second half-year (₹ 3.60 per unit)	32.4	3.6	36.0
	77.4	3.6	81.0
Add: Equalisation payment recovered			5.0
Total available for distribution			86.0

Note: Equalisation payment = ₹ 45 lakh / 9 lakh = ₹ 5 per unit.

Distribution of earning per unit

	Old unit holders ₹	*New unit holders* ₹
Dividend distributed	8.60	8.60
Less: Equalisation payment		(5.00)
Net distributed income	8.60	3.60

Journal Entries

Date		*₹ lakh*	*₹ lakh*	
30/09/16	Bank Dr.	65		1 lakh x ₹ 65
	To Unit Capital		10	1 lakh x ₹ 10
	To Reserves		50	1 lakh x ₹ 50
	To Dividend Equalisation		5	1 lakh x ₹ 5
31/03/17	Dividend Equalisation Dr.	5		
	To Revenue A/c		5	
31/03/17	Revenue A/c Dr.	86		
	To Bank		86	10 lakh x ₹ 8.60

UNIT 2: NON-BANKING FINANCE COMPANY

2.1 Introduction

Non Banking Financial Companies (NBFC) play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognised as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress. Simplified sanction procedures, orientation towards customers, attractive rates of return on deposits and flexibility and timeliness in meeting the credit needs of specified sectors (like equipment leasing and hire purchase), are some of the factors that enhanced the attractiveness of NBFCs.

2.2 Definition of NBFC

Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non-banking institution which is a company with principal business of receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) Such other non-banking institution or class of such institutions, as the Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – "Loan company", "Investment company", "Hire purchase finance company", "Equipment leasing company" and "Mutual benefit financial company".

In a simple language, an Non-Banking Financial Company (NBFC)

- is a company registered under the Companies Act, 1956 or 2013
- is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business
- does not include any institution whose **principal business** is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.

Residuary non-banking company - A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or any other manner, or lending in any manner is also a non-banking financial company.

What does conducting financial activity as "principal business" mean?

Financial activity as principal business is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business.

2.3 Registration of Every NBFC with RBI

In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial company can commence or carry on business of a non-banking financial institution without a) obtaining a certificate of registration from the Bank and without having a Net Owned Funds of ₹ 25 lakhs (₹ Two crore since April 1999). However, in terms of the powers given to the Bank, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982,Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit company.

2.4 Distinction between an NBFC and a Bank

NBFCs perform functions similar to that of banks. However there are following few differences:

S.No.	NBFC	Bank
1.	An NBFC cannot accept demand deposits	A Bank can accept demand deposits
2.	An NBFC is not a part of the payment and settlement system	A Bank is a part of the payment and settlement system
3.	An NBFC cannot issue cheques drawn on itself	A Bank can issue cheques drawn on itself
4.	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors, unlike banks	Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available for banks

2.5 Classification of NBFC

Does the Reserve Bank regulate all financial companies? No.

A. Companies exempted from registration under RBI

Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

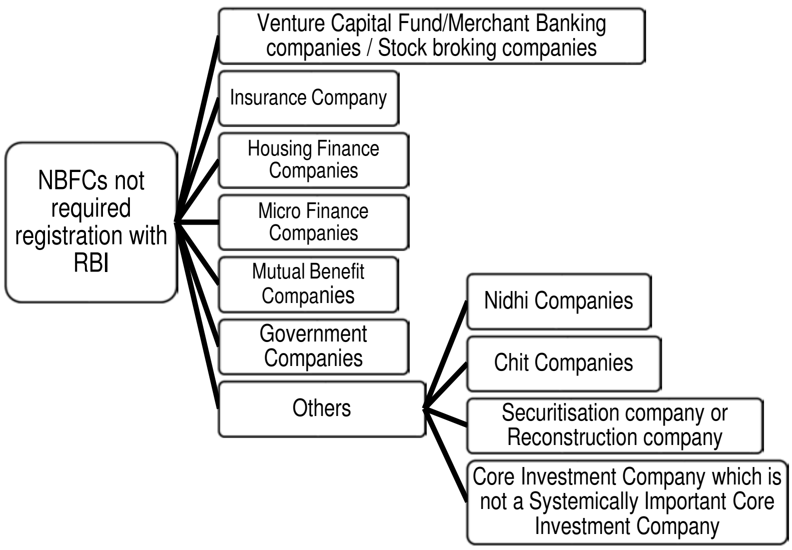
Housing Finance Companies are regulated by National Housing Bank, Merchant Banker/Venture Capital Fund Company/stock-exchanges/stock brokers/sub-brokers are regulated by Securities and Exchange Board of India, and Insurance companies are regulated by Insurance Regulatory and Development Authority. Similarly, Chit Fund Companies are regulated by the respective State Governments and Nidhi Companies are regulated by Ministry of Corporate Affairs, Government of India.

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation.

It may also be mentioned that Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I(f)(iii) of the RBI Act, 1934.

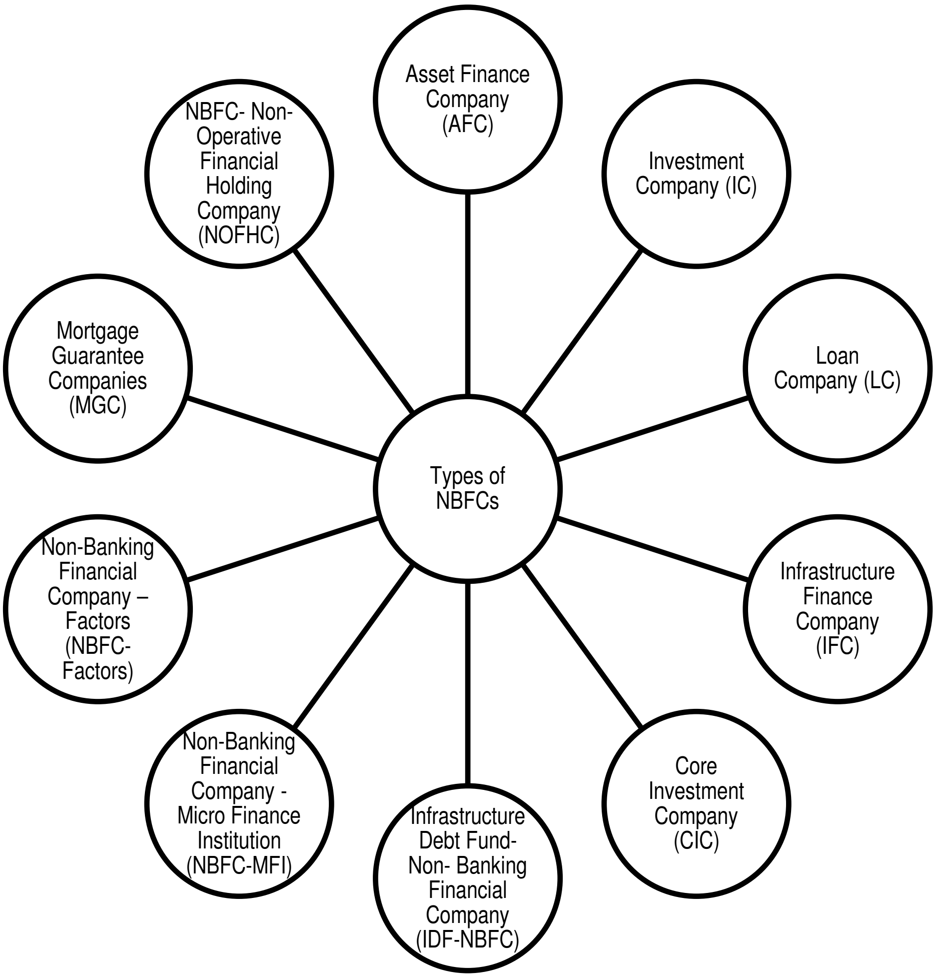
Core Investment Companies with asset size of less than ₹ 100 crore, and those with asset size of ₹ 100 crore and above but not accessing public funds are exempted from registration with the RBI.

NBFCs not registered with RBI are classified under following categories:



B. NBFCs mandated to register under RBI

NBFCs registered with RBI are classified under following categories:



NBFCs are categorized a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs, b) non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

1. Asset Finance Company (AFC)

(i) AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.

(ii) Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively.

2. **Investment Company (IC):** It means a company which is a financial institution carrying on as its main business of the acquisition of securities.

3. **Loan Company (LC):** It means any company which is a financial institution carrying on as its main business by providing finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

4. **Infrastructure Finance Company:** An IFC is defined as **non deposit taking NBFC** that fulfills the criteria mentioned below:

(i) have a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(ii) have a net owned funds of ₹ 300 crore or above;

(iii) have obtained a minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA, Brickwork Ratings India Pvt. Ltd. or equivalent rating by any other crediting rating agency accredited by RBI;

(iv) have a Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

5. **Core Investment Companies:** Core Investment Company means a NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in section 45-I(*c*) and 45-I(*f*) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

Core Investment Companies (CIC) with an asset size of less than ₹ 100 crores will not be required to register themselves with RBI.

Core Investment Companies (CIC) with total assets size of ₹ 100 crores or more either individually or in aggregate alongwith other Core Investment Companies in the groups and raises or holds public funds will be regarded as Systemically Important Core Investment Companies (CICs-ND-SI). NBFCs whose asset size is of ₹ 500 cr or more as per last audited balance sheet are considered as systemically important NBFCs. Systemically Important Core Investment Companies will be required to get themselves registered with Reserve Bank of India.

A CIC-ND-SI which fulfills the following conditions, will not be required to meet the requirement for maintaining Net Owned Funds & capital adequacy and exposure norms as required under Non-Banking Financial (Non-Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007:

- Maintenance of minimum Capital Ratio where Adjusted Net Worth shall not be less than 30% of its Aggregate Risk Weighted Assets on Balance Sheet and risk adjusted value off-balance sheet items as on the date of the last audited Balance Sheet at the end of the financial year.
- Ensuring that it’s outside liabilities at all times doesn’t not exceed 2.5 times of the Adjusted Net Worth as on last audited Balance Sheet date.

The above mentioned categories may further have the following sub-categories depending upon their business functions:

(i) Equipment leasing company engaged in equipment leasing or financing of such activity.

(ii) Hire purchase finance company engaged in hire purchase transaction or financing of such transactions.

(iii) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.

(iv) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing finance Companies (HFCs).

6. Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC): “Infrastructure Finance Company” means a non-deposit taking NBFC that fulfills the following criteria :

(a) a minimum of 75 per cent of its total assets deployed in “infrastructure loans”;

(b) Net owned funds of ` 300 crore or above;

(c) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA, Brickwork Rating India Pvt. Ltd. (Brickwork) or equivalent rating by any other credit rating agency accredited by the Bank;

(d) CRAR of 15 percent (with a minimum Tier I capital of 10 percent).

It invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

Infrastructure Debt Funds (IDFs) facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as trust or as a company. A trust based IDF would normally be a mutual fund while a company based IDF would normally be a NBFC i.e. IDF-NBFC. IDF- NBFC would raise resources through issue of either Rupee or Dollar denominated bonds of minimum

5 year maturity. The investors would be primarily domestic and off-shore institutional investors, especially insurance and pension funds which would have long term resources. IDF-NBFC would be regulated by the Reserve Bank.

7. Non-Banking Financial Company–Micro Finance Institution (NBFC-MFI): The Reserve Bank of India having considered it necessary in the public interest and being satisfied that for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, gave the directions for the Non-Banking Financial Company -Micro Finance Institutions (Reserve Bank) Directions, 2011.

An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956 or Section 8 of the Companies Act, 2013) having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

i. Minimum Net Owned Funds of ₹ 5 crore. (For NBFC-MFIs registered in the North Eastern Region of the country, the minimum NOF requirement shall stand at ₹ 2 crore).

ii. Not less than 85% of its net assets are in the nature of "qualifying assets."

For the purpose of ii above,

"Net assets" are defined as total assets other than cash and bank balances and money market instruments.

"Qualifying asset" shall mean a loan which satisfies the following criteria:-

a. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹ 1,00,000 or urban and semi-urban household income not exceeding ₹ 1,60,000;

b. loan amount does not exceed ₹ 50,000 in the first cycle and ₹ 1,00,000 in subsequent cycles;

c. total indebtedness of the borrower does not exceed ₹ 1,00,000;

d. tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;

e. loan to be extended without collateral;

f. aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;

g. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

8. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

9. Mortgage Guarantee Companies (MGC): MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is ₹ 100 crore.

10. **NBFC- Non-Operative Financial Holding Company (NOFHC)** is financial institution through which promoter / promoter groups will be permitted to set up a new bank. It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

2.6 Registration and Regulation of NBFC

Under Section 45–IA of the Reserve Bank of India (Amendment) Act, 1997, no non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with the following:

i. it should be a company registered under Section 3 of the companies Act, 1956

ii. It should have a minimum net owned fund of ₹ 200 lakh. (The minimum net owned fund (NOF) required for specialized NBFCs like NBFC-MFIs, NBFC-Factors, CICs is indicated separately in the FAQs on specialized NBFCs)

They can apply to Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders. RBI has also issued Fair Practices Code to be adopted by all NBFCs while doing lending business. The guidelines inter alia, covered general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery method.

2.7 Residuary Non-Banking Companies (RNBCs)

Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Asset Financing, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds as per Directions. Besides, Prudential Norms Directions are applicable to these companies also.

The minimum interest an RNBC should pay on deposits should be 5% (to be compounded annually) on the amount deposited in lump sum or at monthly or longer intervals; and 3.5% (to be compounded annually) on the amount deposited under daily deposit scheme. Interest here includes premium, bonus or any other advantage, that an RNBC promises to the depositor by way of return. An RNBC can accept deposits for a minimum period of 12 months and maximum period of 84 months from the date of receipt of such deposit. They cannot accept deposits repayable on demand. However, at present, the only RNBCs in existence (Peerless) has been directed by the Reserve Bank to stop collecting deposits, repay the deposits to the depositor and wind up their RNBC business as their business model is inherently unviable.

2.8 Minimum Net Owned Fund

On registration of NBFC with RBI, all NBFCs have to comply with certain requirements like maintenance of the minimum Net Owned Fund (NOF), creation of reserve fund, compulsory transfer of certain percentage of net profit etc.

NOF requirement for new companies applying for grant of CoR to commence business of an NBFC is stipulated at ₹200 lakh.

As per the definition:

Owned Fund = Aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, after deducting therefrom accumulated balance of loss, deferred revenue expenditure and other intangible assets.

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC – Book value of debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund)

In terms of Section 45-IC of the RBI Act, NBFCs are required to create a reserve fund and transfer therein a sum not less than twenty per cent of its net profit every year.

2.9 Liquid Asset Requirements

In terms of Section 45-IB of the RBI Act, 1934 the minimum level of liquid asset to be maintained by NBFCs is 15 per cent of public deposits outstanding as on the last working day of the second preceding quarter.

Of the 15%, NBFCs are required to invest not less than 10% in approved securities and the remaining 5% can be in unencumbered term deposits with any scheduled commercial bank. Thus, the liquid assets may consist of government securities, government guaranteed bonds and term deposits with any scheduled commercial bank.

The investment in government securities should be in dematerialised form which can be maintained in Constituents' Subsidiary General Ledger (CSGL) Account with a scheduled commercial bank (SCB) / Stock Holding Corporation of India Limited (SHICL). In case of Government guaranteed bonds the same may be kept in dematerialised form with SCB/SHCIL or in a dematerialised account with depositories [National Securities Depository Ltd. (NSDL)/Central Depository Services (India) Ltd. (CDSL)] through a depository participant registered with Securities & Exchange Board of India (SEBI). However in case there are Government bonds which are in physical form the same may be kept in safe custody of SCB/SHCIL.

NBFCs have been directed to maintain the mandated liquid asset securities in a dematerialised form with the entities stated above at a place where the registered office of the company is situated. However, if a NBFC intends to entrust the securities at a place other than the place at which its registered office is located, it may do so after obtaining in writing the permission of RBI. It may be noted that the liquid assets in approved securities will have to be maintained in dematerialised form only.

The liquid assets maintained as above are to be utilised for payment of claims of depositors. However, deposit being unsecured in nature depositors do not have direct claim on liquid assets.

2.10 Categories of NBFCs

The Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into newer areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are as exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system.

Accordingly, NBFCs are categorized into following three groups for the purpose of administering prudential regulations:

1. Deposits taking NBFCs (NBFCs-D);
2. Non-deposit taking NBFCs (NBFCs-ND) (those with assets of less than ₹ 500 crore); and
3. Non–deposit taking systemically important NBFCs (NBFCs-ND-SI) (those with assets of ₹ 500 crore and above),

2.11 Prudential Accounting Norms

In order to ensure that NBFCs function on sound and healthy lines and make adequate disclosures in their financial reports, the Reserve Bank has issued prudential norms for all the Non-banking Financial Companies. The current prudential regulation mainly comprises the following elements:

a) Norms relating to Income Recognition, Asset Classification and Provisioning norms;

b) Capital to Risk Weighted Assets Ratio (CRAR); and

c) Credit Concentration Norms

Note: [norms at b) and c) are applicable to only NBFCs–D and NBFCs-ND-SI].

Currently, there are following two sets of Directions for prudential norms:

1. "Non-Banking Financial Company–Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016"

   The provisions of "Non-Banking Financial Company –Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016", shall apply to

   (i) every non-banking financial company not accepting / holding public deposits which is not systemically important (as defined in paragraph 3 (xxviii) of the Directions;

   (ii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of below ` 500 crore;

   (iii) every Non-Banking Finance Company – Micro Finance Institution (NBFC-MFI) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ` 500 crore;

   (iv) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of below ` 500 crore.

2. "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016"

   The provisions of "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016" shall apply to:

   (i) every Systemically Important Non-Deposit taking Non-Banking Financial Company (NBFC-ND-SI) registered with the Bank under the provisions of RBI Act, 1934;

   (ii) every Deposit taking Non-Banking Financial Company (NBFC-D) registered with the Bank under the provisions of RBI Act, 1934;

   (iii) every NBFC-Factor registered with the Bank under section 3 of the Factoring Regulation Act, 2011 and having an asset size of ` 500 crore and above;

   (iv) every Infrastructure Debt Fund –Non-Banking Finance Company(IDF-NBFC) registered with the Bank under the provisions of RBI Act, 1934;

   (v) every Non-Banking Finance Company –Micro Finance Institutions (NBFC-MFIs) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ` 500 crore and above;

   (vi) every Non-Banking Finance Company - Infrastructure Finance Company (NBFC-IFC) registered with the Bank under the provisions of RBI Act, 1934 and having an asset size of ` 500 crore and above.

2.12 Important Definitions

Break up value means the equity capital and reserves as reduced by intangible assets and revaluation reserves, divided by the number of equity shares of the investee company.

Carrying cost means book value of the assets and interest accrued thereon but not received.

Earning value means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;

(b) in case of predominantly trading company, ten per cent; and

(c) in case of any other company, including non-banking financial company, twelve per cent;

Note: If an investee company is a loss making company the earning value will be taken at zero.

Fair value means the mean of the earning value and the break up value.

Net book value means:

(a) **in the case of hire purchase asset**, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 9(2)(i) of these Directions;

(b) **in the case of leased asset,** aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Infrastructure Finance Company means a non-banking finance company which deploys at least 75 per cent of its total assets in infrastructure loans"

Subordinated debt means an instrument, which is fully paid up, is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of the non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

Remaining Maturity of the instruments	*Rate of discount*
(a) Upto one year	100%
(b) More than one year but upto two years	80%
(c) More than two years but upto three years	60%
(d) More than three years but upto four years	40%
(e) More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier capital.

Substantial interest means holding of a beneficial interest by an individual or his spouse or minor child, whether singly or taken together in the shares of a company, the amount paid up on which exceeds ten per cent of the paid up capital of the company; or the capital subscribed by all the partners of a partnership firm.

Systemically important non-deposit taking non-banking financial company means a non-banking financial company not accepting / holding public deposits and having total assets of ₹ 500 crore and above as shown in the last audited balance sheet.

2.13 Income Recognition

(1) The income recognition shall be based on recognised accounting principles.

(2) Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.

2.14 Income from Investment

(1) Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. Provided that the income from dividend on shares of corporate bodies shall be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the applicable NBFC's right to receive payment is established.

(2) Income from bonds and debentures of corporate bodies and from Government securities/bonds shall be taken into account on accrual basis. Provided that the interest rate on these instruments is pre-determined and interest is serviced regularly and is not in arrears.

(3) Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government shall be taken into account on accrual basis.

2.15 Accounting for Investments

1. (a) The Board of Directors of every non-banking financial company shall frame investment policy for the company and implement the same;

   (b) The criteria to classify the investments into current and long term investments shall be spelt out by the Board of the company in the investment policy;

   (c) Investments in securities shall be classified into current and long term, at the time of making each investment;

   (d) (i) There shall be no inter-class transfer on ad-hoc basis;

   (ii) The inter-class transfer, if warranted, shall be effected only at the beginning of each half year, on April 1 or October 1, with the approval of the Board;

   (iii) The investments shall be transferred scrip-wise, from current to long-term or vice-versa, at book value or market value, whichever is lower;

(iv) The depreciation, if any, in each scrip shall be fully provided for and appreciation, if any, shall be ignored;

(v) The depreciation in one scrip shall not be set off against appreciation in another scrip, at the time of such inter-class transfer, even in respect of the scrips of the same category.

2. Quoted current investments shall, for the purposes of valuation, be grouped into the following categories, viz.,

   (a) equity shares,

   (b) preference shares,

   (c) debentures and bonds,

   (d) Government securities including treasury bills,

   (e) units of mutual fund, and

   (f) others.

   Quoted current investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

3. Unquoted equity shares in the nature of current investments shall be valued at cost or break up value, whichever is lower. However, non-banking financial companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at one Rupee only.

4. Unquoted preference shares in the nature of current investments shall be valued at cost or face value, whichever is lower.

5. Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

6. Unquoted investments in the units of mutual funds in the nature of current investments shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme.

7. Commercial papers shall be valued at carrying cost.

8. A long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

Note: Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

2.16 Applicability of Prudential Norms

One of the main objectives of prudential regulation is to address systemic risks. The systemic risks posed by NBFCs functioning exclusively out of their own funds and NBFCs accessing public funds cannot be equated and hence cannot be subjected to the same level of regulation. Hence, as a principle, enhanced prudential regulations has been made applicable to NBFCs wherever public funds are accepted and conduct of business regulations are made applicable wherever customer interface is involved.

Accordingly, the regulatory approach in respect of NBFCs-ND with an asset size of less than ₹ 500 crore is as under:

(i) They shall not be subjected to any regulation either prudential or conduct of business regulations viz., Fair Practices Code (FPC), KYC, etc., if they have not accessed any public funds and do not have a customer interface.

(ii) Those having customer interface will be subjected only to conduct of business regulations including FPC, KYC etc., if they are not accessing public funds.

(iii) Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.

(iv) Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

All NBFCs-ND with assets of ₹ 500 crore and above, irrespective of whether they have accessed public funds or not, has to comply with prudential regulations as applicable to NBFCs-ND-SI. They has to also comply with conduct of business regulations if customer interface exists.

Note: For this purpose, the term ‘public funds’ includes “funds raised directly or indirectly through public deposits, commercial papers, debentures, inter-corporate deposits and bank finance, but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 5 years from the date of issue”.

2.17 Asset Classification

Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes namely, -

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

(a) Standard asset means an asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business.

(b) ***Sub-standard asset*** : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset means (a) an asset which has been classified as non-performing asset for a period not exceeding 14 months for the financial year ending March 31, 2017; (b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

Note: The above ***14 months*** criteria for classification of sub-standard asset is till the financial year ending March 31, ***2017***. However, in future, for all loan and hire-purchase and lease assets, sub-standard asset would mean an asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

> However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, sub-standard asset shall mean:
>
> (a) an asset which has been classified as non-performing asset for a period not exceeding 18 months;
>
> (b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms

(c) ***Doubtful asset*** : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, doubtful asset means (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding ***14 months*** for the financial year ending ***March 31, 2017***;

Note: The above ***14 months*** criteria for classification of doubtful asset is till the financial year ending ***March 31, 2017***. However, in future, for all loan and hire-purchase and lease assets, doubtful asset would mean an asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

> However, as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, "doubtful asset" shall mean (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 18 months.

(d) ***Loss asset*** means (i) an asset which has been identified as loss asset by the NBFC or its internal or external auditor or by the Reserve Bank during the inspection of the NBFC, to the extent it is not written off by the NBFC; and (ii) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the up gradation.

2.18 Non-Performing Asset (NPA)

'Non-performing asset' means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note : As per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the above six months criteria for the assets covered under (a) to (f) is 4 months for the financial year ending March 31, 2017; and from next year ending March 31, 2018 and thereafter it will be 3 months.

It implies that as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months only.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is 6 months for the financial year ending March 31, 2017 and from next year ending March 31, 2018 and thereafter it will be 3 months.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery;

2.19 Provisioning Requirements

Every NBFC shall, after taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

A. Loans, advances and other credit facilities including bills purchased and discounted

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

1. Loss Assets

The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding should be provided for.

2. Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis: -

Period for which the asset has been considered as doubtful	*% of provision*
Upto one year	20
One to three years	30
More than three years	50

3. Sub-standard asset

A general provision of 10% of total outstanding shall be made.

4. Standard asset

A general provision at ***0.35*** per cent of the outstanding standard assets shall be made by the end of March 2017. The provision for standard assets as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, is being increased to 0.40% by the end of March 2018.

Note: As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every applicable NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' in the balance sheet.

B. Lease and hire purchase assets

The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire purchase assets

(i) In respect of hire purchase assets, the total dues (overdue and future instalments taken together) as reduced by

(a) the finance charges not credited to the profit and loss account and carried forward as unmatured finance charges; and

(b) the depreciated value of the underlying asset,

shall be provided for.

Explanation:

For the purpose of this paragraph,

(1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method; and

(2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under:

(a) Where hire charges or lease rentals are overdue upto 12 months	Nil
(b) where hire charges or lease rentals are overdue for more than 12 months but upto 24 months	10% of the net book value
(c) where hire charges or lease rentals are overdue for more than 24 months but upto 36 months	40 percent of the net book value
(d) where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value
(e) where hire charges or lease rentals are overdue for more than 48 months	100 percent of the net book value

(iii) On expiry of a period of 12 months after the due date of the last instalment of hire purchase/leased asset, the entire net book value shall be fully provided for.

Here, 'Net book value' means

(a) in the case of hire purchase asset, the aggregate of overdue and future instalments receivable as reduced by the balance of unmatured finance charges and further reduced by the provisions made as per paragraph 9(2)(i) of these Directions;

(b) in the case of leased asset, aggregate of capital portion of overdue lease rentals accounted as receivable and depreciated book value of the lease asset as adjusted by the balance of lease adjustment account.

Notes:

(1) The amount of caution money/margin money or security deposits kept by the borrower with the non-banking financial company in pursuance of the hire purchase agreement may be deducted against the provisions stipulated under clause (i) above, if not already taken into account while arriving at the equated monthly instalments under the agreement. The value of any other security available in pursuance to the hire purchase agreement may be deducted only against the provisions stipulated under clause (ii) above.

(2) The amount of security deposits kept by the borrower with the non-banking financial company in pursuance to the lease agreement together with the value of any other security available in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.

(3) It is clarified that income recognition on and provisioning against NPAs are two different aspects of prudential norms and provisions as per the norms are required to be made on NPAs on total outstanding balances including the depreciated book value of the leased asset under reference after adjusting the balance, if any, in the lease adjustment account. The fact that income on an NPA has not been recognised cannot be taken as reason for not making provision.

(4) An asset which has been renegotiated or rescheduled as referred to in paragraph (2) (1) (xvi) (b) of these Directions shall be a sub-standard asset or continue to remain in the same category in which it was prior to its renegotiation or reschedulement as a doubtful asset or a loss asset as the case may be. Necessary provision is required to be made as applicable to such asset till it is upgraded.

(5) The balance sheet to be prepared by the non-banking financial company may be in accordance with the provisions contained in sub-paragraph (2) of paragraph 10.

(6) All financial leases written on or after April 1, 2001 attract the provisioning requirements as applicable to hire purchase assets.

(7) In case of NBFC-MFIs, if the advance covered by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

2.20 Disclosure in the Balance Sheet

Every non-banking financial company shall finalize its balance sheet within a period of 3 months from the date to which it pertains.

(a) Every NBFC shall, separately disclose in its balance sheet the provisions made as per requirements without netting them from the income or against the value of assets.

(b) The provisions shall be distinctly indicated under separate heads of accounts as provisions for bad and doubtful debts and provisions for depreciation in investments.

(c) Such provisions shall not be appropriated from the general provisions and loss reserves held, if any, by the NBFC.

(d) Such provisions for each year shall be debited to the profit and loss account. The excess of provisions, if any, held under the heads general Provisions and loss reserves may be written back without making adjustment against them.

2.21 Accounting Year

Every non-banking financial company shall prepare its balance sheet and profit and loss account as on March 31 every year. Whenever a non-banking financial company intends to extend the date of its balance sheet as per provisions of the Companies Act, it should take prior approval of the Reserve Bank of India before approaching the Registrar of Companies for this purpose.

Further, even in cases where the Bank and the Registrar of Companies grant extension of time, the non-banking financial company shall furnish to the Bank a proforma balance sheet (unaudited) as on March 31 of the year and the statutory returns due on the said date. Every non-banking financial company shall finalise its balance sheet within a period of 3 months from the date to which it pertains.

2.22 Preparation of Financial Statements of NBFCs

All NBFCs should comply with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, so far as these are not inconsistent with the prudential norms directions of the Reserve Bank of India.

On 30th March, 2016 the Ministry of Corporate Affairs of India (MCA) has issued the roadmap for implementation of Ind AS by Non-Banking Financial Companies;

As per the notification

(a) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2018, with comparatives for the periods ending on 31st March, 2018, or thereafter—

  (A) NBFCs having net worth of rupees five hundred crore or more;

  (B) holding, subsidiary, joint venture or associate companies of companies covered under item (A),

(b) The following NBFCs shall comply with the Indian Accounting Standards (Ind AS) for accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter—

(A) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

(B) NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

(C) holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b),

Other NBFCs shall prepare their financial statements based on the Companies (Accounting Standards) Rules, 2006.

2.23 Requirement as to Capital Adequacy

NBFCs-ND with asset size of less than ₹500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

At present, all NBFCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than ***10%***. For Infrastructure Finance Companies (IFCs), however, Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum Tier 1 capital of 12% w.e.f. April 01, 2014.

The minimum Tier 1 capital requirement for NBFCs primarily engaged in lending against gold jewellery remains unchanged for the present.

The total of Tier II capital, at any point of time, shall not exceed one hundred percent of Tier I capital.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

"*Subordinated debt*" means an instrument, which is fully paid up and is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of non-banking financial company. The book value of such instrument shall be subjected to discounting as provided hereunder:

	Remaining Maturity of the instruments	*Rate of discount*
(a)	Upto one year	100%
(b)	More than one year but upto two years	80%
(c)	More than two years but upto three years	60%
(d)	More than three years but upto four years	40%
(e)	More than four years but upto five years	20%

to the extent such discounted value does not exceed fifty per cent of Tier I capital.

The Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, require the NBFCs to maintain a minimum CRAR based on risk weights assigned to both on and off balance sheet items.

On balance sheet assets - Degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:

Weighted risk assets – On-Balance Sheet items	*Percentage weight*
(i) Cash and bank balances including fixed deposits and certificates of deposits with banks	0
(ii) Investments	
(a) Approved securities [Except at (c) below]	0
(b) Bonds of public sector banks	20
(c) Fixed deposits/certificates of deposits/bonds of public financial institutions	100

	(d)	Shares of all companies and debentures/bonds/commercial papers of all companies and units of all mutual funds	100
	(e)	All assets covering PPP and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation	50
(iii)	Current assets		
	(a)	Stock on hire (net book value)	100
	(b)	Inter-corporate loans/deposits	100
	(c)	Loans and advances fully secured against deposits held by the company itself	0
	(d)	Loans to staff	0
	(e)	Other secured loans and advances considered good	100
	(f)	Bills purchased/discounted	100
	(g)	Others (To be specified)	100
(iv)	Fixed Assets (net of depreciation)		
	(a)	Assets leased out (net book value)	100
	(b)	Premises	100
	(c)	Furniture & Fixtures	100
(v)	Other assets		
	(a)	Income tax deducted at source (net of provision)	0
	(b)	Advance tax paid (net of provision)	0
	(c)	Interest due on Government securities	0
	(d)	Others (to be specified)	100
(vi)	Domestic Sovereign		
	(a)	fund based claims on the Central Government	0
	(b)	Direct loan / credit / overdraft exposure and investment in State Government securities	0
	(c)	Central Government guaranteed claims	0
	(d)	State Government guaranteed claims, which have not remained in default/ which are in default for a period not more than 90 days	20
	(e)	State Government guaranteed claims, which have remained in default for a period of more than 90 days	100

Notes:

(1) Netting may be done only in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

(2) Assets which have been deducted from owned fund to arrive at net owned fund shall have a weightage of `zero'.

(3) While calculating the aggregate of funded exposure of a borrower for the purpose of assignment of risk weight, non-banking financial companies may net off the amount of cash margin / caution money/security deposits (against which right to set-off is available) held as collateral against the advances out of the total outstanding exposure of the borrower.

(4) The counterparty credit risk, arising out of exposure of NBFCs to CCIL on account of securities financing transactions (CBLOs) will carry a risk weight of zero, as it is presumed that the CCP's exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures. The deposits / collaterals kept by NBFCs with CCIL will attract a risk weight of 20 per cent

(5) For loans guaranteed by Credit Risk Guarantee Fund Trust for Low Income Housing (CRGFTLIH) NBFC-MFIs may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as per extant guidelines.

On Off-Balance Sheet Items - It has been considered necessary to expand the off-balance sheet regulatory framework to introduce greater granularity in the risk weights and credit conversion factors for different types of off balance sheet items. For this purpose, NBFCs will need to calculate the total risk weighted off-balance sheet credit exposure as the sum of the risk-weighted amount of the market related and non-market related off-balance sheet items. The risk-weighted amount of an off-balance sheet item that gives rise to credit exposure will be calculated by means of a two-step process:

(a) the notional amount of the transaction is converted into a credit equivalent amount, by multiplying the amount by the specified credit conversion factor or by applying the current exposure method; and

(b) the resulting credit equivalent amount is multiplied by the risk weight applicable viz; zero percent for exposure to Central Government/State Governments, 20 percent for exposure to banks and 100 percent for others.

(1) Non-market-related off- balance sheet items

i. The credit equivalent amount in relation to a non-market related off-balance sheet item will be determined by multiplying the contracted amount of that particular transaction by the relevant credit conversion factor (CCF).

Sr. No.	*Instruments*	*Credit Conversion Factor*
i.	Financial & other guarantees	100
ii.	Share/debenture underwriting obligations	50
iii.	Partly-paid shares/debentures	100
iv.	Bills discounted/rediscounted	100
v.	Lease contracts entered into but yet to be executed	100

vi.	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the NBFC.	100
vii.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down.	100
viii.	Lending of NBFC securities or posting of securities as collateral by NBFC, including instances where these arise out of repo style transactions	100
ix.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of	
	up to one year	20
	over one year	50
x.	Similar commitments that are unconditionally cancellable at any time by the NBFC without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness'.	0
xi.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take-out finance	100
	(ii) Conditional take-out finance	50
	Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by Government guarantee.	
xii.	Commitment to provide liquidity facility for securitization of standard asset transactions	100
xiii.	Second loss credit enhancement for securitization of standard asset transactions provided by third party	100
xiv.	Other contingent liabilities (To be specified)	50
xv	Non-fund based claims on the Central Government	0

Note:

i. Cash margins/deposits shall be deducted before applying the conversion factor

ii. Where the non-market related off-balance sheet item is an undrawn or partially undrawn fund-based facility, the amount of undrawn commitment to be included in calculating the off-balance sheet non-market related credit exposures is the maximum unused portion of the commitment that could be drawn during the remaining period to maturity. Any drawn portion of a commitment forms a part of NBFC's on-balance sheet credit exposure'.

For example:

A term loan of ₹ 700 cr is sanctioned for a large project which can be drawn down in stages over a three year period. The terms of sanction allow draw down in three stages – ₹ 150 cr in Stage I, ₹ 200 cr in Stage II and ₹ 350 cr in Stage III, where the borrower needs the

NBFC's explicit approval for draw downunder Stages II and III after completion of certain formalities. If the borrower has drawn already ₹ 50 cr under Stage I, then the undrawn portion would be computed with reference to Stage I alone i.e., it will be ₹ 100 cr. If Stage I is scheduled to be completed within one year, the CCF will be 20 per cent and if it is more than one year then the applicable CCF will be 50 per cent'.

(2) Market Related Off-Balance Sheet Items

i. NBFCs should take into account all market related off-balance sheet items (OTC derivatives and Securities Financing Transactions such as repo / reverse repo/ CBLO etc.) while calculating the risk weighted off-balance sheet credit exposures.

ii. The credit risk on market related off-balance sheet items is the cost to an NBFC of replacing the cash flow specified by the contract in the event of counterparty default. This would depend, among other things, upon the maturity of the contract and on the volatility of rates underlying the type of instrument.

iii. Market related off-balance sheet items would include:

   a. interest rate contracts - including single currency interest rate swaps, basis swaps, forward rate agreements, and interest rate futures;

   b. foreign exchange contracts, including contracts involving gold, - includes cross currency swaps (including cross currency interest rate swaps), forward foreign exchange contracts, currency futures, currency options;

   c. Credit Default Swaps; and

   d. any other market related contracts specifically allowed by the Reserve Bank which give rise to credit risk.

iv. Exemption from capital requirements is permitted for -

   a. foreign exchange (except gold) contracts which have an original maturity of 14 calendar days or less; and

   b. instruments traded on futures and options exchanges which are subject to daily mark-to-market and margin payments.

v. The exposures to Central Counter Parties (CCPs), on account of derivatives trading and securities financing transactions (e.g. Collateralised Borrowing and Lending Obligations – CBLOs, Repos) outstanding against them will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures.

vi. A CCF of 100 per cent will be applied to the corporate securities posted as collaterals with CCPs and the resultant off-balance sheet exposure will be assigned risk weights appropriate to the nature of the CCPs. In the case of Clearing Corporation of India Limited (CCIL), the risk weight will be 20 per cent and for other CCPs, the risk weight will be 50 percent.

vii. The total credit exposure to counterparty in respect of derivative transactions should be calculated according to the current exposure method as explained below:

Current Exposure Method:

The credit equivalent amount of a market related off-balance sheet transaction calculated using the current exposure method is the sum of a) current credit exposure and b) potential future credit exposure of the contract.

a) Current credit exposure is defined as the sum of the gross positive mark-to-market value of all contracts with respect to a single counterparty (positive and negative marked-to-market values of various contracts with the same counterparty should not be netted). The Current Exposure Method requires periodical calculation of the current credit exposure by marking these contracts to market.

b) Potential future credit exposure is determined by multiplying the notional principal amount of each of these contracts, irrespective of whether the contract has a zero, positive or negative mark-to-market value by the relevant add-on factor indicated below according to the nature and residual maturity of the instrument.

Credit Conversion Factors for interest rate related, exchange rate related and gold related derivatives		
Credit Conversion Factors (%)		
	Interest Rate Contracts	*Exchange Rate Contracts & Gold*
One year or less	0.50	2.00
Over one year to five years	1.00	10.00
Over five years	3.00	15.00

i. For contracts with multiple exchanges of principal, the add-on factors are to be multiplied by the number of remaining payments in the contract.

ii. For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be set equal to the time until the next reset date. However, in the case of interest rate contracts which have residual maturities of more than one year and meet the above criteria, the CCF or add-on factor is subject to a floor of 1.0 per cent.

iii. No potential future credit exposure would be calculated for single currency floating / floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

iv. Potential future exposures should be based on 'effective' rather than 'apparent notional amounts'. In the event that the 'stated notional amount' is leveraged or enhanced by the structure of the transaction, the 'effective notional amount' must be used for determining potential future exposure. For example, a stated notional amount of USD 1 million with payments based on an internal rate of two times the lending rate of the NBFC would have an effective notional amount of USD 2 million.

Credit conversion factors for Credit Default Swaps(CDS):

NBFCs are only permitted to buy credit protection to hedge their credit risk on corporate bonds they hold. The bonds may be held in current category or permanent category. The capital charge for these exposures will be as under:

(i) For corporate bonds held in current category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, the credit protection will be permitted to be recognised to a maximum of 80% of the exposure hedged. Therefore, the NBFC will continue to maintain capital charge for the corporate bond to the extent of 20% of the applicable capital charge. This can be achieved by taking the exposure value at 20% of the market value of the bond and then multiplying that with the risk weight of the issuing entity. In addition to this, the bought CDS position will attract a capital charge for counterparty risk which will be calculated by applying a credit conversion factor of 100 percent and a risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

(ii) For corporate bonds held in permanent category and hedged by CDS where there is no mismatch between the CDS and the hedged bond, NBFCs can recognise full credit protection for the underlying asset and no capital will be required to be maintained thereon. The exposure will stand fully substituted by the exposure to the protection seller and attract risk weight as applicable to the protection seller i.e. 20 per cent for banks and 100 per cent for others.

2.24 Asset-Liability Management (ALM)

ALM is a risk management tool that helps a bank/NBFC to manage its liquidity risk and interest rate risk. This is a powerful tool that helps banks/NBFCs plan long term financial, funding, and capital strategy using present value analysis. With ALM, a bank/NBFC can model interest income and expenses for analysis and re-price assets and liabilities. Based on ALM position, banks/NBFCs can also model effect of competitive pricing to create innovative and imaginative new banking products. ALM also helps regulatory compliance for banks/NBFCs by through appropriate investment / disinvestment decisions to maintain the required statutory liquidity ratio (SLR), credit reserve ratio (CRR) and other ratios as per Reserve Bank of India (RBI) guidelines. ALM involves the analysis of Structural Liquidity Gap Analysis, Interest Rate Gap Analysis, Net Interest Income (NII) Analysis, Net Interest Margin (NIM) Analysis, Tolerance Analysis, Cost to Close Analysis, Duration Gap Analysis, Trend Analysis, Comparative Analysis, Present Value Analysis, Forward Analysis and Scenario Analysis The Reserve Bank of India has announced its ALM guidelines for NBFCs for effective risk management. The NBFCs covered under the system are required to submit ALM returns comprising of statements on structural liquidity, short-term dynamic liquidity and interest rate sensitivity, to the Reserve Bank of India.

Miscellaneous Illustrations

Illustration 1

Templeton Finance Ltd. is a non-banking finance company. The extracts of its balance sheet are given below:

Liabilities	*Amount*	*Assets*	*Amount*
	₹ in 000		*₹ in 000*
Paid-up equity capital	*100*	*Leased out assets*	*800*
Free reserves	*500*	*Investment:*	
Loans	*400*	*In shares of subsidiaries and*	
Deposits	*400*	*group companies*	*100*
		In debentures of subsidiaries and group Companies	*100*
		Cash and bank balances	*200*
		Deferred expenditure	*200*
	1,400		*1,400*

You are required to compute 'Net owned Fund' of Templeton Finance Ltd. as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Statement showing computation of 'Net Owned Fund'

		₹ in 000
Paid up Equity Capital		100
Free Reserves		500
		600
Less: Deferred expenditure		(200)
	A	400
Investments		
In shares of subsidiaries and group companies		100
In debentures of subsidiaries and group companies		100
	B	200
10% of A		40
Excess of Investment over 10% of A (200-40)	C	160
Net Owned Fund [(A) - (C)] (400-160)		240

Illustration 2

Bright Finance Ltd. is a non-banking financial company. It provides you with the following information regarding its outstanding amount, ₹ 200 lakhs of which instalments are overdue on 200 accounts for last *two months (amount overdue ₹ 40 lakhs), on 24 accounts for three months (amount overdue ₹ 24 lakhs), on 10 accounts for more than 30 months (amount overdue ₹ 20 lakhs) and on 4 accounts for more than three years (amount over due ₹ 20 lakhs-already identified as sub-standard assets) and one account of ₹ 10 lakhs which has been identified as non-recoverable by the management. Out of 10 accounts overdue for more than 30 months, 6 accounts are already identified as sub-standard (amount ₹ 6 lakhs) for more than fourteen months and other are identified as sub-standard asset for a period of less than fourteen months.*

Classify the assets of the company in line with Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Solution

Statement showing classification as per Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

		(₹ in lakhs)
Standard Assets		
Accounts (Balancing figure)	86.00	
200 accounts overdue for a period for 2 months	40.00	
24 accounts overdue for a period by 3 months	24.00	150.00
Sub-Standard Assets		
4 accounts identified as sub-standard asset for a period less than 14 months		14.00
Doubtful Debts		
6 accounts identified as sub-standard for a period more than 14 months		6.00
4 accounts identified as sub-standard for a period more than 3 years		20.00
Loss Assets		
1 account identified by management as loss asset		10.00
Total overdue		200.00

Illustration 3

While closing its books of account on 31st March, 2017 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	*16,800*
Sub-standard assets	*1,340*
Secured portions of doubtful debts:	
– *upto one year*	*320*
– *one year to three years*	*90*
– *more than three years*	*30*

Unsecured portions of doubtful debts	*97*
Loss assets	*48*

Calculate the amount of provision, which must be made against the Advances as per

(i) the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016; and

(ii) Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Answer

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.25	42.00
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			427.00

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.35	58.80
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			443.80

UNIT 3: MERCHANT BANKERS

3.1 Introduction

In banking a **merchant bank** is a financial institution primarily engaged in offering financial services and advice to corporations and wealthy individuals on how to use their money. The term can also be used to describe the private equity activities of banking.

According to Cox D., merchant banking is defined as, “merchant banks are the financial institutions providing specialist services which generally include the acceptance of bills of exchange, corporate finance, portfolio management and other banking services”.

The Notification of the Ministry of Finance defines a merchant banker as, **“any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management”.**

A merchant banker is an organization that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

In exercise of the powers conferred vide Section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Board, with the previous approval of the Central Government made the SEBI (Merchant Bankers) Regulations, 1992 which specify various requirements. Further, the SEBI has amended SEBI (Merchant Bankers) Regulations, 1992 in various years i.e. 2006, 2007, 2010 and 2011. These regulations specify the norms which SEBI takes into account for considering the grant of a certificate of registration and its renewal. The code of conduct has been given in schedule III and Chapter III of these regulations contain general obligations and responsibilities of merchant bankers.

3.2 Registration of Merchant Banker

Under Regulation 3, a person can apply for grant of certificate as merchant banker under any one of the following categories:

(i) Merchant bankers who carry on activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscriptions; and act as advisor, consultant, manager, underwriter, portfolio manager;

(ii) Merchant bankers who act as advisor, consultant, co-manager, underwriter, portfolio manager;

(iii) Merchant bankers who act as underwriter, advisor, consultant to an issue;

(iv) Merchant bankers who act only as advisor or consultant to an issue.

3.3 Capital Adequacy Requirement

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees.

For the purpose of this regulation, 'Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

3.4 Maintenance of Books of Account, Records etc.

Every merchant banker shall keep and maintain the following books of account, records and documents as per regulation 14:

(*a*) a copy of balance sheet as at the end of the each accounting period;

(*b*) a copy of profit and loss account for that period;

(*c*) a copy of the auditor's report on the accounts for that period;

(*d*) a statement of financial position;

(e) Records and documents pertaining to due diligence exercised in pre-issue and post issue activities of issue management and in case of takeover, buy-back and delisting of securities.

Every merchant banker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every merchant banker shall, after the end of each accounting period furnish to the Board copies of the balance sheet, profit and loss account and such other documents for any other preceding five accounting years when required by the SEBI. The merchant banker shall preserve the books of account and other records and documents maintained under regulation 14 for a minimum period of five years.

As per Regulation 28 of the SEBI (Merchant Banker) Regulations 1992, a merchant banker shall disclose to the Board, as and when required, the following information, namely :–

(i) his responsibilities with regard to the management of the issue;

(ii) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to it.

(iii) the names of the body corporate whose issue he has managed or has been associated with;

(iv) the particulars relating to the breach of the capital adequacy requirements as specified in regulation 7;

(v) relating to the activities as manager, underwriter, consultant or advisor to an issue, as the case may be.

Under Regulation 29, the merchant banker shall submit a half yearly report for the period ending up to 31st March and 30th September of every year in the format specified in Schedule IV, within three months from the close of the period to which it corresponds. The merchant banker shall

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes :

(i) to ensure that the books of account are being maintained in the required manner;

(ii) that the provisions of the Act, rules, regulations are complied with;

(iii) to investigate into the complaints received from investors, other merchant bankers or any other person on any matter having a bearing on the activities of the merchant banker; and

(iv) to investigate suo motu in the interest of securities business or investors' interest into the affairs of the merchant banker.

As per Regulation 31, it shall be the duty of the merchant banker to allow the inspecting authority to have reasonable access to the premises occupied by such merchant banker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the merchant banker or any such other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority, are relevant for the purposes of the inspection.

The SEBI may also appoint a qualified auditor to investigate into the books of account or the affairs of the merchant bankers.

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 has specified a format for half yearly report to be submitted by merchant bankers.

3.5 Underwriting Obligations

As per Regulation 22, in respect of every issue to be managed, the lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of five per cent of the total underwriting commitment or rupees twenty-five lacs, whichever is less.

Further, in any issue made in accordance with Chapter XA of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 the merchant banker shall, itself or jointly with other merchant bankers associated with the issue, underwrite at least fifteen per cent of the issue size.

UNIT 4: STOCK AND COMMODITY MARKET INTERMEDIARIES

4.1 Introduction

A **stock market** or **equity market** is a public entity (a loose network of economic transactions, not a physical facility or discrete entity) for the trading of company stock (shares) and derivatives at an agreed price. These are securities listed on a stock exchange as well as those only traded privately.

Commodity markets are markets where raw or primary products are exchanged. These raw commodities are traded on regulated commodities exchanges, in which they are bought and sold in standardized contracts.

Intermediary is a firm or person (such as a broker or consultant) who acts as a mediator on a link between parties to a business deal, investment decision, negotiation, etc. In money markets, for example, banks act as intermediaries between depositors seeking interest income and borrowers seeking debt capital. Intermediaries usually specialize in specific areas, and serve as a conduit for market and other types of information.

With the removal of the ban on forward trading in all commodities, the Indian commodities futures market has been totally liberalised. Participants in the securities and other financial markets can now think of exploring the opportunities offered by the emerging commodities market. There are, however, some basic issues relating to the securities and commodity derivative markets and the likely impact of any moves for unifying the two on participant institutions, players and regulatory bodies. Neither convergence nor divergence may necessarily mean a win-win situation for the existing stock and commodity exchanges in the present situation. Even though there are differences between commodity and financial derivatives markets, they also have some close link in so far as trading practices and mechanisms are concerned. The reforms in the securities market over the past two decades were carried out both in the primary and secondary markets. The Securities and Exchange Board of India has introduced in the past decade a number of measures to streamline the capital market, professionalize trading and protect the interests of the small investor. There is complete automation of trading in the securities market. Proper risk management, governance principles and regulatory measures are in place.

In the commodities markets too the situation is changing. Some commodity exchanges are specializing in specific areas with varying degrees of success. The task force has stressed the need to have at least a third of each exchange board manned by independent directors. Licenses have been given for a multiple commodities exchange and single commodity exchanges and for conducting trading on-line. Even a single commodity exchange can trade in multiple commodities after obtaining permission from the Forward Markets Commission (FMC). FMC has issued various guidelines to control the operations of stock and commodity market intermediaries.

Commodity exchanges are promoted by institutions and associations. With convergence, there will be an opportunity to speed up the development of the commodity markets. Because of the economies of scale in operations there will be scope for further improvement However, there are certain differences. Financial futures generally draw their strength from actively traded cash markets. The exchanges oversee the operations. While organised trading in commodities may closely resemble financials (as in bullion), one area of concern in the former case is the impact of price volatility on the market; also, commodities markets require specialised knowledge that is different from securities trading.

The task force has identified many legal and regulatory hurdles in the way of convergence of securities and commodities markets. The securities market is governed by the Securities Contracts Regulation Act, 1956 whereas the forward market is regulated by the Forward Contracts Regulation Act 1952. Another basic consideration is that stock exchanges and futures markets for financials are Central subjects whereas agriculture is under the jurisdiction of States and futures trading in commodities are with the Union Government. In reality, policies for the securities market and development of the commodities market are of different nature. Even though the volume of trading in commodities is much higher than in securities, it is better to keep them apart in the initial stages. Clearing members of a stock exchange would like to trade in a commodity exchange as it provides them another avenue for making money. The Securities Contracts Regulation Act has therefore been amended whereby members of a stock exchange can be members of a commodity exchange by forming a separate company. This is essential because at present there are two regulators and each one will exercise his supervisory powers as provided under the rules in the respective market. The net worth for becoming a clearing member can be fixed separately for the two exchanges and this will play an important role in risk management. Even if there is a risk in one market, no cascading effect will be felt in the other. There is also the fact that net worth from one market cannot be moved to another. This will provide the necessary firewall between the two markets and will benefit all the participants.

4.2 Stock Brokers

"Stock broker" means a person having trading rights in any recognised stock exchange and includes a trading member;

A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Brokers are subject to capital adequacy requirements comprising of a basic minimum capital and additional volume related capital. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In exercise of the powers conferred by section 30 of the Securities and Exchange Board of India Act, 1992, the SEBI Board made the SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992 to exercise the control on the activities of stock brokers and their sub-brokers. In a contract for buying and selling securities, stock brokers act as agents for investors. In return for this service they charge commission or brokerage at a specified percentage on contract value. In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

A sub-broker is any person not being a member of a recognised stock exchange who acts on behalf of a stock-broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stockbroker.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992 provides that no stockbroker or sub-broker can buy, sell or deal in securities, unless he holds a certificate of registration granted by the Securities and Exchange Board of India (SEBI). The certification of registration is granted by SEBI on an application made to it in prescribed form, subject to fulfillment of conditions specified in the Securities and Exchange Board of India (Stockbrokers and sub-brokers) Rules, 1992.

The Securities and Exchange Board of India (Stockbrokers and sub-brokers) Regulations, 1992 provides inter-alia, for the obligations and responsibilities of stock brokers regarding maintenance of proper books of accounts, records and documents and other allied matters. In the regulations, board means, the Securities and Exchange Board of India (SEBI).

4.3 Registration of Stock Brokers

No person shall act as a stock broker, unless he seeks a certificate of registration from the Board for each stock exchange in which he seeks to operate provided that no separate registration shall be required for a clearing member registered with the Board to ***act*** as a stock broker in the stock exchange of which he is ***admitted as a member, subject to grant of approval by the concerned stock exchange.***

Payment of fees

Every applicant eligible for grant of a certificate of registration as a stock broker shall pay such fees provided that the Board may on sufficient cause being shown permit the stockbroker to pay such fees at any time before the expiry of six months from the date on which such fees become due.

Conditions of registration

Any registration granted by the Board shall be subject to the following conditions, namely,-

(a) the stock broker holds the membership of any stock exchange;

(b) he shall abide by the rules, regulations and bye-laws of the stock exchange which are applicable to him;

(c) where the stock broker proposes change in control, he shall obtain prior approval of the Board for continuing to act as such after the change;

(d) he shall pay fees charged by the Board in the manner provided in these regulations;

(e) he shall take adequate steps for redressal of grievances, of the investors within one month of the date of receipt of the complaint and inform the Board as and when required by the Board;

(f) he shall at all times abide by the Code of Conduct as specified in Schedule II; and

(g) he shall at all times maintain the minimum networth as specified in Schedule VI.

4.4 Maintenance of Proper Books of Account, Records etc. (Regulation 17)

Every stock boker is required to maintain the following books of account and records as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992 :

(a) Register of transactions (Sauda Book);

(b) Clients ledger;

(c) General ledger;

(d) Journals;

(e) Cash book;

(f) Bank pass book;

(g) Documents register containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities;

(h) Member's contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members;

(i) Counterfoils or duplicates of contract notes issued to clients;

(j) Written consent of clients in respect of contracts entered into as principals;

(k) Margin deposit book;

(l) Registers of accounts of sub-brokers;

(m) An agreement with a sub-broker specifying the scope of authority, and responsibilities of the Stock Broker and such Sub-broker;

(n) Client account opening form in the format as may be specified by the Board.

In addition to the above statutory requirements, they are also required to maintain the following records/documents:

(a) Scripwise clientwise list in respect of scrips of specified group, i.e., 'A' Group (inclusive of brought forward positions);

(b) Client upla statement (i.e. carry forward position of all clients);

(c) Duplicate copies of self-certificates submitted on monthly basis (i.e., that the daily and badla break-up have been reported correctly without netting positions of two different clients in the same scrip);

(d) Copies of all margin statements downloaded by the Stock Exchange;

(e) Copies of Valan Balance Sheet (Form 31) along with all relevant assets;

(f) Details of spot delivery transactions entered into (including securities delivered and payments made to the members);

(g) Client database and broker client agreement;

(h) Copy of registration certificate of each sub-broker issued by SEBI;

(i) Copy of approval for each remisier given by the exchange;

(j) Copy of the power of attorney/board resolution authoritizing directors, employees to sign the contract note;

(k) Copies of pool account statements.

Every stock broker shall intimate to the SEBI the place where the books of account, records and documents are maintained. Every stock broker shall, after the close of each accounting period furnish to the SEBI if so required as soon as possible but not later than six months from the close of the said period a copy of the audited balance sheet and profit and loss account as at the end of the said accounting period; provided that if, it is not possible to furnish the above documents within the time specified, the stock broker shall keep the SEBI informed of the same together with the reasons for delay and the period of time by which such documents would be furnished. Every stock broker is required to preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

SEBI may appoint one or more persons as inspecting authority to undertake inspection of the books of account, other records and documents of the stock brokers for any of the following purposes:

(a) to ensure that the books of the account and other books are being maintained in the manner required;

(b) that the provisions of the Act, rules, regulations and the provisions of the Securities Contract (Regulation) Act, and the rules made there under are being complied with;

(c) to investigate into the complaints received from investors, other stock brokers, sub-brokers or any other person on any matter having a bearing on the activities of the stock brokers; and

(d) to investigate suo motu, in the interest of securities business or investors' interest into the affairs of the stock-brokers.

The SEBI may appoint a qualified auditor to investigate into the books of account or the affairs of the stock-broker.

As per Regulation 25, a stock broker or a sub-broker who contravenes any of the provisions of the Act, rules or regulations framed there under shall be liable for any one or more of the following actions—

(i) Monetary penalty under Chapter VIA of the Act.

(ii) Penalties as specified under [Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008] including suspension or cancellation of certificate of registration as a stock broker or a sub-broker,

(iii) Prosecution under section 24 of the Act.

4.5 Preservation of Books of Accounts and Records (Regulation 18)

Every stockbroker shall preserve the books of account and other records maintained under regulation 17 for a minimum period of five years.

4.6 Obligations of Stock Broker on Inspection by the Board (Regulation 21)

It shall be the duty of broker on inspection by the Board every director, proprietor, partner, officer and employee of the stock-broker, who is being inspected, to produce to the inspecting authority such books, accounts and other documents in his custody or control and furnish him with the statements and information relating to the transactions in securities market within such time as the said officer may require.

The stock-broker shall allow the inspecting authority to have reasonable access to the premises occupied by such stock- broker or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the stock- broker or any other person and also provide copies of documents or other materials which, in the opinion of the inspecting authority are relevant.

The inspecting authority, in the course of inspection, shall be entitled to examine or record statements of any member, director, partner, proprietor and employee of the stock- broker.

It shall be the duty of every director proprietor, partner, officer and employee of the stock broker to give to the inspecting authority all assistance in connection with the inspection, which the stock broker may be reasonably expected to give.

4.7 Regulation of Transactions between Clients and Brokers

It shall be compulsory for all member brokers to keep the money of the clients in a separate account and their own money in a separate account. No payment for transactions in which the member broker is taking a position as a principal will be allowed to be made from the client's account.

4.8 Member Broker to Keep Accounts

Every member broker shall keep such books of accounts, as will be necessary, to show and distinguish in connection with his business as a member –

(a) Moneys received from or on account of each of his clients and,

(b) The moneys received and the moneys paid on Member's own account.

4.9 Obligation to Pay Money into "Clients Accounts"

Every member broker who holds or receives money on account of a client shall forthwith pay such money to current or deposit account at bank to be kept in the name of the member in the title of which the word "clients" shall appear (hereinafter referred to as "clients account").

Member broker may keep one consolidated clients account for all the clients or accounts in the name of each client, as he thinks fit. If a Member broker receives a cheque or draft representing in part money belonging to the client and in part money due to the Member, he shall pay the whole of such cheque or draft into the clients account and effect subsequent transfer.

Nothing in the above paragraph shall deprive a Member broker of any recourse or right, whether by way of lien, set-off, counter-claim charge or otherwise against moneys standing to the credit of clients account.

Moneys to be paid into "clients account"

No money shall be paid into clients account other than –

(a) Money held or received on account of clients;

(b) Such money belonging to the Member as may be necessary for the purpose of opening or maintaining the account;

(c) Money for replacement of any sum, which may by mistake or accident have been drawn from the account.

(d) A cheque or draft received by the Member representing in part money belonging to the client and in part money due to the Member.

Moneys to be withdrawn from "clients account"

No money shall be drawn from clients account other than -

(a) Money properly required for payment to or on behalf of clients or for or towards payment of a debt due to the Member from clients or money drawn on client's authority, or money in respect of which there is a liability of clients to the Member, provided that money so drawn shall not in any case exceed the total of the money so held for the time being for such each client;

(b) Such money belonging to the Member as may have been paid into the client account;

(c) Money, which may by mistake or accident have been paid into such account.

4.10 Accounts for Client's Securities

It shall be compulsory for all Member brokers to keep separate accounts for client's securities and to keep such books of accounts, as may be necessary, to distinguish such securities from his/their own securities. Such accounts for client's securities shall, inter-alia provide for the following:

(a) Securities received for sale or kept pending delivery in the market;

(b) Securities fully paid for, pending delivery to clients;

(c) Securities received for transfer or sent for transfer by the Member, in the name of client or his nominees;

(d) Securities that are fully paid for and are held in custody by the Member as security/margin etc. Proper authorization from client for the same shall be obtained by Member;

(e) Fully paid for client's securities registered in the name of Member, if any, towards margin requirements etc.;

(f) Securities given on Vyaj-badla. Member shall obtain authorization from clients for the same.

4.11 Payment and Delivery of Securities

Member Brokers shall make payment to their clients or deliver the securities purchased within two working days of payout unless the client has requested otherwise. Stock Exchange shall issue a Press Release immediately after the payout.

Member brokers shall issue the contract note for purchase/sale of securities to a client within 24 hours of the execution of the contract.

4.12 Margin

Member Brokers shall buy securities on behalf of client only on receipt of specified margin money on the price of the securities proposed to be purchased, unless the client already has an equivalent credit with the broker. Member may not, if they so desire, collect such a margin from Financial Institutions, Mutual Funds and FII's.

Member brokers shall sell securities on behalf of client only on receipt of a margin money on the price of securities proposed to be sold, unless the member has received the securities to be sold with valid transfer documents to his satisfaction prior to such sale.

4.13 Closing Out

In case of purchases on behalf of clients, Member brokers shall be a liberty to close out the transactions by selling the securities, in case the client fails to make the full payment to the Member Broker for the execution of the contract within two days of contract note having been delivered for cash shares and seven days for specified shares or before pay-in day (as fixed by Stock Exchange for the concerned settlement period), whichever is earlier; unless the client already has an equivalent credit with the Member. The loss incurred in this regard, if any, will be met from the margin money of that client.

In case of sales on behalf of clients, Member broker shall be at liberty to close out the contract by effecting purchases if the client fails to deliver the securities sold with valid transfer documents within 48 hours of the contract note having been delivered or before delivery day (as fixed by Stock Exchange authorities for the concerned settlement period), whichever is earlier. Loss on the transaction, if any, will be deductible from the margin money of that client.

4.14 Requirement of Base Minimum Capital for Stock Trading Member

The BMC (Base Minimum Capital) deposit requirement for stock brokers trading on stock exchange has been prescribed by SEBI to be commensurate with the risks (other than market risk), that the broker may bring to the system. The various technological changes and the increased speeds of trading have brought to fore the greater quantum of risks arising during the course of execution of transactions. In light of this, based on deliberations at various forums, it has been decided to realign the BMC requirements with the risk profiles of the stock brokers / trading members in cash / derivative segment of the stock exchange vide circular no. CIR/MRD/DRMNP/ 36 /2012 dated December 19, 2012 which shall be implemented by March 31, 2013. Accordingly, the requirement of BMC would be implemented in the following manner:

(i) It shall be enhanced for members holding registration as "stock-broker" in cash segment.

(ii) BMC shall be introduced for members holding registration as "trading member" in any derivative segment.

(iii) Stock brokers / trading members shall maintain the prescribed BMC based on their profiles –

Categories	*BMC Deposit*
Deposit Only Proprietary trading without Algorithmic trading (Algo)	₹ 10 Lacs
Trading only on behalf of Client (without proprietary trading) and without Algo	₹ 15 Lacs
Proprietary trading and trading on behalf of Client without Algo	₹ 25 Lacs
All Trading Members/Brokers with Algo	₹ 50 Lacs

Explanation: The profiling of members may be explained with the following example – A scenario may arise, wherein, a member has registration as a "stock broker" as well as a "trading member" and is engaged as a principal doing proprietary trading on cash segment and is also engaged as an agent and transacting only on behalf of the clients in the derivatives segment.

Further, the member may not have availed facility for algorithmic trading. In such a case, the profile of such a member shall be assessed as "Proprietary trading and trading on behalf of client without Algo". The applicable BMC deposit for such a member shall be ₹ 25 Lacs.

This BMC deposit requirement stipulated in the above table, is applicable to all stock brokers / trading members of exchanges having nation-wide trading terminals.

(iv) For stock brokers/trading members of exchanges not having nation-wide trading terminals, the deposit requirement shall be 40% of the above said BMC deposit requirements.

(v) The BMC deposit shall be maintained for meeting contingencies in any segment of the exchange. For members having registration for more than one segment of the same exchange, the BMC deposit requirement shall not be additive for such number of segments and shall be the highest applicable BMC deposit, across various segment.

(v) No exposure shall be granted against such BMC deposit. The Stock Exchanges shall be permitted to prescribe suitable deposit requirements, over and above the SEBI prescribed norms, based on their perception and evaluation of risks involved.

(vi) Minimum 50% of the deposit shall be in the form of cash and cash equivalents. The existing guidelines on collateral composition shall continue to remain applicable.

9
Valuation

UNIT 1: CONCEPT OF VALUATION

1.1 Introduction

Valuation is the process of estimating what something is worth. Items that are usually valued are either financial assets or liabilities. Valuation can be used as a very effective business tool by management for better decision making throughout the life of the enterprise. Valuations are needed for many reasons such as investment analysis, capital budgeting, merger and acquisition transactions, financial reporting, determination of tax liability and in litigation.

Companies are governed and valuations are influenced by the market supply-demand life cycles along with product and technology supply-demand lifecycles. Correspondingly, the value of an enterprise over the course of its life peaks with the market and product / technology factors. Both financial investors such as venture capitalists and entrepreneurs involved in a venture would ideally like to exit the venture in some form near the peak to maximize their return on investment. Thus, valuation helps determine the exit value of an enterprise at that peak. This exit value typically includes the tangible and intangible value of the company's assets. Tangible value would typically include balance sheet items recorded as the book value of the enterprise. Intangibles would typically include intellectual property, human capital, brand and customers, among others. In more traditional companies considering the private equity markets, the value of intangibles is much higher than the value of the tangible assets. Therefore, an effective enterprise valuation methodology needs to be developed.

One can also define valuation as Measurement of value in monetary terms. Measurement of income and valuation of wealth are two interdependent core aspects of financial accounting and reporting. Wealth comprises of assets and liabilities. Valuation of assets and liabilities are made to portray the wealth position of a firm through a balance sheet and to supply logistics to the measure of the periodical income of the firm through a profit and loss account.

Again valuation of business and valuation of share are made through financial statement analysis for management appraisal and investment decisions. Valuation is pivotal in strategic, long term or short term decision making process in cases like reorganization of company, merger and acquisition, extension or diversification, or for launching new schemes or projects. As the application area of valuation moves from financial accounting to financial management, the role of accountant also undergoes a transition. That order of transition in the concept and use of valuation process is followed in the subsequent units of this chapter.

1.2 Concept of Valuation

Valuation means measurement of an item in monetary term. The subjects of valuation are varied as stated below:

- Valuation of Tangible Fixed Assets
- Valuation of Intangibles including brand valuation and valuation of goodwill
- Valuation of Shares
- Valuation of Business

The objectives of valuation are again different in different areas of application in financial accounting and in financial management.

1.3 Need for Valuation

Financial statements must give a "true and fair view" of the state of affairs of a company as per provisions of the Companies Act. Proper valuation of all assets and liabilities is required to ensure true and fair financial position of the business entity. In other words, all matters which affect the financial position of the business have to be disclosed. Under or overvaluation of assets may not only affect the operating results and financial position of the current period but will also affect these for the next accounting period. The present unit deals with different principles involved in the valuation of different types of assets.

For the purposes of Part I of Schedule III to the Companies Act, 2013 assets are classified as (i) Non- current assets and (ii) current assets. Non-current assets have been further sub-classified into (a) fixed assets i.e. tangible assets, intangible assets, capital W.I.P. and intangible assets under development (b) non- current investments (c) deferred tax assets(Net) (d) long term loans and advances and (e) other non-current assets. Current assets have been further sub-classified into (a) Current Investments (b) Inventories (c) Trade Receivables (d) Cash and Cash Equivalents (e) Short Term Loans and Advances and (f) Other Current Assets.

The students are expected to learn the essence and modalities of valuation, a core function in financial accounting. Valuation is done sometimes by the Chartered Valuers /Engineers in cases where technical inputs and knowledge is required to arrive at the Fair value and accepted by various Government and Statutory Authorities. Students should be familiar with these valuation Reports and their basis of valuation.

Different approaches to valuation of different kinds of assets and liabilities in different perspectives have pushed the role of accountant to a complex position. This chapter is aimed to differentiate the objectives, approaches and methods of valuation in order to integrate them in a comprehensive logical frame. In this chapter, we shall discuss valuation of tangible fixed assets following the requirement of the Companies Act and guidelines of AS 10 'Property, Plant and Equipment ', AS 12 'Accounting for Government Grants' and AS 14 'Accounting for Amalgamations'.

1.4 Bases of Valuation

A number of different measurement bases are employed to different degrees and in varying combinations in valuation of different assets in different areas of application. They include the following:

(a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition.

(b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently.

(c) *Realizable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.

(d) *Present value.* Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business.

Other generally used valuation bases are as follows:

Net Realizable Value (NRV): This is same as the Realizable (settlement) value. This is the value (net of expenses) that can be realized by disposing off the assets in an orderly manner. Net selling price or exit values also convey the same meaning.

Economic value: This is same as the present value. The other name of it is value to business.

Replacement (cost) value: This is also same as the current cost.

Recoverable (amount) value: This is the higher of the net selling price and value in use.

Deprival value: This is the lower of the replacement value and recoverable (amount) value.

Liquidation value: This is the value (net of expenses), that a business can expect to realize by disposing of the assets in the event of liquidation. Such a value is usually lower than the NRV or exit value. This is also called break-up value.

Fair value: This is not based on a particular method of valuation. It is the acceptable value based on appropriate method of valuation in context of the situation of valuation. Thus fair value may represent current cost, NRV or present value as the case may be.

In financial accounting 'An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.' 'The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of hanging prices of non-monetary assets.' (Framework, Issued 2000, Para 100)

The requirements of regulations and accounting standards as to recognition of assets, reliability of measurement and disclosure in financial reports have set certain limitations to the freedom of valuation so far as financial accounting is concerned.

1.5 Types of Value

The following are six types of value:

- Going-concern value is the value of a firm as an operating business.
- Liquidation value is the projected price that a firm would receive by selling its assets if it were going out of business.
- Book value is the value of an asset as carried on a balance sheet. In other words, it means (i) the cost of an asset minus accumulated depreciation (ii) the net asset value of a company, calculated by total assets minus intangible assets (patents, goodwill) and liabilities (iii) the initial outlay for an investment. This number may be net or gross of expenses such as trading costs, sales taxes, service charges and so on. It is the total value of the company's assets that shareholders would theoretically receive if a company were liquidated. By being compared to the company's market value, the book value can indicate whether an Inventory is under or overpriced. In personal finance, the book value of an investment is the price paid for a security or debt investment. When an inventory is sold, the selling price less the book value is the capital gain (or loss) from the investment.
- Market value is the price at which buyers and sellers trade similar items in an open market place. The current quoted price at which investors buy or sell a share of common Inventory or a bond at a given time. The market capitalization plus the market value of debt. Sometimes referred to as "total market value". In the context of securities, market value is often different from book value because the market takes into account future growth potential. Most investors who use fundamental analysis to picks Inventory's look at a company's market value and then determine whether or not the market value is adequate or if it's undervalued in comparison to its book value, net assets or some other measure.
- Fair market value is the price that a given property or asset would fetch in the market place, subject to the following conditions: (i) Prospective buyers and sellers are reasonably knowledgeable about the asset; they are behaving in their own best interests and are free of undue pressure to trade. (ii) A reasonable time period is given for the transaction to be completed. Given these conditions, an asset's fair market value should represent an accurate valuation or assessment of its worth. Fair market values are widely used across many areas of commerce. For example, municipal property taxes are often assessed based on the fair market value of the owner's property. Depending upon how many years the owner has owned the home, the difference between the purchase price and the residence's fair market value can be substantial. Fair market values are often used in the insurance industry as well. For example, when an insurance claim is made as a result of a car accident, the insurance company covering the damage to the owner's vehicle will usually cover damages up to the fair market value of the automobile.
- Intrinsic value is the value at which an asset should sell based on applying data inputs to a valuation theory or model. The actual value of a company or an asset based on an

underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible factors. This value may or may not be the same as the current market value. Value investors use a variety of analytical techniques in order to estimate the intrinsic value of securities in hopes of finding investments where the true value of the investment exceeds its current market value. For call options, this is the difference between the underlying Inventory's price and the strike price. For put options, it is the difference between the strike price and the underlying Inventory's price. In the case of both puts and calls, if the respective difference value is negative, the intrinsic value is given as zero. For example, value investors that follow fundamental analysis look at both qualitative (business model, governance, target market factors etc.) and quantitative (ratios, financial statement analysis, etc.) aspects of a business to see if the business is currently out of favour with the market and is really worth much more than its current valuation.

- Extrinsic value is another variety. It is the difference between an option's price and the intrinsic value. For example, an option that has a premium price of ₹ 10 and an intrinsic value of ₹ 5 would have an extrinsic value of ₹ 5. Denoting the amount that the option's price is greater than the intrinsic value, the extrinsic or time value of the option declines as the expiration date of an option draws closer.

These types of values can differ from one another. For example, a firm's going-concern value is likely to be higher than its liquidation value. The excess of going-concern value over liquidation value represents the value of the operating firm as distinct from the value of its assets. Book value can differ substantially from market value. For example, a piece of equipment appears on a firm's books at cost when purchased but decreases each year due to depreciation charges. The price that someone is willing to pay for the asset in the market may have little relationship with its book value. Market value reflects what someone is willing to pay for an asset whereas intrinsic value shows what the person should be willing to pay for the same asset.

1.6 Approaches of Valuation

Three generally accepted approaches to valuation are as follows:

1) Cost Approach: e.g. Adjusted Book Value
2) Market Approach: e.g. Comparables
3) Income Approach: e.g. Discounted Cash Flow

Each approach has advantages and disadvantages. Generally, there is no "right" answer to a valuation problem. Valuation is very much an art as much as a science! These approaches can be briefly discussed as:

Cost Approach: This technique involves restating the value of individual assets to reflect their fair market values. It is useful for valuing holding companies where assets are easy to value (for example, securities) and less useful for valuing operating businesses. The value of an operating company is generally greater than that of its assets. The difference between that value of the expected cash flows and that of its assets is called the "going concern value". It is a useful approach when the purpose of the valuation is that the business will be liquidated and Trade payables must be satisfied. While doing this valuation following adjustments to book value can be made:

- Inventory undervaluation
- Bad debt reserves
- Market value of plant and equipment
- Patents and franchises
- Investments in affiliates
- Tax-loss carried forward

Market Approach: The market approach, as the name implies, relies on signs from the real market place to determine what a business is worth. It is to be understood that business does not operate in vacuum. If what one does is really great, then chances of others doing the same or similar things are more. If one is looking to buy a business, one decides what type of business he is interested in and then looks around to see what the "going rate" is for businesses of this type. If one is planning to sell business, he will check the market to see what similar businesses sell for. So the market approach to valuing a business is a great way to determine its fair market value - a monetary value likely to be exchanged in an arms-length transaction, when the buyer and seller act in their best interest.

Income approach: The income approach considers the core reason for running a business ie. making money. Here the so-called economic principle of expectation applies. Since the business value must be established in the present, the expected income and risk must be translated to today. The income approach generally uses two ways to do this translation: (i) Capitalization and (ii) Discounting.

UNIT 2 : VALUATION OF TANGIBLE FIXED ASSETS

2.1 Introduction

Tangible Fixed Assets are valued for presenting them in the balance sheet with due reference to the relevant portions of the "Framework for the Preparation and Presentation of Financial Statements", Part I of Schedule III to the Companies Act, 2013 (Division A), AS 10, AS 11, AS 12, AS 14, AS 16 and AS 28. We shall discuss different approaches to and procedural aspects of valuation of tangible fixed assets.

Part I of Schedule III, to the Companies Act, 2013 (Division A) requires the following classification of tangible assets (a) Land (b) Buildings (c) Plant and Equipment (d) Furniture and fixtures (e) Vehicles (f) Office Equipment and (g) Others (specifying nature).

Assets under lease shall be separately specified under each class of asset.

The said Part I of the Schedule III also requires that a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals should be disclosed separately.

2.2 Measurement at Cost

As per AS 10, the cost of an item of property, plant and equipment comprises:

(a) Its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.

(b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

  (i) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

  (ii) costs of site preparation;

  (iii) initial delivery and handling costs;

  (iv) installation and assembly costs;

  (v) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

  (vi) professional fees.

(c) The initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.

(d) An enterprise applies AS 2, Valuation of Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. The obligations for costs accounted for in accordance with AS 2 or AS 10 are recognised and measured in accordance with AS 29, Provisions, Contingent Liabilities and Contingent Assets.

(e) Examples of costs that are not costs of an item of property, plant and equipment are:

(i) costs of opening a new facility or business, such as, inauguration costs;

(ii) costs of introducing a new product or service (including costs of advertising and promotional activities);

(iii) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(iv) administration and other general overhead costs.

(f) Some incidental operations may occur before or during the construction or development activities but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. The income and related expenses of incidental operations are recognised in the statement of profit and loss and included in their respective classifications of income and expense.

(g) Self constructed fixed assets: The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale as per AS 2. Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

2.3 Subsequent Change in Original Cost

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, and changes in duties or similar factors. (Refer AS 11 (Revised) for better understanding).

Government Grants related to specific fixed assets, as per AS 12, can be deducted from the cost of the said assets. Alternatively, the Grant can be shown as deferred income.

Parts of some items of property, plant and equipment may require replacement at regular intervals. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement or to make a non-recurring replacement. An enterprise recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met as per AS 10. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of the standard.

The derecognition of the carrying amount occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed.

2.4 Measurement After Recognition Change of Original Cost – Improvements, Revaluation, Impairment

AS 10 also deals with the recognition of costs incurred subsequently to add, to replace part of, or service a previously recognized tangible fixed asset. The general recognition criteria set out in AS 10 are applied to such expenditure.

The criteria is –

It is probable that future economic benefits associated with the asset will flow to the enterprise; and

The cost of the asset to the enterprise can be measured reliably**.**

If the recognition criteria are met, then the expenditure will be added to the carrying amount of the tangible fixed asset. If the recognition criteria are not met, then the expenditure will be charged to the statement of profit and loss when incurred.

Revaluation: AS 10 permits two different bases for the determination of the carrying amount of tangible fixed assets at subsequent reporting dates- the cost model and the revaluation model. The accounting policy selected is required to be applied to an entire class of property, plant and equipment.

Cost model: Where the cost model is selected, after recognition as an asset, a tangible fixed asset is carried at cost less any accumulated depreciation and any accumulated impairment losses.

When the cost model is used, the cost of the asset will normally remain unchanged until it is derecognized. The income generated by an asset should not be deducted from its cost.

Revaluation Model: Where the revaluation model is selected, after recognition as an asset, a tangible fixed asset whose fair value can be measured reliably is carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and any subsequent accumulated impairment losses. Revaluations are required to be carried out with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

An increase in the carrying amount of an asset arising on revaluation should be credited directly to owners' interests under the heading of revaluation surplus. However, the increase should be recognised in the statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the statement of profit and loss.

A decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Impairment of assets: When the recoverable amount of an asset falls below its carrying amount, as per AS 28, the carrying amount has to be reduced to the recoverable amount and the loss on impairment should be charged to profit and loss account in addition to the depreciation. If subsequently the recoverable amount rises the reversal, i.e., addition shall be made to the already reduced carrying amount. However, the reversed carrying amount should never exceed the original carrying amount which would have been had there been no impairment.

2.5 Valuation Approaches

From the discussion in the above paragraphs we clearly observe that:

(a) In most of the cases the basis of valuation is historical cost.

(b) In case of revaluation the current cost basis is applied.

(c) In case of impairment of assets we get another value called 'recoverable amount'. Recoverable amount is the higher of an asset's net selling price and its value in use. Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. (AS 28)

(d) When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident. (AS 10)

(**Note:** We find different terms in different references viz., Realizable (settlement) value, Net selling price and fair market value connoting the same meaning. Again, Present value and Value in use are also carrying the same meaning.)

2.6 Net Valuation

After arriving at the gross book value (gross block) based on any or combination of the different approaches, accumulated depreciation is deducted there from to get the Net Book Value (net block). Thus, net valuation is dependent on the amount of depreciation accumulated through annual depreciation, which, again, differs with different methods of depreciation.

2.7 Disposal and Retirement

An item of fixed assets is eliminated from financial statements on disposal. If any fixed asset is retired from active use and held for disposal, it should be valued at the lower of the net book value and net realisable value. This means expected loss arising out of retirement of the fixed assets is immediately accounted for. Such loss should be charged to Profit and Loss Account. Similarly, gain or loss arising out of disposal of fixed assets is generally charged to Profit and Loss Account.

If any fixed asset was revalued earlier and the revaluation reserve remains unutilised partly or fully any loss arising out of sale of such fixed assets can be adjusted with the unutilised balance of revaluation reserve.

2.8 Depreciation

Assessment of depreciation and the amount to be charged is based on three factors:

(i) Value of fixed assets (already discussed);

(ii) Useful life of fixed assets; and

(iii) Estimated residual value.

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.

An enterprise allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates each such part separately.

There are several methods for charging depreciation of which straight line method and written down value method are used.

Regarding depreciation, AS 10 suggests adoption of the following principles:

(i) Consistency in application of the depreciation method.

(ii) If there is change in method, unamortised amount of the fixed assets should be charged to revenue following the new method from the date of the asset coming into use.

(iii) If useful life is revised, the unamortised value of the fixed assets should be charged to revenue over the revised remaining period of useful life.

(iv) If the value of the fixed asset is revised, the depreciation should be charged to write off the unamortised value of the fixed assets including revaluation profit/loss over the remaining useful life. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

(v) Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

Illustration 1

Fixed Assets of XYZ Ltd:

Purchased as on 1.4.2012 ₹ 7,50,000

Revaluation + 20% on 1.4.2014.

Expected life 15 years.

The company charged straight line depreciation.

The fixed asset was sold on 1.4.2017 for ₹ 5,60,000

Show Fixed Assets A/c, Depreciation A/c and Revaluation Reserve A/c in the book of XYZ Ltd.

Solution

Fixed Assets Account

		₹			₹
1.4.12	To Bank	7,50,000	31.3.13	By Depreciation	50,000
				By Balance c/d	7,00,000
		7,50,000			7,50,000
1.4.13	To Balance b/d	7,00,000	31.3.14	By Depreciation	50,000
				By Balance c/d	6,50,000
		7,00,000			7,00,000
1.4.14	To Balance b/d	6,50,000	31.3.15	By Depreciation	60,000
	To Revaluation Reserve	1,30,000		By Balance c/d	7,20,000
		7,80,000			7,80,000
1.4.15	To Balance b/d	7,20,000	31.3.16	By Depreciation	60,000
				By Balance c/d	6,60,000
		7,20,000			7,20,000
1.4.16	To Balance b/d	6,60,000	31.3.17	By Depreciation	60,000
				By Balance c/d	6,00,000
		6,60,000			6,60,000
1.4.17	To Balance b/d	6,00,000	1.4.17	By Bank	5,60,000
				By Revaluation Reserve A/c	40,000
		6,00,000			6,00,000

Depreciation A/c

31.3.13	To Fixed Assets A/c	50,000	31.3.13	By P & L A/c	50,000
31.3.14	To Fixed Assets A/c	50,000	31.3.14	By P & L A/c	50,000
31.3.15	To Fixed Assets A/c	60,000	31.3.15	By P & L A/c	60,000
31.3.16	To Fixed Assets A/c	60,000	31.3.16	By P & L A/c	60,000
31.3.17	To Fixed Assets A/c	60,000	31.3.17	By P & L A/c	60,000

Revaluation Reserve A/c

31.3.15	To Balance c/d	1,30,000	1.4.14	By Fixed Assets A/c	1,30,000
		1,30,000			1,30,000
31.3.16	To Balance c/d	1,30,000	1.4.15	By Balance b/d	1,30,000
		1,30,000			1,30,000
31.3.17	To Balance c/d	1,30,000	1.4.16	By Balance b/d	1,30,000
		1,30,000			1,30,000
1.4.17	To Fixed Assets A/c - Loss on disposal	40,000	1.4.17	By Balance b/d	1,30,000
	To General Reserve	90,000			
		1,30,000			1,30,000

Illustration 2

Vidarva Chemical Ltd. purchased a machinery from Madras Machine Manufacturing Ltd. (MMM Ltd.) on 30.9.2016. Quoted price was ₹ 162 lakhs. MMM Ltd. offers 1% trade discount. Sales tax on quoted price is 5%. Vidarva Chemical Ltd. spent ₹ 42,000 for transportation and ₹ 30,000 for architect's fees. They borrowed money from ICICI ₹ 150 lakhs for acquisition of the assets @ 20% p.a. Also they spent ₹ 18,000 for material in relation to trial run. Wages and overheads incurred during trial run were ₹ 12,000 and ₹ 8,000 respectively. The machinery was ready for use on 15.11.2016. It was put to use on 15.4.2017. Find out the original cost. Also suggest the accounting treatment for the cost incurred in the interval between the date the machine was ready for commercial production and the date at which commercial production actually begins.

Solution

(1) Determination of the original cost of the machine

	₹ in lakhs	*₹ in lakhs*
Quoted price	162.00	
Less: 1% Trade discount	(1.62)	160.38
Add: Sales tax	8.10	
Transportation	0.42	
Architect's fees	0.30	
Financing cost (since it is a non-qualifying asset)	Nil	8.82
		169.20

Expenditure for start-up:		
Material	0.18	
Wages	0.12	
Overhead	0.08	0.38
		169.58

(2) Cost incurred in the interval

Financing cost @ 20% on ₹ 150 lakhs for 15.11.16 – 15.4.2017 = ₹ 12.50 will be charged to statement of profit and loss as per AS 16 "Borrowing Costs".

Illustration 3

The original cost of the machine shown in the books of PK Ltd. as on 1st Jan., 2014 is ₹ 180 lakhs which they revalued upward by 20% during 2014. In the year 2016, it appears that a 5% downward revaluation should be made to arrive at the true value of the asset in the changed economic and industry conditions. They charged 15% depreciation on W.D.V. of the asset.

Show the value of the asset at which it should appear in the Balance Sheet dated 31st Dec. 2016 and show the Revaluation Reserve Account.

Solution

(1) Determination of Cost

	₹ in lakhs
W.D.V as on 1.1.2014	180.00
Add: Revaluation profit	36.00
	216.00
Less: Depreciation for 2014	(32.40)
W.D.V as on 1.1.2015	183.60
Less: Depreciation for 2015	(27.54)
W.D.V as on 1.1.2016	156.06
Less : Revaluation loss	(7.80)
	148.26
Less: Depreciation for 2016	22.24
W.D.V as on 31.12.2016	126.02

(2) Revaluation Reserve Account

		₹ in lakhs			*₹ in lakhs*
31.12.14	To Balance c/d	36.00	31.12.14	By Machinery A/c	36.00
31.12.15	To Balance c/d	36.00	01.01.15	By Balance b/d	36.00
31.12.16	To Machinery A/c	7.80	01.01.16	By Balance b/d	36.00
	To Balance c/d	28.20			
		36.00			36.00

Illustration 4

X Ltd. purchased fixed assets for ₹ 10 lakhs for which it got grants from an international agency (which comes within the definition of government as mentioned in AS 12) ₹ 8 lakhs. X Ltd. decides to treat the grant as deferred income. Suggest appropriate basis for taking credit of the grant to Profit and Loss A/c. Take life of the assets 10 years. The company followed W.D.V method. Scrap value ₹ 2.5 lakhs.

Solution

Deferred income on account of grant should be taken credit at the proportion by which depreciation is charged.

Calculation of Depreciation and taking Credit of Deferred Grant (Depreciation Rate 12.95)

	Original Cost /W.D.V (₹ in lakhs)	*Depreciation (₹ in lakhs)*	*Recovery of Grant (₹ in lakhs)*
t_0	10.000	–	–
t_1	10.000	1.295	1.381
t_2	8.705	1.127	1.202
t_3	7.578	0.981	1.046
t_4	6.597	0.854	0.912
t_5	5.743	0.744	0.794
t_6	4.999	0.647	0.690
t_7	4.352	0.564	0.602
t_8	3.788	0.491	0.524
t_9	3.297	0.427	0.455
t_{10}	2.870	0.370	0.394

Notes:

(i) Rate of Depreciation = $1 - \left[\frac{2.5}{10}\right]^{\frac{1}{10}} = 12.95\%$

(ii) Recovery of grant = Amount of grant × $\frac{\text{Depreciation for the year}}{\text{Total depreciation}}$

For t_{01}, ₹ 8 lakhs × 1.295 / 7.5 = 1.381 lakhs.

UNIT 3 : VALUATION OF INTANGIBLES

3.1 Definition of Intangibles

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes (As per Para 6 of AS 26 "Intangible Assets"). It is important to note that Intangible assets are the major contributors for the disparity between company value according to accounting records and company value as per market capitalization. Therefore, understanding the concept of an intangible asset from the angle of an accountant is necessary. Enterprises usually expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including branch names and publishing titles) at regular intervals of time. Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, finishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated. Intangible fixed assets can be classified as identifiable intangibles and not identifiable intangibles. The identifiable intangibles include patents, trademarks and designs and brands whereas the not identifiable intangibles are clubbed together as goodwill. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable.

3.2 Recognition

AS 26 establishes general principles for the recognition and measurement of Intangible Assets. An intangible asset should be recognised in the financial statements if, and only if:

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) The cost of the asset can be measured reliably.

These recognition criteria apply to both costs incurred to acquire an intangible asset and those incurred to generate an asset internally. The Standard imposes additional criteria, however, for the recognition of internally-generated intangible assets.

If an intangible asset is acquired separately:

Cost of the intangible asset can usually be measured reliably and such intangible asset is recognized and valued at cost in the same manner as in case if the tangible fixed assets.

If the intangible asset is internally generated:

AS 26 prohibits the recognition of internally generated goodwill as an asset. In addition, certain internally generated items are specifically identified in AS 26 as not capable of being distinguished from the cost of developing the business as a whole and therefore are prohibited from being capitalized as internally-generated intangible assets. Brands, Mastheads, Publishing titles, Customer Lists etc. are all internally generated assets.

However, when such assets are purchased either individually or as part of an amalgamation in the nature of a purchase, they may meet the general recognition criteria for intangible assets and, therefore, potentially may be recognized. This difference means that intangible assets such as brands can be capitalized if acquired, but will be expensed if they are generated internally.

The Standard distinguishes between two phases in the generation of an intangible asset internally, namely, the research phase and the development phase. Capitalisation is only permitted during the development phase.

Research is defined as original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

If it is not possible to distinguish the research phase from the development phase of an internal project to create an intangible asset, the expenditure on that project is treated as relating only to the research phase.

Subsequent expenditure on an intangible asset after its purchase or its completion should be added to the cost of the intangible asset if:

(a) It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

Designs which are acquired separately valuation would be made at initial cost of acquisition (with subsequent addition to cost, if any). If they are generated internally and are not recognized then no valuation shall be made. However, for internally generated recognized, valuation would be made at cost (with subsequent addition to cost, if any).

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use.

Amortisation should commence when the asset is available for use.

3.3 Goodwill

Goodwill is said to be that element arising from reputation, connection or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by net tangible assets employed in the business. In considering the return normally to be expected, regard must be had to the nature of the business, the risk involved, fair management remuneration and other relevant circumstances.

Goodwill of a business may arise in two ways. It may be inherent to the business that is generated internally or it may be acquired while purchasing any concern. Purchased goodwill can be defined as being the excess of fair value of the purchase consideration over the fair value of the separable net assets acquired. The value of purchased goodwill is not necessarily equal to the inherent goodwill of the business acquired as the purchase price may reflect the future prospects of the entity as a whole. This point has been elaborated in Unit 6: Valuation of Business. Non-purchased goodwill is any goodwill other than purchased goodwill. AS 26 'Intangible Assets' states that only purchased goodwill should be recognized in the accounts.

Goodwill in financial statements arises when a company is purchased for more than the fair value of the identifiable net assets of the company. The difference between the purchase price and the sum of the fair value of the net assets is by definition the value of the "goodwill" of the purchased company. The acquiring company must recognize goodwill as an asset in its financial statements and present it as a separate line item on the balance sheet, according to the current purchase accounting method. In this sense, goodwill serves as the balancing sum that allows one firm to provide accounting information regarding its purchase of another firm for a price substantially different from its book value. Goodwill can be negative, arising where the net assets at the date of acquisition, fairly valued, exceed the cost of acquisition. Negative goodwill is recognized as a gain to the extent that it exceeds allocations to certain assets. Under current accounting standards, it is no longer recognized as an extraordinary item. For example, a software company may have net assets (consisting primarily of miscellaneous equipment, and assuming no debt) valued at ₹ 1 million, but the company's overall value (including brand, customers, intellectual capital) is valued at ₹ 10 million. Anybody buying that company would book ₹ 10 million in total assets acquired, comprising ₹ 1 million physical assets, and ₹ 9 million in goodwill.

3.4 Relevant Provisions of the Accounting Standards on Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as 'goodwill'. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

In case of amalgamation under purchase method any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation.

If expenditure on an intangible item acquired in an amalgamation in the nature of purchase cannot be recognised as an intangible asset, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill at the date of acquisition.

Again in case of consolidation of balance sheet in the books of the parent company any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements.

Internally generated goodwill should not be recognised as an asset. Thus, in corporate financial accounting the scope for valuation of goodwill is limited to the measurements stated in the above circumstances. In case of amalgamation in the nature of merger, there does not arise any goodwill. In case of amalgamation in the nature of purchase, the excess of purchase consideration over the net asset value is computed as goodwill. In case of consolidation of final accounts, the excess of cost of investment in subsidiary over the parent's share in subsidiary's equity at the date of acquisition is computed as goodwill. Thus for determining the value of goodwill to be shown in the financial statements, one has to find the amount of purchase consideration, net asset value, cost to the parent of its investment in subsidiary and parent's share in subsidiary's equity.

If we assume that the purchase consideration or the cost of investment in subsidiary is inclusive of the price for goodwill, if any, then question may arise whether the valuation process is a circular one as stated below. The purchase consideration/ cost of investment in subsidiary are determined on the basis of valuation of business or valuation of share of transferor/subsidiary. The purchase consideration/cost of investment determines value of goodwill in amalgamation in the nature of purchase or in consolidation of financial statements. Thus in the above mentioned situations value of goodwill is the resultant figure derived from purchase consideration or cost of acquisition. Then this purchase consideration/cost of acquisition cannot again be derived from the valuation of goodwill. This inconsistency can be removed if we recognize that goodwill has no identity separable from the business and there need be no separate valuation of goodwill. The valuation of business as a whole would automatically include the value of goodwill. The fact that purchase consideration in excess of net asset value of business taken over is recorded as goodwill also suggests that goodwill value should not be a part of net asset value of business.

However, for the purpose of management information brand valuation and goodwill valuation may be done by applying any of the alternative methods available although that may not be in line with the requirements of Accounting Standards.

3.5 Valuation of Goodwill

There are basically two accounting methods for goodwill valuation. These are:

(i) Capitalisation Method and (ii) Super Profit Method. A third method called annuity method is a refinement of the super profit method of goodwill valuation.

3.5.1 Capitalisation method

Under this method future maintainable profit is capitalised applying normal rate of return to arrive at the normal capital employed. Goodwill is taken as the excess of normal capital employed over the actual capital employed.

Normal Capital employed = $\frac{\text{Future maintainable profit}}{\text{Normal rate of return}}$

Goodwill = Normal Capital Employed – Actual Closing Capital Employed

Factors considered in this method are:

(i) Future maintainable profit;

(ii) Actual capital employed in the business enterprise for which goodwill is to be computed;

(iii) Normal rate of return in the industry to which the business enterprise belongs.

For example, Capital employed in X Ltd. is ₹ 17,00,000, future maintainable profit is ₹ 3,00,000 and normal rate of return is 15%.

So goodwill = $\frac{₹\,3,00,000}{0.15}$ – ₹ 17,00,000 = ₹ 3,00,000

Naturally, if normal capital employed becomes less than actual capital employed there arises *negative goodwill.*

3.5.2 Super profit method

Excess of future maintainable profit over normally expected profit is called super profit. Under this method goodwill is taken as the aggregate super profit of the future years for which such super profit is expected to be maintained.

Factors considered in this method are:

(i) Future maintainable profit;

(ii) Actual capital employed;

(iii) Normal rate of return;

(iv) Period for which super profit is projected.

Super profit = Future maintainable profit minus (Actual Capital employed × Normal rate of return)

Goodwill = Super profit × No. of years for which Super Profit can be maintained.

Example

Capital employed by X Ltd. ₹ 17,00,000, Future maintainable profit ₹ 3,50,000, Normal rate of return 15%, Super profit can be maintained for 5 years.

Future maintainable profit	₹ 3,50,000
Less: Normal Profit $\left[₹\,17,00,000 \times \frac{15}{100}\right]$	(₹ 2,55,000)
Super Profit	₹ 95,000

Goodwill = Super profit × No. of years for which the super profit can be maintained.

= ₹ 95,000 × 5 = ₹ 4,75,000

3.5.3 Annuity method

It is a refinement of the super profit method. Since super profit is expected to arise at different future time periods, it is not logical to simply multiply super profit into number of years for which that super profit is expected to be maintained. Further future values of super profits should be discounted using appropriate discount factor. The annuity method got the nomenclature because of suitability to use annuity table in the discounting process of the uniform super profit. In other words, when uniform annual super profit is expected, annuity factor can be used for discounting the future values for converting into the present value. Here in addition to the factors considered in super profit method, appropriate discount rate is to be chosen for discounting the cash flows.

Example

Super Profit of X Ltd. ₹ 95,000 p.a. can be maintained for 5 years. Discount rate is 15%.

Goodwill = ₹ 95,000 × 3.352 = ₹ 3,18,440

There are atleast two frequently used approaches for arriving at the Capital employed: (i) based on a particular Balance Sheet and (ii) average of Capital employed at different balance sheet dates.

Capital employed is determined using historical cost values available at the balance sheet date. However, if revalued figures are given that should be considered.

3.6 Determination of Capital Employed

Conventionally 'Capital Employed' means Total Assets *Minus* non-trading assets i.e. assets not used in the business *Minus* miscellaneous expenditure and losses *Minus* all outside liabilities.

As per this concept capital employed becomes equivalent to net worth less non-trading assets. But this concept has its own shortcomings:

(i) This approach ignores other long term fund in the business;

(ii) On the other hand, it considers preference share capital which bears fixed rate of dividend.

The argument in favour of adopting this approach is to count only such fund which is attributable to the shareholders. Alternatively, by capital employed one can mean long term capital employed. However, leverage gives some advantage as well as riskiness. Use of lower amount of owned fund results in higher return because of using borrowed fund advantageously. This is called leverage effect. By taking only 'shareholders fund' as capital employed, one can give weightage to leverage while calculating goodwill.

Example

Balance Sheet of X Ltd.

Liabilities	*₹ in lakhs*	*Assets*	*₹ in lakhs*
Share Capital	*80*	*fixed assets*	*1,80*
P & L A/c	*20*	*Inventory*	*40*
13% Debentures	*1,20*	*Trade receivables*	*20*
Trade payables	*40*	*Cash & Bank*	*20*
	2,60		*2,60*

Capital employed (shareholders' fund approach)

₹ 260 lakhs – ₹ 160 lakhs outside liabilities = ₹ 100 lakhs.

Capital employed (long term fund approach):

₹ 260 Lakhs – ₹ 40 lakhs Trade payables = ₹ 220 lakhs

Suppose normal return on shareholders' fund is 20% and normal return on long term fund is 18%

Also suppose Future Maintainable Profit (before interest) of X Ltd. is ₹ 38.4 lakhs.

Future Maintainable Profit (after interest) of X Ltd. is

₹ 22.8 lakhs i.e. (₹ 38.4 lakhs –₹ 15.6 lakhs debenture interest)

If long term fund approach is followed value of goodwill as per Capitalisation method is i.e.,

$$\frac{38.4 \text{ lakhs}}{0.18} - 220 \text{ lakhs}$$

₹ 213.33 lakhs – ₹ 220 lakhs

i.e., (-) ₹ 6.67 lakhs, negative goodwill.

If shareholders' fund approach is followed, value of goodwill as per capitalisation method is,

$$\frac{22.8 \text{ lakhs}}{0.20} - 100 \text{ lakhs} = ₹\ 114 \text{ lakhs} - ₹\ 100 \text{ lakhs}$$

i.e., ₹ 14 lakhs, positive goodwill.

In this example, when long term capital employed was considered there was negative goodwill, but it became positive when shareholders' fund was considered. In the second approach leverage advantage has been taken into consideration. Thus, in goodwill valuation generally shareholders' fund approach is preferred.

Non-trading assets are ignored while computing capital employed. This is because surplus fund invested outside does not influence the future maintainable profit. Particularly, Non-trade investments are not counted while computing capital employed, but trade investments should be taken into consideration.

Another important aspect is often discussed regarding valuation of capital employed. What value should the accountant put for fixed assets and inventory. Since historical cost is not true indicator of the value of these assets, then it is suggested to take current cost of such assets. Current cost represents the cost for which asset can be replaced at its present state. However, if the asset cannot be replaced at its present state because of obsolescence, then cost at which its best substitute is available may be taken as current cost.

Capital employed may be determined using the value given by the latest balance sheet or taking simple average of the capitals employed at the beginning of the accounting period as well as at the end.

Illustration 1

Balance Sheets of X Ltd.
As on 31st March 2x16 and 31st March 2x17

Liabilities	*31.3.16*	*31.3.17*	*Assets*	*31.3.16*	*31.3.17*
Share Capital	*18,00*	*18,00*	*Fixed assets*	*24,00*	*26,00*
General Reserve	*6,00*	*6,00*	*Investments*	*1,00*	*2,00*
Profit & Loss A/c	*6,80*	*9,40*	*Inventory*	*6,00*	*5,50*
12% Debentures	*2,00*	*2,00*	*Trade receivables*	*3,00*	*3,50*
18% Term Loan	*3,00*	*3,20*	*Cash and Bank*	*4,00*	*3,40*
Cash Credit	*1,20*	*80*			
Trade payables	*70*	*60*			
Tax Provision	*30*	*40*			
	38,00	*40,40*		*38,00*	*40,40*

Non-trade investments were 75% of the total investments. Find capital employed as on 31.3.14 and as on 31.3.17 and average capital employed.

Solution

Computation of capital employed

				(₹ in lakhs)
		31.3.16		31.3.17
Total Assets as per Balance Sheet		38,00		40,40
Less: Non-trade Investments		(75)		(1,50)
		37,25		38,90
Less: Outside Liabilities:				
12% Debentures	2,00		2,00	
18% Term Loan	3,00		3,20	

Cash Credit	1,20		80	
Trade payables	70		60	
Tax Provision	30	7,20	40	7,00
Capital employed		30,05		31,90

Average capital employed = $\frac{30,05 \text{ lakhs} + 31,90 \text{ lakhs}}{2}$ = ₹ 3,097.5 lakhs.

Illustration 2

Balance Sheet of AP Ltd. as on 31st March, 2017

Liabilities	*₹ in lakhs*	*Assets*	*₹ in lakhs*
Share Capital		*Land & Building*	*51,20*
Equity Shares of ₹ 10 each	*90,00*	*Plant & Machinery*	*108,70*
8½% Preference Shares	*20,00*	*Furniture*	*27,00*
General Reserve	*30,20*	*Vehicles*	*2,00*
Profit & Loss A/c	*30,00*	*Inventory*	*7,00*
18% Term Loan	*45,00*	*Trade receivables*	*4,50*
Cash Credit	*5,60*	*Cash & Bank*	*23,40*
Trade payables	*2,00*		
Provision for Taxation			
(net of advance tax)	*1,00*		
	223,80		*223,80*

Other information

Balance as on 1.4.16

Profit and Loss A/c	*₹ 4,80 Lakhs*
Reserve	*₹ 4,50 Lakhs*

Find out average capital employed of AP Ltd.

Solution

Computation of Average Capital Employed

	₹ in lakhs	₹ in lakhs
Total of Assets as per Balance Sheet as on 31.3.2017		223,80
Less: Outside Liabilities:		
18% Term Loan	45,00	
Cash Credit	5,60	
Trade payables	2,00	

Provision for Taxation	1,00	(53,60)
Capital employed as on 31.3.17		170,20
Less: 1/2 of profit earned:		
Increase in Reserve balance	25,70	
Increase in Profit & Loss A/c	25,20	
	50,90	
		25,45
Average capital employed		144,75

3.7 Future Maintainable Profit

We have seen earlier while discussing various methods of goodwill valuation that estimation of average maintainable profit is another important step in goodwill valuation. Future maintainable profit is ascertained taking either simple or weighted average of the past profits or by fitting trend line. Generally, profits of past three to five years are considered.

(i) Simple Average of Past Profits: If the past profits do not have any definite trend, average is taken to arrive at the future maintainable profit.

Example

Profits of the past five years of XX Ltd. are given below:

Year	*₹ '000*
2013	71,20
2014	87,20
2015	75,70
2016	82,70
2017	78,90

In this case no trend of past profit is available. So, simple average is best suitable method to arrive at a figure which may be taken as future maintainable profit.

Future maintainable profit (₹ in '000) = $\frac{7{,}120 + 87{,}20 + 75{,}70 + 82{,}70 + 78{,}90}{5}$ = 79,14

(ii) Trend Equation: If the past profits show increasing or decreasing trend, linear trend equation gives better estimation of the future maintainable profit.

Example

B K Ltd. gives the following profit figures for the last five years:

Year	*Profits ₹ '000*
2013	37,20
2014	42,00

2015	47,50
2016	53,50
2017	57,20

Since, past profits show increasing trend, time series trend may be used to determine future maintainable profit. Applying Linear trend equation three to five years profit may be predicted and average of such future profits may be taken as future maintainable profit.

Year	*X*	*Y*	*XY*	X^2
2013	–2	37,20	–74,40	4
2014	–1	42,00	–42,00	1
2015	0	47,50	0	0
2016	1	53,50	53,50	1
2017	2	57,20	114,40	4
	0	237,40	51,50	10

$$A = \frac{\sum Y}{n} = \frac{237{,}40}{5} = 47{,}48$$

$$b = \frac{\sum XY}{\sum X^2} = \frac{51{,}50}{10} = \quad 51{,}5$$

Trend Equation is given by:

Y = 4748 + 515 X

Alternatively, using trend equation, estimated profit will be:

Estimated Profit:

2018	4748 + 515 (3) =	₹ 62,93
2019	4748 + 515 (4) =	₹ 68,08
2020	4748 + 515 (5) =	₹ 73,23
Average of the Future Profit		₹ 68,08
i.e., Future Maintainable Profit		₹ 68,00 (say)

(iii) Weighted average of past profits: If the past profits show increasing or decreasing trend, then more weights are given to the profit figures of the immediate past years and less weight to the profit figures of the furthest past.

Example

Profits of the past five years of BB Ltd. are given below:

Year	*Profits (₹ '000)*
2013	71,20
2014	82,50
2015	87,00
2016	92,00
2017	95,00

In this example past profits showed an increasing trend. Weighted average of past profits may be used in such cases to arrive at future maintainable profit.

Derivation of weighted average of the past profits:

Year	*Profits (P) '000 ₹*	*Weight (W)*	*PW*
2013	71,20	1	71,20
2014	82,50	3	247,50
2015	87,00	5	435,00
2016	92,00	7	644,00
2017	95,00	9	855,00
		25	22,52,70

Weighted average profit = $\frac{\sum PW}{\sum W} = \frac{22{,}52{,}70}{25}$

i.e. ₹ 9010.80 thousand.

Illustration 3

PPX Ltd. gives the following information about past profits:

Year	*Profits (₹ '000)*
2013	*21,70*
2014	*22,50*
2015	*23,70*
2016	*24,50*
2017	*21,10*

On scrutiny it is found (i) that upto 2015, PPX Ltd. followed FIFO method of finished inventory valuation thereafter adopted LIFO method, (ii) that upto 2016 it followed straight line depreciation and thereafter adopted written down value method.

Given below the details of Inventory valuation: (Figures in ₹ '000)

Year	*Opening Inventory*		*Closing Inventory*	
	FIFO	*LIFO*	*FIFO*	*LIFO*
2013	*40,00*	*39,80*	*46,00*	*41,20*
2014	*46,00*	*41,20*	*49,20*	*47,90*
2015	*49,20*	*47,90*	*38,90*	*39,10*
2016	*38,90*	*39,10*	*42,00*	*38,50*
2017	*42,00*	*38,50*	*45,00*	*43,10*

Straight line and written down value depreciation were as follows:

Year	*Straight Line (₹ '000)*	*W.D. V (₹ '000)*
2013	*12,10*	*17,00*
2014	*14,15*	*18,10*
2015	*15,00*	*19,25*
2016	*16,70*	*19,60*
2017	*18,00*	*19,40*

Determine future maintainable profits that can be used for valuation of goodwill.

Solution

Past profits of PPX Ltd. showed an increasing trend excepting in year 2017. But the effects of changes in accounting policies should be eliminated to ascertain the true nature of trend. Since the company has adopted LIFO method of Inventory valuation and W.D.V method of depreciation, profits may be recomputed applying these policies consistently in all the past years. Recomputation of profits following uniform accounting policies are shown below:

(Figures in ₹ '000)

Year	*Book Profits*	*Effect of LIFO Effect of Valuation of Inventory W.D. V Depn.*	*Profits after elimination of the effect of change in Accounting policies*	
2013	21,70	– 4,60	– 4,90	12,20
2014	22,50	+ 3,50	– 3,95	22,05
2015	23,70	+ 1,50	– 4,25	20,95
2016	24,50	–20	– 2,90	21,40
2017	21,10	—	—	21,10

After elimination of the effect of change in accounting policies, increasing trend disappeared. Rather profits were oscillating during the last four years excepting 2013. So a simple average may be taken of the last 4 years profits to arrive at the future maintainable profits:

Future Maintainable Profit ('000 ₹) = $\frac{22,05 + 20,95 + 21,40 + 21,10}{4}$ = 21,37.50

Working Note:

Effect of LIFO Valuation:

2013:	Increase in Inventory as per FIFO valuation	6,00
	Less: Increase in Inventory per LIFO valuation	(1,40)
	Reduction in profit	4,60
2014:	Increase in Inventory as per FIFO valuation	3,20
	Increase in Inventory as per LIFO valuation	6,70
	Increase in profit	3,50
2015:	Decrease in Inventory as per FIFO valuation	10,30
	Decrease in Inventory as per LIFO valuation	8,80
	Increase in profit	1,50
2016:	Opening Inventory as per FIFO valuation	38,90
	Opening Inventory as per LIFO valuation	39,10
	Reduction in profit	20

3.7.1 Adjustments needed with past profits

Since past profits are used to make an estimation about the future maintainable profit, it is necessary to make appropriate adjustments for better projection. The following adjustments generally become necessary:

(i) Elimination of abnormal loss arising out of strikes, lock-out, fire, etc. Profit/loss figures which contain abnormal loss should either be ignored or eliminated. Similarly, if there is any abnormal gain included in past profits that needs elimination.

(ii) Interest/dividend or any other income from non-trading assets needs elimination because 'capital employed' used for valuation of goodwill comprises only of trading assets.

(iii) If there is a change in rate of tax, tax charged at the old rate should be added back and tax should be charged at the new rate.

(iv) Effect of change in accounting policies should be neutralised to have profit figures which are arrived at on the basis of uniform policies.

3.8 Normal Rate of Return

Apart from capital employed and future maintainable profit, the third important step in valuation of goodwill is determination of normal rate of return. It comprises of:

(i) the risk-free rate, i.e., the pure interest rate prevailing in the concerned economy; (the rate of return on long term government securities or fixed deposit in bank may be taken as risk-free rate)

(ii) the premium for business risks appropriate for the industry to which the firm/company belongs.

If the industry is well established and yielding profits steadily the rate of return that will satisfy entrepreneurs will be rather low though higher than the risk- free rate. Higher the business risk, higher will be the normal rate of return.

For practical purposes industry average return is taken as normal rate of return.

Illustration 4

On the basis of the following information, calculate the value of goodwill of Gee Ltd. at three years' purchase of super profits, if any, earned by the company in the previous four completed accounting years.

Summarised Balance Sheet of Gee Ltd. as at 31st March, 2017

Liabilities	*₹ in lakhs*	*Assets*	*₹ in lakhs*
Share Capital:		*Goodwill*	*310*
Authorised	*7,500*	*Land and Buildings*	*1,850*
Issued and Subscribed		*Machinery*	*3,760*
5 crore equity shares of ₹ 10 each, fully paid up	*5,000*	*Furniture and Fixtures*	*1,015*
		Patents and Trade Marks	*32*
Capital Reserve	*260*	*9% Non-trading Investments*	*600*
General Reserve	*3,293*	*Inventory*	*873*
Surplus i.e. credit balance of Profit and Loss (appropriation) A/c	*457*	*Trade receivables*	*614*
		Cash in hand and at Bank	*546*
Trade payables	*568*		
Provision for Taxation (net)	*22*		
	9,600		*9,600*

The profits before tax of the four years have been as follows:

Year ended 31st March	*Profit before tax in lakhs of Rupees*
2013	*3,190*
2014	*2,500*
2015	*3,108*
2016	*2,900*

The rate of income tax for the accounting year 2012-2013 was 40%. Thereafter it has been 38% for all the years so far. But for the accounting year 2016-2017 it will be 35%.

In the accounting year 2012-2013, the company earned an extraordinary income of ₹ 1 crore due to a *special foreign contract. In August, 2013 there was an earthquake due to which the company lost property worth ₹ 50 lakhs and the insurance policy did not cover the loss due to earthquake or riots.*

9% Non-trading investments appearing in the above mentioned Balance Sheet were purchased at par by the company on 1st April, 2014.

The normal rate of return for the industry in which the company is engaged is 20%. Also note that the company's shareholders, in their general meeting have passed a resolution sanctioning the directors an additional remuneration of ₹ 50 lakhs every year beginning from the accounting year 2016-2017.

Solution

(1) Capital employed as on 31st March, 2017 (Refer to 'Note')

		₹ in lakhs
Land and Buildings		1,850
Machinery		3,760
Furniture and Fixtures		1,015
Patents and Trade Marks		32
Inventory		873
Trade receivables		614
Cash in hand and at Bank		546
		8,690
Less: Trade payables	568	
Provision for taxation (net)	22	590
		8,100

(2) Future maintainable profit

(Amounts in lakhs of rupees)

	2012-2013 ₹	*2013-2014* ₹	*2014-2015* ₹	*2015-2016* ₹
Profit before tax	3,190	2,500	3,108	2,900
Less: Extraordinary income due to foreign contract	(100)			
Add: Loss due to earthquake		50		
Less: Income from non-trading investments			(54)	(54)
	3,090	2,550	3,054	2,846

As there is no trend, simple average profits will be considered for calculation of goodwill.

Total adjusted trading profits for the last four years = ₹ (3,090 + 2,550 + 3,054 + 2,846)

= ₹ 11,540 lakhs

Average trading profit before tax = $\left(\frac{₹\ 11,540\ \text{lakhs}}{4}\right)$ = ₹ 2,885 lakhs

Less: Additional remuneration to directors	(50)	Lakh
	2,835	Lakh
Less: Income tax @ 35% (approx.)	(992)	(Approx)
	1,843	Lakh

(3) Valuation of Goodwill on Super Profits Basis

	₹ in lakh
Future maintainable profits	1,843
Less: Normal profits (20% of ₹ 8,100 lakhs)	(1,620)
Super profits	223

Goodwill at 3 years' purchase of super profits = 3 x ₹ 223 lakhs = ₹ 669 lakhs

3.9 Brand Valuation

In modern competitive environment, the corporate value and earning power are decided and generated by both the classes of assets, often more by intangibles than tangibles. In a turbulent marketing environment, brand gives tremendous competitive advantage to corporate. It can be said that rather than product selling itself, it is brand that sells the product. Vast sums are being spent by corporate to propagate and perpetuate the brand identity among product or service users. Brands are strategic assets. The key to survival of companies is their brands in the modern world of complex and competitive business environment.

3.9.1 Concept of Brand

According to American Marketing Association, brand means a name, term, sign, symbol or design or a combination of these intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors.

Corporate branding can be taken to mean the strategic exercise, by managerial decision making, of creating, developing, maintaining and monitoring the identity, image and ownership of a product corporate entity. Among various intangibles such as goodwill, patents, copyrights, brands etc., brands comprise an important item in that they greatly determine the corporate market value of a firm.

Brand achieves a significant value in commercial operation through the tangible and intangible elements. Brands may be that which is acquired from outside source while acquiring business or may also be nurtured internally by a company, which are known as 'Home-grown brands'. By assigning a brand name to the product, the manufacturer distinguishes it from rival products and helps the customers to identity it while going in for it. The necessity of branding of products has increased enormously due to influence of various factors like growth of competition, increasing importance of advertising etc.

Power brands make such a lasting impact on the consumers that it is almost impossible to change his preferences even if cheaper and alternative products are available in the market. Brands have major influence on takeover decisions as the premium paid on takeover is almost always in respect of the strong brand portfolio of the acquired company and of its long-term effect on the profits of the acquiring company in the post-acquisition period.

Brands should be considered as an asset. The sole purpose of establishing brand names is to incur future economic benefits, through increased sale to loyal customers or through an increased sale price of the brand itself or the business that owns the brand.

The companies with valuable brands register those names and are legally entitled to sole ownership and use of them. Brands are created through marketing efforts over time, they are the result of several past transactions and events.

A brand is a trademark (or combination of trademarks) that, through promotion and use, has acquired significance in distinguishing the source or origin of the goods or services offered under the trademark from those offered by others in the marketplace. Trademarks can take a variety of forms. While a trademark is often thought of as a word, phrase or logo, trademarks can also consist of numbers, designs, stylized lettering, colors, sounds, smells and any combination thereof, among various other possibilities such as the appearance or shape of the goods or their packaging. Brands are intellectual property and, as such, are part of the assets or "goodwill" of a company, and may be bought or sold like any other asset or property

The value of a brand is often defined as the amount of money another party is prepared to pay for it. Sometimes this is readily ascertainable after a company purchases a brand and the associated goodwill without any other assets; however, in many situations, determining a value for a brand can be significantly more complicated. Another readily identified value of a brand, or brands, is the difference between the amount paid to buy a company and the value of the fixed assets of that company. That difference represents the "goodwill" being purchased, and this goodwill is usually reflected in the brands of the company. The true value of a brand is ascertainable only when there is a willing purchaser and willing seller who reach to an agreement in the marketplace. A much more difficult question is how to value a brand when there is no current offer to sell or purchase.

3.10 Objectives of Corporate Branding

A strong corporate branding strategy can add significant value in terms of helping the entire corporation and the management team to implement the long-term vision, create unique positions in the market place of the company and its brands, and not the least to unlock the leadership potential within the organization. Hence, a corporate branding strategy can enable the corporation to further leverage on its tangible and non-tangible assets leading to branding excellence throughout the corporation.

The important objectives of corporate branding are as follows:

1. **Corporate Identity:** Brands help companies in creating and maintaining an identity for them in the market place. This is chiefly facilitated by brand popularity and the eventual customer loyalty attached to the brands.

2. **TQM:** By building brand image, it is possible for a body corporate to adopt and practice Total Quality Management (TQM). Brands help in building a lasting relationship between the brand owner and the brand user.
3. **Customer Preference:** The need for branding a product or service arises on account of the perceived choice and preferences which are built up psychologically by the customers. In fact, branding gives them the advantage of status fulfillment.
4. **Market Segmentation:** Segmenting a market requires classification of markets into more strategic areas on a homogeneous pattern for efficient operations to enable firms to effectively target consumers and to meet the competition. This segmenting of a market is facilitated through the built-up strong brand values.
5. **Strong Market:** By building strong brands, firms can enlarge and strengthen their market base. This would also facilitate programmes, designed to achieve maximum market share.

3.11 Corporate Brand Accounting

The term brand accounting refers to "the practice of valuation and reporting of the value of brand of a product or service in the financial statements of a corporate entity, the value of a brand being ascertained either as a result of revaluation in the case of home-grown brands or as a result of acquisition/ merger in the case of newly acquired brands.

Accounting is basically a measurement and communication system. Corporate brand accounting can be defined as a process of identification, measurement and communication of brand value and brand equity to permit informed judgment and decisions by the users of the information.

It is a system designed to determine the brand value with a view to reflect the brands as assets in the corporate balance sheet. However, brand accounting goes beyond valuation of corporate brand. It is the process of total brand management through accounting information.

3.12 Objectives of Brand Accounting

The accounting for brands is motivated by the following reasons:

1. **Real Economic Value:** By showing brand value in the Balance Sheet of a firm, an objective and realistic assessment of the company's real economic value could be made possible. This would facilitate the ascertainment of correct Net Asset Value (NAV) which would be useful in times of business acquisitions and mergers.
2. **Future Profitability:** A brand generated or purchased, could be very useful for ascertaining the future income making ability of companies. In fact, enormous sums of money spent on promoting and supporting brands would go to appreciate the value of the firm. Companies which enjoy brand equity will have the market value of their share enhanced. Brand equity refers to the value added to the equity of a firm by the brand popularity and loyalty.

3. **Preventing Predation:** By building and explicitly disclosing brands in financial statements, companies could put up a powerful defense against potential predators and thereby ward off possible acquisition and take-over bids.

4. **Leverage Benefits**: By enhancing the NAVs through brand disclosure separately in the Balance sheet, it is possible for companies to resort to easy debt borrowings as this causes an increase in NAV. In fact, the borrowing limits a firm enhances with the increase in NAV. This ultimately paves the way for sound capital structure and an improved gearing ratio.

5. **Quality Decisions**: Inclusion of brand values not only enhances NAV, ensure fair valuation of the firm. This promotes quality managerial decision making. Brand valuation may help managers in placing importance on brand promotion and strategic brand positioning which hold the key for corporate marketing success.

6. **Quality Accounting**: Brand value inclusion enhances the quality of accounting practice since the value added by corporate brands are considered significant in financial statements. This could ultimately improve the financial accounting system and management control.

7. **Social Obligation**: Brand valuation and its disclosure would help managers and shareholders alike appreciate the significant role of brands in maintaining and enhancing the market value of firms. This could help especially the shareholders in making an objective evaluation of companies (rating) before investing their money. This exercise, in a way, helps firms fulfill their social obligations.

8. **Other Benefits**: Brand accounting provides a strong basis for self-evaluation of its value by corporate. This could help firms in making a perfect estimate of the ability to take on the competitors. It not only helps in tackling competitors locally, but could be of much greater advantage to the foreign joint ventures and collaborations.

3.13 Difficulties in Brand Accounting

Intangibles are not easily measurable and it poses severe challenges in valuation of brands also. Some of the difficulties faced by the accountants in brand valuation are as follows:

1. **Distinctiveness:** Brands need to be valued distinctively as different from other intangibles such as Goodwill etc. For instance, any attempt to commonly treat brand as a part of Goodwill as is done at present may create serious distortions in accounting position. Besides, this would create handicaps in brand accounting. This is because, a brand cannot be treated like any other item such as patents and copyrights. In fact, a brand needs to be separately disclosed in the Balance sheet, because of its significant contribution to corporate image and identity.

2. **Disclosure:** There is always a problem of making disclosure of brand values in financial statements. This is because, there is no standard accounting practice requiring statement and disclosure of brand values in a particular way.

3. **Uncertainty:** The problem that is associated with the brand, as an item of intangibles, is that its possible returns are uncertain, immeasurable and non-current in nature. Any expected on such intangibles are usually either written off or treated as Deferred Revenue Expenditure.
4. **The Dilemma:** Another area of challenge posing brand accounting is whether to amortise or capitalise the value of brand. There is no question of amortising brand values as either the economic life of the brand cannot be determined in advance or its value depreciates over time. In fact, it is "to be noted that a brand can be purchased or generated and maintained, thus enhancing the corporate future income earnings capacity. The challenge could, however, be overcome by categorising the brand expenditure into Maintenance and Investment. Whereas the maintenance expenditure could be charged to Profit and Loss Account and the Capital Expenditures be shown in the Balance Sheet and where the brand value is shown separately and explicitly in the Balance Sheet, the leverage position of the company can be shown enhanced.
5. **No Market:** The prevailing practice is that the intangibles are not required to be revalued according to some accounting standards on account of the non-existence of an active secondary market for them. In fact, the need for brand accounting arises mainly on account of conditions warranted by acquisition and merger.
6. **New Brands:** A related problem, in accounting for such intangibles as brands is that it is often difficult to determine whether a new one is being gradually substituted for an existing brand. This raises the issue as to how to account for it in subsequent years. In such case, the relevant question is: Should the original cost of brand be written-down as it erodes? It may be difficult to determine whether a brand remains the same asset overtime as it is subtly reshaped to meet new market opportunities.
7. **Joint Costs:** The contribution to the value of a brand is made not simply by investing a desirable product with a customer seductive name, but by building market share by the skilful exploitation of the product in a whole host of ways of general efficiency with which a business is conducted by expending money on a joint cost basis. It is very difficult to segregate and account for joint costs that are incurred and the cost of brand developed as a result of general operations of the business.

3.14 Valuation of Brands

The methods of brand valuation would depend on one or more of the following variables:

1. Exclusive earning power of brand.
2. Product as a brand and hence, product life cycle.
3. Separating a brand from other less important value drivers
4. Cost of acquisition of brand.
5. Expenses incurred on nurturing a home grown brand.
6. Impact of other brands as new entrants to the market.

7. Intrinsic strength of the people and process handling the brand.
8. Accuracy in projecting the super or extra earnings offered by a brand and rate of discounting such cash flows.
9. The cost of withdrawing or replacing the brand.
10. Internationalisation of a brand and therefore, local earning power of a brand in various countries or markets.

The valuation of brands is discussed from the angle of (i) Acquired brands, and (ii) Self generated brands.

Valuation of Acquired Brands: A purchased brand is one, which is acquired from other existing concerns. The acquiring company may acquire only the brand name(s). The value of acquired brands is given below:

Brand value = Price paid for acquisition

On the other hand, a company may acquire an existing business concern along with its brands. These are the cases of business mergers and amalgamations. The sum involved in these transactions provides an indication of the financial value of the brands. At the maximum this value is equal to the difference between the price and the value of the net assets indicated on the acquired company's balance sheet.

Brand value = Purchase consideration - Net assets taken over

However, it is questionable to say that the excess price paid always represents the brand value. The excess is only an amount of purchased goodwill and the acquiring company may have paid the excess price for varied factors also, location of the factory, long term contracts with suppliers, better employee morale, better manufacturing technology etc. besides for brands.

It would be difficult to say what part of the excess price paid is attributable to brands. Besides, the price payable is always decided by forces of demand and supply conditions of mergers and amalgamations in the market. Competitive force may make the acquirer to increase the bid price thereby increasing the amount of purchased goodwill. This inseparability of brand from other intangible assets makes it difficult to value the brands.

Valuation of Self-generated Brands: Several approaches have been evolved over a period of time for determining the brand values. The important methods in valuation of self-generated brands are discussed below:

Historical Cost Model – According to this approach, the valuation of a brand is determined by taking into account the actual expenses incurred in the creation, maintenance and growth of corporate brands. The value of the brand computed as follows:

Brand value = Brand Development Cost + Brand Marketing and Distribution Cost + Brand Promotion Costs including advertising and other costs.

The historical cost method is specifically applicable to home-grown brands for which various costs like development costs, marketing costs, advertising and general communication costs etc. are incurred. The sum total of all these costs would represent the value of brands. However, the entire advertisement costs cannot be regarded as incurred for brand. Further, several heavily advertised brands today show hardly any value or presence.

The chief advantage of this model is that the various types of costs that are actually incurred are considered. This facilitates easy computation of brand values. However, it does not explain the impact of brand value on the profitability of a firm.

Replacement Cost Model – Under this model, the brands are valued at the costs, which would be required to recreate the existing brands. The method is based on the assumption that the existing brands can be recreated exactly by new brands. It is the opportunity cost of investments made for the replacement of the brand.

Brand value = Replacement Brand Cost

The main disadvantage with this model is that this model gives an estimation of brand value but it is near impossible to replace the existing brands by new brands. Further, such values are only subjective ones.

Market Price Model – The probable value that a company would get for sale of its brands is taken as the value of the brands under this model. Therefore, the brand value is given by:

Brand value = Net Realisable Value

However, this value is only an assumed value because there exists no ready-made market for many brands. Further, brands are created or bought by corporate not for sale or resale. Value payable by the purchaser depends upon the benefits expected from the purchase of brand. But the method determines the value from the seller's point of view.

Current Cost Model – According to this approach, the current corporate brands are valued at the current value (current costs) to the Group, which is reviewed annually and is not subject to amortisation. This basis of valuation ignores any possible alternative use of brand, any possible extension to the range of products currently marketed under a brand, any element of hope value and any possible increase in value of a brand due to either a special investment or a financial transaction (e.g. licensing) which would leave the Group with different interest from the one being valued.

Potential Earning Model – The Potential Earnings (PE) model is based on the estimated potential earnings that would be generated by a brand and their capitalisation by using appropriate discount rate, the volume of revenues raised by a brand in the market, determines its value. Accordingly, the value of a brand at any one point of time is given by:

Total Market value of brand = Net Brand Revenue/Capitalisation Rate

Where

Net Brand Revenues = (Brand units × Unit brand price) - (Brand units × Unit brand cost) (Marketing cost + R & D cost + Tax costs).

Though the model sounds objective, problem lies in ascertaining the actual marketing cost incurred for I particular brand of a product. Moreover, it is difficult to select an appropriate capitalisation rate.

Present Value Model – According to present value model, the value of a brand is the sum total of present value of future estimated flow of brand revenues for the entire economic life of the brand plus the residual value attached to the brand. This model is also called Discounted Cash Flow model which has been wisely used by considering the year wise revenue attributable to the brand over a period of 5, 8 or I0 years. The discounting rate is the weighted average capital cost, this being increased where necessary to account the risks arising out of a week brand. The residual value is estimated on the basis of a perpetual income, assuming that such revenue is constant or increased at a constant rate.

Brand value = $\frac{R_t}{(1+r)^t} + \frac{\text{Residual value}}{(1+r)^N}$

Where,

R_1 = Anticipated revenue in year t, attributable to the brand.

t = Discounting rate

Residual value beyond year N

Brands supported by strong customer loyalty, may be visualised as a kind of an 'annuity', since, mathematically, an annuity is a series of equal payments made at equal intervals of time. Brands backed by the loyalty of hard-core customers offer strong probability of having steady long-term incomes. Great care must be taken to estimate as much correctly as possible, the future cash flow likely to emanate from a strongly positioned specific brand. A realistic present value of a particular brand having strong loyalty of customers can thus be obtained from summation of discounted values of the expected future incomes from it.

The DCF model for evaluating brand values has got three sources of failure: (i) Anticipation of cash flow, (ii) Choice of period, and (iii) Discounting rate.

Sensitivity Model – According to this approach, the brand revenues are determined as a functional inflow of such market factors as level of awareness of brand (AB), level of customer influence P) and level of brand autonomy (BA) in the market, all these factors in the first place predominating the sales revenues and then the brand revenues or the brand value. In other words, sensitivity of each of the above forces determines the brand value.

Brand value = (Brand units sold x Unit Brand price) x AB x BI x BA

(-)

(BDC + BMDC + BPC)

Where,

AB, BI and BA are sensitivity index of brand values

BDC = Brand Development Cost

BMD = Brand Marketing and Distribution Cost

BPC = Brand Promotion Cost

The demerit of this model is that it gives more importance to subjective variables in the estimation of brand value and this renders the whole exercise less reliable.

Life Cycle Model – Under this approach, the brand value is indicated by means of relating the brand dimensions to the brand strength. This model is applicable to home-grown brands, where the brands are generated, nurtured and developed throughout their life which resembles a product life cycle. The model is so called because the various brand dimensions behave in a way over a period of time thus forming the brand value, to its life. This results in the formation of S-curve. The model merely gives diagrammatic representation of formation and behaviour of brand strength. The various dimension assumed in this approach are difficult to be quantified. The figure depicts the life cycle model of corporate brand strength

Incremental Model – Under this approach, the value of a brand is measured in terms o| incremental benefits accruing to a firm on account of additions made to the brand value as a result of acquisition or revaluation of brands. The brand value is computed as follows:

Brand value

= Total expected benefits after acquiring or revaluing brands – Total benefits of brands owned

Super Profits Model – This is the most commonly used method for brand valuation. The simple formula of valuation under this method is as follows:

Brand value = Discounting Factor x (Total profit of an enterprise in 'n' years x Profit of an enterprise without the brand in 'n' years)

The disadvantages in this method are as follows:

1. How many years ('n') profits to be considered?
2. What should be the discounting rate?
3. How do we decide the profit of an enterprise without the brand?

Market Oriented Approach – This method is much outward looking and emphasises on the market forces and competition, to arrive at a brand's value. The method requires very good understanding of the market, new entrants, exit of old competitors, market expansion and shrinkage and impact of other macro-level variables on the market. The valuation process demands due amount of conservatism in projecting the market-size and the company's share in the market.

Brand value = Discounting Factor × Company's profitability ratio × (Cumulative market's size in next ten years - Cumulative total of market share enjoyed by other branded and non-branded products in next 10 years)

The advantage of this method is, it looks at macro aspects governing the brand's growth or shrinkage. It also takes the cognizance of non-branded products and their threat to the company's brand. Company's profitability ratio and the accounting factor are a matter of strategic benchmarking.

Whole Organisation as a brand: Normally one cannot identify a product or process or program as an exclusive brand. All the value drivers bring together and make the enterprise a big integrated brand, the premium enjoyed by such enterprise becomes the value of the brand.

Brand value = Intrinsic value of an enterprise - Net asset value of the assets of an enterprise

This method is useful under the following circumstances:

1. The buyer acquires the whole of the enterprise.
2. A going concern values itself and exhibits such premium enjoyed by it, in its Balance Sheet.
3. One company becomes the brand equity or brand name for whole of the group.
4. Valuation of an enterprise as a brand is to be used as a base for computing the brand value of each value driver in the value chain of the enterprise.

This method is a very accurate choice of performance indicators and their weight ages which together decide the intrinsic value of the enterprise.

Which brand valuation method to use?

It is generally best to value brands using all appropriate brand valuation methods and synthesise the results to arrive at a conclusion.

3.15 Human Resources as a Brand

Defining or recognising human resources as a brand could be a very complex process. The leading value drivers in an organisation could effectively be the brand. These value drivers may be the top executives or divisional heads. They could be from the most sensitive division of the organisation. Such sensitive division may also be the brand for the whole of the organisation. For example, many CEOs of most profitable corporations who enjoy the maximum brand value in the market.

The valuation of entrepreneurial employees goes parallel with the intrinsic valuation of the enterprise, for an obvious reason that most of the value addition is done by these employees. The approaches to valuation may be as follows:

(a) **Cost Approach:** The total cost incurred on developing these key employees may be capitalised as an 'asset' and shown in the Balance sheet with yearly alternations on account of recurring development costs incurred further.

(b) **Compensation Approach:** Discounted value of the total future compensation payable to the key employees for their remaining tenure with the organisation may be the ultimate valuation. The main drawback of this approach is that employees of a high profile organisation may be unnecessarily valued at a much higher price. Hence, it may not be a genuine representation of the employees brand-equity enjoyed by the organisation.

(c) **Intrinsic Approach:** The total discounted value of future compensation payable is further increased (or decreased) by the 'performance index' of the enterprise. This performance index explains the overall intrinsic value of an enterprise's potentials.

(d) **Remainder Approach:** This approach would be very notional and subjective, as it depends upon, the computation of 'non-branded employees' in an organization

Brand value = Discounting Factor $\times$ (Total profits of the organisation in next 10 years -

Profit of the organisation without the branded employees in next 10 years)

Assuming that the branded employees are not there and then notionally computing the 'non-branded employees' performance' would require accurate benchmarking. Treating key employees as brands and valuing them, has some good advantages:

1. Entrepreneurial wages can be determined, based on 'brand value'.
2. Strategy of taking over an enterprise with branded employees can be better handled, if such valuation is done.
3. Empowerment for growth and diversification becomes easy, when different benchmarks are available on the valuation of the employees to be empowered.
4. Branded employees and their valuation make the enterprise's Balance sheet distinctive strong and much more transparent.
5. Products, processes and programmes can be distinguished from the important value driven employees, valuation becomes easy. Exclusively of the products and processes from the employees becomes clear, when the branding of employees is done.

(e) Value Chain Approach: The outsourcing approach can be used considerably to find out the cost and contribution associated with every value driver or factor of production. The sum total of such contributions, if deducted from the total contribution achieved by the organisation should give the brand value of the organisation. The surplus offered by the brand for ten years may be discounted at rate applicable to average market conditions.

3.16 Corporate Brand Strength

The brand valuation models lay emphasis on methods of ascertaining the 'Brand Strength' product or service of a corporate entity, which is defined as the sum total of all benefits flowing from different dimensions of a brand such as quality of market leadership (ML) of the brand, relative stability* of market (SM) enjoyed by the brand, the extent of market share (MS) of the brand, the levels oi' international acceptance (IA) of the brand, ability of the brand to meet the changing modern marketing trends (MT), the extent of strategic support (SS) provided by the brand to the corporate's survival and growth, competitive strength (CS) offered by the brand and above all the legal and social brand protection (BP). The composition of corporate brand strength is shown in the following figure

Thus, the brand value/strength can be stated as follows:

Brand value = (ML + MS + SM + IA + MT + SS + CS + BP)

Illustration 5

From the following information, determine the possible value of brand as per potential earning model:

		₹ in lakhs
(i)	*Profit After Tax (PAT)*	*₹ 2,500*
(ii)	*Tangible fixed assets*	*₹ 10,000*

(iii)	*Identifiable intangible other than brand*	*₹ 1,500*
(iv)	*Weighted average cost of capital (%)*	*14%*
(v)	*Expected normal return on tangible assets*	
	[weighted average cost (14%) + normal spread 4%]	*18%*
(vi)	*Appropriate capitalization factor for intangibles*	*25%*

Solution

Calculation of Possible Value of Brand

	₹ in lakhs
Profit after Tax (PAT)	2,500
Less: Profit allocated to tangible assets [18% of ₹ 10,000]	1,800
Profit allocated to intangible assets including brand	700
Capitalisation factor 25%	
Capitalised value of intangibles including brand $\left[\frac{700}{25}\times 100\right]$	2,800
Less: Identifiable intangibles other than brand	1,500
Brand value	1,300

Illustration 6

Rough-use Ltd. has hired a Marketing Consultancy Firm for doing market research and provide data relating to Tyre Industry for the next 10 years. The following were the observations and projections made by the consultancy firm:

1. *The Tyre Industry in the target area i.e. whole of India, is expected to grow at 5% per annum for the next 3 years, and thereafter at 7% per annum over the subsequent seven years.*
2. *The market size in terms of unencumbered basic sales of tyres was estimated at ₹ 8,000 crores in the last year, dominated by medium and large players. This includes roughly 10% of fake brands and locally manufactured tyres. Market share of this segment is expected to increase by 0.5% over the decade.*
3. *Cheap Chinese Imports accounted for 40% of the business (but 60% of the volume) last year. This is expected to be increase by 0.25% over the next decade.*
4. *The other large players accounted for roughly 34% of the business value last year, which is expected to go down by 0.5% over the next ten years, due to expansion of Rough-use Ltd.'s product portfolio.*
5. *The Company is in the process of business process re-engineering, which will start yielding results in 2 years time, and increase its profitability by 3% from its existing 8%.*

What is the Brand Value of Rough-use Ltd., under Market Oriented Approach, if the appropriate discount rate is 10%?

Solution

Market Share of Rough-use Ltd.

(a) Last year's market share = 100% – Fake Brands 10% - Chinese Imports 40% - Other Domestic Brands (large players) 34% = 16%

(b) Increase or decrease in market share: Chinese Imports 0.25% + Local Brands 0.5% - Other Domestic Brands (large players) 0.5% = 0.25% i.e. increase in others' market share. Hence, market share of Rough-use Ltd. is expected to fall by 0.25% every year over the decade, from the current level of 16%. Therefore, this year it will be 15.75%, next year 15.50%, the year after 15.25% etc.

Brand Valuation under Market Approach

Year	*Market Size (₹ in Crores)*	*Market Share of Rough-use Ltd.*	*Market Share (₹ in Crores)*	*Expected Profit (₹ in Crores)*	*Discount Factor @ 10%*	*Discounted Cash Flow (₹ in Crores)*
1	8,000.00 + 5% = 8,400.00	15.75%	1,323.00	@ 8% = 105.84	0.909	96.22
2	8,400.00 + 5% = 8,820.00	15.50%	1,367.10	@ 8% = 109.37	0.826	90.34
3	8,820.00 + 5% = 9,261.00	15.25%	1,412.30	@11% = 155.32	0.751	116.65
4	9,261.00+ 7% = 9,909.27	15.00%	1,486.39	@11% = 163.50	0.683	111.67
5	9,909.27 + 7% = 10,602.92	14.75%	1,563.93	@11% = 172.03	0.621	106.83
6	10,602.92 + 7% = 11,345.12	14.50%	1,645.04	@ 11% = 180.95	0.564	102.06
7	11,345.12 + 7% = 12,139.28	14.25%	1,729.85	@11% = 190.28	0.513	97.62
8	12,139.28 + 7% = 12,989.03	14.00%	1,818.46	@11% = 200.03	0.467	93.41
9	12,989.03 + 7% = 13,898.26	13.75%	1,911.01	@11% = 210.21	0.424	89.13
10	13,898.26 + 7% = 14,871.14	13.50%	2,007.60	@11% = 220.84	0.386	85.24
	Brand Value					989.17

Brand Value of Rough-use Ltd. under Market Oriented Approach is 989.17 crores.

Illustration 7

During the financial year 2016-2017, Smart Ltd. had the following transactions:

(i) On 1st April 2016, Smart Ltd. purchased new asset of Ok Ltd. for ₹ 7,20,000. The fair value of Ok Ltd.'s identifiable net assets was ₹ 3,44,000. Smart Ltd. is of the view that due to popularity of Ok Ltd.'s products, the life of resulting goodwill is unlimited.

(ii) On May 2016, Smart Ltd., purchased a franchise to operate boating service from the State Government for ₹ 1,20,000 and at an annual fee of 1% of boating revenues. The franchise expires after 5 years. Boating revenues were ₹ 40,000 during financial year 2016-2017. Smart Ltd. projects future revenue of ₹ 80,000 in 2017-2018 and ₹ 1,20,000 per annum for 3 years thereafter.

(iii) On 5th July 2016, Smart Ltd. was granted a patent that had been applied for by Ok Ltd. During 2016-17, Smart Ltd. incurred legal costs of ₹ 1,02,000 to register the patent and an additional ₹ 1,70,000 to successfully prosecute a patent infringement suit against a competitor. Smart Ltd. expects the patents economic life to be 10 years. Smart Ltd. follows an accounting policy to amortize all intangibles on straight line basis over the maximum period permitted by accounting standard taking a full year amortization in the year of acquisition.

Prepare

(a) A schedule showing the intangible section in Smart Ltd. balance sheet at 31st March 2017.

(b) A schedule showing the related expenses that would appear in the Statement of Profit and Loss of Smart Ltd. for 2016-2017.

Solution

(a)

Smart Ltd.
Balance Sheet (Extract)
(Extract relating to intangible asset)
as on 31st March 2017

	Note No.	₹
Assets		
(1) Non- current asset		
Intangible assets	1	6,79,200

(b)

Statement of Profit and Loss (Extract)
for the year ended 31st March 2017

	Note No.	₹
Revenue from Operations		40,000
Total Revenue		?
Expenses:		
Amortization	2	88,800
Other expenses	3	400
Total Expenses		?

Notes to Accounts (Extract)

		₹	₹
1.	Intangible assets		
	Goodwill (Refer to note 1)	3,38,400	
	Franchise (Refer to Note 2)	96,000	
	Patents	2,44,800	6,79,200
2.	Amortization expenses		
	Goodwill	37,600	
	Franchise	24,000	
	Legal Cost	27,200	88,800
3.	Other expenses		
	Franchise for 1% of 40,000		400

Working Notes:

		₹
(1)	Cash Paid	7,20,000
	Less: Fair value of net assets	(3,44,000)
	Goodwill	3,76,000
	Less: Amortisation (over 10 years as per SLM)	(37,600)
	Balance to be shown in the balance sheet	3,38,400
(2)	Franchise	1,20,000
	Less: Amortisation (over five years)	(24,000)
	Balance to be shown in the balance sheet	96,000
(3)	Legal Costs (1,02,000 + 1,70,000)	2,72,000
	Less: Amortisation (over ten years as per SLM)	(27,200)
	Balance to be shown in the balance sheet	2,44,800

(4) As per para 63 of AS 26, 'Intangible Assets', there is a rebuttable presumption that useful life of an intangible asset will not exceed ten years. If life is taken for more than 10 years, then company will have to disclose the significant reasons for the assumption. Here, Smart Ltd. has simply stated that life is unlimited by saying that Ok Ltd.'s products are popular. However, this cannot be constituted as significant reason. Therefore, this assumption has not been taken into consideration.

UNIT 4 : VALUATION OF LIABILITIES

4.1 Introduction

Proper valuation of all assets and liabilities is required to ensure true and fair financial position of the business entity. In other words, all matters which affect the financial position of the business has to be disclosed. Under- or over-valuation of liabilities may not only affect the operating results and financial position of the current period but will also affect theses for the next accounting period The present unit deals with different principles involved in the valuation of different types of liabilities.

4.2 Base of Valuation

The different bases of valuation of liabilities are depicted below:

(a) *Historical cost*. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost*. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value*. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) *Present value*. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business. (Framework, Issued 2000)

4.3 Carrying Value

The liability items of the balance sheet are generally carried at the settlement values. However for shares and debentures if the book value is measured including the premium or loss on issue, that comprehensive book value should match with the historical cost value. For certain items like income received in advance, liability for tax the historical cost basis is generally applicable. In such cases the historical cost and settlement value should be similar. Liabilities may be carried at the present value in case of finance lease.

4.4 Leases

In case of a finance lease, the lessee should recognize a liability equal to the fair value of the leased asset at the inception of the lease.

If the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used. (AS 19 Para 11)

4.5 Provisions

In regard provision, the valuation is based on settlement value and not on present value. AS 29 states in para 35 that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

UNIT 5 : VALUATION OF SHARES

5.1 Introduction

The considerations governing share valuation are varied, intricate and numerous of which some are accounting and others non-accounting; some are objective, others are subjective. As a result, very often accountants fail to come to agreement on the valuation to be placed on shares. Valuation calls for judicious assessment of the rights, advantages, interests, expectations, hazards and difficulties of the parties involved in it, having conflicting interests. If the purpose of valuation is known, the valuer should arrive at the same value whether he is appointed by the seller or the buyer. However, the valuer's approach to the question is influenced by the purpose for which the valuation is requested. For example, though the underlying principles are the same, a valuer may apply them in a liberal way in cases of valuation for compensation purposes, while a more conservative test may be applied in valuation for tax-purposes.

5.2 Purposes of Valuation

Purposes of share valuation can be given as follows:

(i) Assessments under the Wealth Tax Act.

(ii) Purchase of a block of shares which may or may not give the holder thereof a controlling interest in the company.

(iii) Purchase of shares by employees of the company where the retention of such shares is limited to the period of their employment.

(iv) Formulation of schemes of amalgamation, absorption, etc.

(v) Acquisition of interest of dissenting shareholders under a scheme of reconstruction.

(vi) Compensating shareholders, on the acquisition of their shares, by the Government under a scheme of nationalization.

(vii) Conversion of shares, say, preference into equity shares.

(viii) Advancing a loan on the security of shares.

(ix) Resolving a deadlock in the management of a private limited company on the basis of the controlling block of shares given to either of the parties.

5.3 Relevance of Valuation

Valuation by an expert is generally called for when parties involved in the transaction/deal/scheme, etc. fail to arrive at a mutually acceptable value or agreement or when the Articles of Association etc. provide for valuation by experts. For transactions concerning relatively small blocks of shares which are quoted on the Inventory exchange, generally the ruling Inventory exchange price (average price) provides the basis. But valuation, by a valuer becomes necessary when:

(i) shares are not quoted;

(ii) shares relate to private limited companies;

(iii) the court so directs;

(iv) Articles of Association or relevant agreements so provide;

(v) a large block of shares is under transfer; and

(vi) Statutes so require (like Wealth Tax Act, Income Tax Act and FEMA Regulations).

5.4 Limitation of Stock Exchange Price as a Basis for Valuation

A rough classification of buyers at the stock exchange may be made as: (a) informed or analytical investors; (b) informed speculators; and (c) the un-informed. Similarly, a rough classification of sellers is: (a) informed; and (b) those with an urgent need to sell. It is sufficient to say that in a stock exchange numerous people collect-some to deal, some to watch and some to rig. Consequently, depending on the motivation they react and the result of such reactions come out as the market price, which is partly an outcome of reasoned investments or sales policy, partly embodying the effect of speculative motives. Thus it is not reasonable to use stock exchange price as share value - one should consider other factors too. The Council of the London Stock Exchange has opined: "We desire to state authoritatively that stock exchange quotations are not related directly to the value of a company's assets, or to the amount of its profits and consequently these quotations, no matter what date may be chosen for reference, cannot form a fair and equitable, or rational basis for compensation. The stock exchange, does not determine the prices of which the official list is the record. The stock exchange may be likened to a scientific recording instrument which registers, not its own actions and opinions, but the actions and opinions of private and institutional investors all over the country and, indeed the world. These actions and opinions are the results of hope, fear, guesswork, intelligent or otherwise, good or bad investment policy and many other considerations. The quotations that result definitely do not represent a valuation of a company by reference to its assets and its earning potential".

On a summarisation, it may be stated that stock exchange price is mostly determined by bull and bear effects rather than fundamental factors like net assets, earnings, yield, etc. Stock exchange price is basically determined on the inter-action of demand and supply and may not reflect a true value of shares.

Factors: Two factors stand out to be basically important: assets employed and the profit earned; mostly both are considered. The following has general acceptance:

(i) For a company destined to be liquidated, assets will constitute the basis for valuing the shares of the company.

(ii) Where assets play a relatively unimportant role, for example in the case of professional practice of architects and engineering consultants, valuation may depend wholly on the earning capacity.

(iii) Earning power and assets both may be considered in valuation of the shares of a going concern, earning power playing a major role while assets are considered only to indicate safety margin i.e. asset backing.

5.5 Methods

Principally two basic methods are used for share valuation; one on the basis *of net assets* and the other on the basis of *earning capacity* or yield (which, nevertheless, must take into consideration net assets used).

5.5.1 Net Asset Basis

According to this method, value of equity share is determined as follows:

$$\frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}}$$

The following important aspects are to be considered while arriving at the net assets available to the equity shareholders:

(i) *Value of tangible fixed assets*: Tangible fixed assets like plant, machinery, building, land, furniture, etc. should be taken at their current cost. Current cost implies current entry price, i.e., the price to be paid by the enterprise if it wants to acquire such assets at their present locations and conditions.

(ii) *Value of intangibles:* Intangibles like goodwill, patents and know-how should also be taken at their current cost. Inherent goodwill is not shown in the books of accounts. For asset based valuation of share, valuation of goodwill is essential and valuation should be made following any of the methods (depending upon the circumstances) discussed in Unit 3. If purchased goodwill appears in the books of account it should be eliminated and new valuation should be taken into consideration.

(iii) *Investments:* Shares and securities which are quoted in the stock exchange and traded on a regular basis, market price of them should be used as current value of investments. For other investments book value may be taken after adjustments for known loss or gain.

(iv) *Inventories:* The Inventory of finished goods may be taken at the market price. But other Inventories like raw material, stores and work-in-progress should be taken at cost following conservative approach. Due allowance should be made for any obsolete, unusable or unmarketable Inventories held by the company.

(v) *Trade receivables:* Appropriate allowance should be made for bad and doubtful debts.

(vi) *Development expenses:* These arise (i) in the case of a new company, when it is in the process of executing its project and (ii) in the case of an old company, when either there is an expansion of the existing production lines or diversifications with a view to entering new lines.

Such expenses generally appear in the balance sheet as Capital Work-in-Progress. It may not be advisable to take whole of the expenses as asset while valuing equity shares.

Rather a conservative approach may be followed to assess the current 'entry' value of such Capital Work-in-Progress.

(vii) *Miscellaneous expenditure and losses:* All fictitious assets appearing under this head should not be taken into consideration.

(viii) *Unrecorded assets and liabilities:* If there is any unrecorded asset which can be realised, it should be considered. In the same way, all unrecorded liabilities should also be provided for.

From the value of assets arrived at as per the criteria discussed above the liabilities are deducted to arrive at net assets. These liabilities are:

- All short term and long term liabilities including outstanding and accrued interest;
- Tax provisions;
- All liabilities not provided for in the account;
- All prior period adjustments which would reduce profit of the earlier years net of items which would increase profit;
- Preference share capital including arrear of dividends.

However, if some shares are partly paid up, a notional call equivalent to the calls unpaid added with the net assets. And value of shares is determined taking partly paid up shares as notionally fully paid up. Thereafter value of partly paid up shares is arrived at after deducting unpaid call or uncalled amount from value of fully paid up shares.

Net Asset Method can be fairly used to value shares when the firm is liquidated. This method takes into account the real worth of the business and is also related to the market value of assets. But it is difficult to estimate the realisable value of shares in case of going concern. This method does not give any weight to earning capacity of the company. This method is suitably applicable when two or more companies are going to be amalgamated or merged and also when controlling shares are being acquired.

5.5.2 Yield Basis

Yield based valuation may take the form of valuation based on rate of return. The rate of return may imply rate of earning or rate of dividend. If a block of shares is sufficiently large, so as to warrant virtual control over the company the rate of earning should be the basis; for small blocks the rate of dividend basis will be appropriate. It is necessary to determine (i) the (after tax) maintainable profit or dividend for the company in the foreseeable future, and (ii) the normal rate of yield or earning of dividend, as the case may be, for the company. After the rate of yield or earning of dividend has been determined, the capitalisation factor, or the multiplier, should be determined for applying the same to the adjusted maintainable profit of business to arrive at the total value. If the yield expected in the market is 8% the capitalisation factor would be 100/8 or 12.5. On this basis the value of an undertaking earning ₹ 4,00,000 p.a. would be ₹ 4,00,000 × l2.5 or ₹ 50,00,000. Total value of the undertaking divided by the number of equity shares gives the value for each equity share. Similar is the process for dividend yield basis.

Stages for yield-based Valuation: Broadly, the following steps are envisaged in a yield based valuation considering the rate of return:

(i) Determination of future maintainable profit;

(ii) Ascertaining the normal rate of return;

(iii) Finding out the capitalisation factor or the multiplier;

(iv) Multiplying the future maintainable profit, by the multiplier; and

(v) Dividing the results obtained in (iv) by the number of shares.

5.5.3 Determination of the normal rate of return and capitalisation factor

This obviously has tremendous bearing on the ultimate result but, unfortunately, it is subjective and therefore, valuers differ more widely in this area than in any other in the whole valuation process.

As a general rule, the nature of investment would decide the rate of return. Companies, investment in which is more risky, would call for a higher rate of return and consequently they will have lower capitalisation factor and lower valuation than companies with assured profits. For investment in government securities, the risk is least and consequently, the investor would be content with a very low rate of return.

In a logical order, we find that mortgage debentures, being riskier than government paper, require slightly higher rate of return. Preference shares are less risky than equity shares but more risky than mortgage debentures; preference shares rank in between debentures and equity shares in the matter of rate of return. Equity shares are exposed to the highest risk and, consequently, the normal rate of return is highest in the case of equity shares, though, in the case of equity shares of progressive and efficiently managed companies, such a risk is rather low. In fact, shares of such companies provide a safeguard against inflation - equity share prices are likely to rise sufficiently high to counteract the effect of a rise in prices.

The above also applies to companies and industries–the normal rate of return will always depend on the attendant risk. In this respect, net tangible asset backing is also relevant. The higher the net tangible asset backing for each share, the greater would be the confidence of the investor. Normally 1.5 to 2 times backing is considered satisfactory. This ratio should be reviewed carefully to ascertain whether shares are adequately covered or too much covered which may indicate over-capitalisation in the form of idle funds or inadequate use of productive resources. Symptoms suggesting idle assets would be holding of large cash and bank balances, high current ratio, unutilised land and machinery, etc. The normal rate of return should be increased suitably in either case.

5.5.4 Adjustment necessary for the determination of future maintainable profit

The steps necessary to arrive at the future maintainable profits of a company are: (a) calculation of past average taxed earnings, (b) projection of the future maintainable taxed profits, and (c) adjustment of preferred rights.

(a) Calculation of past average earnings: In order to calculate the past average earnings, it is necessary to decide upon the number of years whose results should be taken for averaging. Whether a 3-yearly, 5- yearly or longer average would reflect the correct future earnings of a company depend upon the nature of concerned industry. Select the years and adjust their profits to make them acceptable for averaging.

The following are some items which generally require adjustment in arriving at the average of the past earnings:

(i) Elimination of material non-recurring items such as loss of exceptional nature through strikes, fires, floods and theft, etc., profit and loss of any isolated transaction not being part of the business of the company, lump-sum compensation or retiring allowances and cost in legal actions, abnormal repair charges in a particular year, etc.

(ii) Elimination of income and profits and losses from non-trading assets.

(iii) Elimination of any capital profit or loss or receipt or expense included in the profit and loss account.

(iv) Adjustment for any interest, remuneration, commission, etc., foregone or overcharged by directors and any other managerial personnel.

(v) Adjustment for any matters suggested by notes, appended to the accounts, or by qualification in the auditor's report such as provisions for taxation and gratuities, bad debts, under or over provision for depreciation, inconsistency in the valuation of Inventories, etc.

(vi) *Taxation:* The tax rates may be such as were ruling for the respective years or the latest ruling rate may be deducted from the average profit. However, the consensus of opinion is for adjusting tax payable rather than tax paid because so many short-term reliefs and tax holidays might have temporarily reduced the effective tax burden.

(vii) *Depreciation:* The valuer may adopt book depreciation provided he is satisfied that the rate was realistic and the method was suitable for the nature of the company and they were consistently applied from year to year. But imbalances do arise in cases where consistently written down value method was in use and heavy expenditure in the recent past has been made in rehabilitating or expanding fixed assets, since the depreciation charges would be unfairly heavy and would prejudice the seller. Under such circumstances, it would be desirable to readjust depreciation on a straight line basis to bring a more equitable charge on the profits meant for averaging.

Averaging the past earnings

In averaging past earnings, another important factor comes up for consideration and that is the trend of profits earned. It is indeed imperative that estimation of maintainable profits be based on the only available record, i.e., the record of past earnings. But indiscreet use of past results may lead to an entirely fallacious and unrealistic result. In this regard, three situations may have to be faced.

1. Where the past profits of a company are widely fluctuating from year to year, the average fails to aid future projection. In such cases, a study of the whole history of the company and

of earnings of a fairly long period may be necessary.

2. If the profits of a company do not show a regular trend upward or downward, the average of the cycle can usefully be employed for projection of future earnings.

3. In some companies, profits may record a distinct rising or falling trend, from year to year; in these circumstances, a simple average fails to consider the significant factor, namely trend in earning. The share of a company which records a clear upward trend of past profits would certainly be more valuable than that of a company whose trend of past earnings indicate a static or down-trend. In such cases, a weighted average, giving more weight to the recent years than to the past, is appropriate. A simple way of weighting is to multiply the profits by the respective number of the years arranged chronologically so that the largest weight is associated with the most recent past year and the least for the remotest (If net worth is under consideration, the respective years' average net worth may be weighted in a similar way). However, if the profits have been consistently coming down, even weighted average may be misleading-fitting a trend line may be more appropriate.

(b) Projection of future maintainable taxed profits: Projection is more a matter of intelligent guess work since it is essentially an estimation of what will happen in the risky and uncertain future. The average profit earned by a company in the past could be normally taken as the average profit that would be maintainable by it in the future, if the future is considered basically as a continuation of the past. If future performance of the company is viewed as departing significantly from the past, then appropriate adjustment will be called for before accepting the past average profit as the future maintainable profit of the company. The factors requiring consideration may be as stated below:

(i) Discontinuance of a part of the business;

(ii) Under-utilisation of installed capacity;

(iii) Expansion programmes;

(iv) Major change in the policy of the company; and

(v) Adjustment for rehabilitation and replacement.

(c) Adjustment of Preferred Rights: *In arriving at the average profits and their future projection all charges including interest on debentures and other borrowings are deducted. But the dividend on preference shares depends upon the availability of divisible profits and, therefore, should be considered after the estimate of future profits has been arrived at. Dividends payable to preference shareholders, according to the terms of their issue, should be deducted from the maintainable profit.*

Illustration 1

The following information is available from Tina Ltd. as at 31st March, 2017:

Capital :	
1,000, 5% Preference Shares of ₹ 100 each fully paid	*₹ 1,00,000*
2,000 Equity Shares of ₹ 100 each fully paid	*₹ 2,00,000*
Reserve and Surplus	*₹ 2,00,000*

6% Debentures	*₹ 1,00,000*
Current Liabilities	*₹ 1,00,000*
Assets: Fixed Assets	*₹ 4,00,000*
Current Assets	*₹ 3,00,000*

For the purpose of valuation of shares, fixed assets and current assets are to be depreciated by 10%; Interest on debentures is due for six months; preference dividend is also due for the year. Neither of these has been provided for in the balance sheet.

Calculate the value of each equity share under Net Asset Method.

Solution

Note: Since there is only one class of equity shares and all the shares are fully paid up, the value of each equity share will be ascertained as under:

Value of one equity share = Net Assets available for equity shareholders ÷ Number of equity shares

Net Assets Available to Equity Shareholders:		₹
Assets		
Fixed Assets (4,00,000 – 10% on ₹ 4,00,000)		3,60,000
Current Assets (3,00,000 – 10% on ₹ 3,00,000)		2,70,000
Value of Assets		6,30,000
Less: Liabilities:		
Current Liabilities		1,00,000
6% Debentures	1,00,000	
Add: Interest Outstanding (₹ 1,00,000 × 6/100 × 6/12)	3,000	1,03,000
5% Preference Share Capital	1,00,000	
Add: Arrear Dividend (₹ 1,00,000 × 5%)	5,000	1,05,000
		3,08,000
Net Assets available to Equity Shareholders		3,22,000
No. of equity shares	2,000	

Value of each share under Net Assets Method:

Value per share = Net Assets available to Equity Shareholders / No. of Equity Shares

= ₹ 3,22,000/ 2,000 = ₹ 161

Illustration 2

Sailee Ltd has a paid up capital of ₹ 3,00,000 divided into 20,000 Equity shares of ₹ 10 each and 5%, 1,000 Preference Shares of ₹ 100 each. The company has ₹ 1,00,000 debentures; the interest payable is 10% p.a. During the year 2016-17 the company earned a profit of ₹ 1,60,000 before charging interest. The company declared dividend at the rate of ₹ 4 per share for the last year. The normal rate of return is 20%. Assume tax rate of 30%.

Calculate value per share under Earning Yield method and Dividend Yield Method.

Solution

	₹
Profits before interest and Tax	1,60,000
Less: Interest 10% on ₹ 1,00,000	10,000
Profit after interest	1,50,000
Less: Tax 30% on ₹ 1,50,000	45,000
Profit after Tax	1,05,000
Less: Preference Dividend @ 5% on ₹ 1,00,000	5,000
Profit available to Equity share holders	1,00,000

Earning Yield method: Value of each equity share is calculated as under:

Rate of Earnings ÷ Normal rate of return x Paid up value of a share.

Rate of Earnings = ₹ 1,00,000 ÷ ₹ 2,00,000 x 100 = 50%

Value of each equity share = (50% ÷ 20%) x ₹ 10 = ₹ 25

Dividend Yield method: Under this method value of each equity share is calculated as under:

Rate of Dividend ÷ Normal rate of return x Paid up value of a share.

Rate of Dividend = ₹ 4 per share or 4 ÷ 10 x100 = 40%

Value of each equity share = (40% ÷ 20%) x ₹ 10 = ₹ 20

5.5.3 Factors having a bearing on valuation

In addition to what has already been stated, consideration of the following factors is also necessary in a valuation:

(a) Nature of industry, its history and risks to which it is subject;

(b) Prospects of the industry in the future;

(c) The company's history, its past performance and its record of past dividends;

(d) The basis of valuation of assets of the company and their value;

(e) The ratio of liabilities to capital;

(f) The nature of management and chance for its continuation;

(g) Capital structure or gearing;

(h) Size, location and reputation of the company's products;

(i) Incidence of taxation;

(j) The number of shareholders;

(k) Yield on shares of companies engaged in the same industry, which are listed on the stock exchanges;

(l) Composition of purchasers of the products of the company; and

(m) Size of the block of shares offered for sale since, for large blocks, very few buyers would be available and that has a depressing effect on the valuation. Question of control, however, may become important when large blocks are involved.

Special Factors: Valuation of equity shares must take note of special features in the company or in the particular task. These are briefly stated below:

(a) *Importance of the size of the block of shares:* Valuation of the identical shares of a company may vary quite significantly at the same point of time on a consideration of the size of the block of shares under negotiation. It is common knowledge that the holder of 75% of the voting power in a company can always alter the provisions of the articles of association to suit himself; a holder of voting power exceeding 50% and less than 75% can substantially influence the operations of the company even to alter the articles of association or comfortably pass a special resolution.

Even persons holding much less than 50% of the total voting strength in a public limited company may control the affairs of the company, if the shares carrying the rest of the voting power are widely scattered; such shareholders rarely combine to defeat a determined block. Usually a person holding 50% of the total voting power is in a position to have his way in the company, even to change the provision of the articles of association or pass any special resolution. A controlling interest, according to most authorities, carries a separate substantial value.

(b) *Restricted transferability:* Along with principal consideration of yield and safety of capital, another important factor is easy exchangeability or liquidity. Shares of reputed companies generally enjoy the advantage of easy marketability which is of great significance to the holder. At the time of need, he may get cash in exchange of shares without being required to hunt out a willing buyer or without being required to go through a process of protracted negotiation and valuation. Generally, quoted shares of good companies are preferred for the purpose. On the other hand, holders of shares of unquoted public companies or of private companies do not enjoy this advantage; therefore, such shares, however good, are discounted for lack of liquidity at rates which may be determined on the basis of circumstances of each case. The discount may be either in the form of a reduction in the value otherwise determined or an increase in the normal rate of return. Generally, the articles of private companies contain provision for offering shares to one who is already a member of the company and this necessarily restricts the ready market for the shares. These are discounted for limited transferability. But exceptions are also there; by acquisition of a small block, if one can extend his holding in the company to such an extent as to effectively control the company, the share values may not be discounted in that case.

(c) *Dividends and Valuation:* Generally, companies paying dividends at steady rates enjoy greater popularity and the prices of their shares are high while shares of companies with unstable dividends do not enjoy confidence of the investing public as to returns they expect to get and, consequently, they suffer in valuation. For companies paying dividends at unsteady rates, the question of risk also becomes great and it depresses the

price. The question of risk may be looked upon from another angle. A company which pays only a small proportion of its profits as dividend and thus builds up reserves is less risky than the one which has a high pay-out ratio. The dividend rate is also likely to fluctuate in the latter case. Investors, however, do not like a company whose pay-out ratio is too small.

Shares are generally quoted high immediately before the declaration of dividend if the dividend prospect is good; or immediately after the declaration of dividend to take care of the dividend money that the prospective holder would get.

(d) *Bonus and Right Issue:* Shares values have been noticed to go up when bonus or right issues are announced, since they indicate an immediate prospect of gain to the holder although in the ultimate analysis, it is doubtful whether really these can alter the valuation. Bonus issues are made out of the accumulated reserves in the employment of the business. Such shares in no way contribute to the increased earning capacity of the business and ultimately depress the dividend rate since the same quantum of profit would be distributed over a large number of shares which in turn also would depress the market value of the shares. A progressive company may sometimes pick up the old rate of dividend after a short while but this is in no way a result of the bonus issue; it is the contribution of natural growth potential of the company. Good companies, however, try to maintain the rate of dividend even after the bonus issue. In such a case, the total holdings of shareholders will increase in value.

In the case of right issues, existing holders are offered shares forming part of a new issue; more funds flow into the company for improving the earning capacity. Share value will naturally depend on the effectiveness with which new funds will be used.

5.5.4 Mean between asset and yield based valuation

This is, in fact, no valuation, but a compromise formula for bringing the parties to an agreement. This presents averaging two results obtained on quite different basis. It is argued that average of book value and yield based value incorporates the advantages of both the methods. That is why such average is called the fair value of share.

5.6 Statutory Valuation

Valuation of shares may be necessary under the provision of Wealth tax Act, Companies Act and Income-tax Act. Excepting the Companies where valuation may be called for on amalgamation, and such other purposes and the Income-tax Act for capital gains the other enactments, as mentioned above, have laid down rules for valuation of shares. The rules generally imply acceptance of open market price (i.e., Stock exchange price) for quoted shares and asset based valuation for unquoted equity shares and average of yield and asset methods in valuing shares of investment companies. In the Companies (Central Government's) General Rules and Forms, 1956 methods of determining break-up value of share and yield based valuation have been illustrated.

Illustration 3

Summarised Balance Sheet of John Engg. Ltd. as on 31.12.2017 is given below:

Summarised Balance Sheet

(Figures in 000)

Liabilities	₹	Assets	₹
Share Capital -			
1,50,000 Equity Shares of ₹ 10 each	15,00	Fixed Assets	22,00
2,00,000 Equity Shares of ₹ 10		Investments	4,00
each ₹ 6 paid up	12,00	Inventory	8,00
9% Cumulative Preference Shares	6,00	Trade receivables	4,00
18% Term Loan	14,00	Cash & Bank	4,00
Trade payables	8,00	P & L A/c	13,00
	55,00		55,00

Other Information:

(1) Current Cost of Fixed Assets ₹ 37,00 thousand and Inventory ₹ 10,00 thousand,

(2) Investments could fetch only ₹ 100 thousand,

(3) 50% Trade receivables are doubtful,

(4) Preference dividend was in arrear for the last five years.

Find out the intrinsic value per share of John Engg. Ltd.

Solution

(i) Net assets available to the equity shareholders

	Amount in ₹ '000	
Fixed assets	37,00	
Investments	1,00	
Inventory	10,00	
Trade receivables	2,00	
Cash & Bank	4,00	54,00
Less: Outside liabilities & 9% cumulative preference shares:		
Trade payables	8,00	
18% Term Loan	14,00	
9% Cumulative Preference Shares	6,00	
Arrear Preference Dividend	2,70	(30,70)
Net Assets		23,30

(ii) Valuation of Equity Shares

Net assets as per (i) above	23,30
Add: Notional call on 2,00,000 partly paid up equity shares @ ₹ 4 each	8,00
	31,30

Number of equity shares 350 thousand

Value per fully paid up equity share = ₹ 31,30 thousand / 3,50 thousand = ₹ 8.94

Value per partly paid up equity share = ₹ 8.94 – ₹ 4 = ₹ 4.94

Illustration 4

Balance Sheet of Mcneil Ltd.

as on 31.3.2017 *(Figure in ₹ '000)*

Liabilities	*₹*	*Assets*	*₹*
Share Capital		*Fixed assets*	*280,20*
5,00,000 Equity Shares		*Investments in subsidiaries*	*60,40*
of ₹ 10 each fully paid up	*50,00*	*Non-trade investments*	*50,00*
8,00,000 Equity Shares		*Inventory*	*80,60*
of ₹ 10 each ₹ 8 paid up	*64,00*	*Trade receivables*	*80,40*
10,00,000 Equity Shares		*Advances*	*50,60*
of ₹ 5 each fully paid up	*50,00*	*Cash & Bank*	*16,60*
Share suspense A/c	*20,00*		
General reserve	*102,00*		
P & L A/c	*83,60*		
13% Debentures	*60,00*		
(50% Convertible at the beginning of next year)			
18% Term Loan	*40,00*		
Trade payables	*20,00*		
Tax Provision	*80,00*		
Dividend payable	*49,20*		
	618,80		*618,80*

Other Information:

(1) Profit before tax (and before deducting interest on convertible debentures) of Mcneil Ltd. for the last five years ended on 31st March were as follows ('000 ₹): 2013 – 132,00, 2014 – 244,00, 2015 – 274,00, 2016 – 315,00, 2017 – 332,00.

(2) Non-trade investments earned @ 20% on an average.

(3) Expected increase in expenditure without commensurate increase in selling price ₹ 60,000.

(4) *Annual R & D expenses in future ₹ 1,00,000.*

(5) *Expected foreign currency loss in future (annualised) ₹ 120,000.*

(6) *Expected tax rate 45%. Tax rate in 2016-2017: 52%*

(7) *Normal return 15% (on the basis of closing capital employed)*

Required:

(1) *Find out intrinsic value for different categories of equity shares. For this purpose, goodwill may be taken as 3 years' purchase of super profit.*

(2) *Value of share as per dividend yield. Normal dividend in the industry is 18%.*

(3) *Value of share as per EPS. Average EPS is ₹ 3 for ₹ 10 share.*

Solution

Calculation of intrinsic value of equity shares of Mcneil Ltd.

I. Calculation of Goodwill:

	₹ in '000	*₹ in '000*
(i) *Capital Employed:*		
Total of asset side of the Balance-Sheet		6,18,80
Less: Investment in subsidiaries	6,040	
Non-trade investment	50,00	(1,10,40)
		5,08,40
Less: Outside liabilities:		
Trade payables	20,00	
18% Term loan	40,00	
Tax provision	80,00	
13% Debenture – net of conversion	30,00	(1,70,00)
Capital employed		3,38,40

(ii) Future Maintainable Profit:

Year	*Profit Before Tax (in '000 ₹)*	*Weight*	*Product (in '000 ₹)*
2013	1,32,00	1	1,32,00
2014	2,44,00	2	4,88,00
2015	2,74,00	3	8,22,00
2016	3,15,00	4	12,60,00
2017	3,32,00	5	16,60,00
		15	43,62,00

	₹ in '000	₹ in '000
Weighted average profit before tax = 43,62,00 /15		2,90,80.00
Less : Income from non-trade investments	10,00	
Expected increase in expenditure	60	
Annual R & D expenses	1,00	
Expected increase in Foreign currency liability	1,20	
Interest of non-convertible debentures	390	(1670.00)
		2,74,10.00
Less : Tax @ 45%		1,23,34.50
Expected Profit After Tax		1,50,75.50

(iii) Normal Return:

15% on capital employed

i.e. 15% on ₹ 3,98,80 thousand = ₹ 59,82 thousand

(iv) Super profit:

Expected profit - normal profit

₹ 1,50,75.50 thousand – ₹ 59,82 thousand = ₹ 90,93.50 thousand

(v) Goodwill:

3 years' purchase of super profit

₹ 90,93.50 thousand × 3 = ₹ 272,80.50 thousand

II. Net assets available to equity shareholders

	Amount in ₹ '000
Goodwill as calculated in I (v) above	2,72,80.50
Fixed assets	2,80,20.00
Investment in subsidiaries	60,40.00
Non-trade investment	50,00.00
Inventory	80,60.00
Trade receivables	80,40.00
Advances	50,60.00
Cash & Bank	16,60.00
	8,91,60.50
Less: Outside liabilities	(1,70,00.00)
	7,21,60.50

III. Valuation of equivalent number of equity shares:

	No. in '000
5,00,000 equity shares of ₹ 10 each fully paid up	5,00
8,00,000 equity shares of ₹ 10 each ₹ 8 paid up (notional call to be adjusted)	8,00
10,00,000 equity shares of ₹ 5 each fully paid up	5,00
Share suspense A/c equivalent shares for ₹ 20,00 thousand	2,00
Shares for convertible debenture amounting to ₹ 30,00 thousand	3,00
	23,00

IV. Valuation of equity shares

Net assets as per (II) above + Notional call on 8,00,000 equity shares @ ₹ 2 each i.e. ₹ 16,00 thousand = 7,37,60.50 thousand

Value per equivalent share of ₹ 10 = ₹ 7,37,60.50 thousand / 23,00 thousand = ₹ 32.07

Value per share of ₹ 10 ₹ 8 paid up = ₹ 32.07– ₹ 2 = ₹ 30.07

Value per share of ₹ 5 fully paid up = ₹ 32.07× 1/2 = ₹ 16.04

V. Valuation of equity shares on dividend yield basis

Dividend payable for the year ended 31.3.2017	₹ 49,20 thousand
Paid up value of equity share	₹ 1,64,00 thousand
Rate of dividend 49,20 /164,00 X 100	30%

Value per fully paid up share of ₹ 10

$$\frac{30\%}{18\%} \text{ X ₹ } 10 = \text{₹ } 16.67$$

Value per share of ₹ 5

$$\frac{30\%}{18\%} \text{ X ₹ } 5 = \text{₹ } 8.33$$

Value per share of ₹ 10, ₹ 8 paid up

$$\frac{30\%}{18\%} \text{ X ₹ } 8 = \text{₹ } 13.33$$

Note: It has been assumed that the company will be able to maintain 30% dividend in future despite an increase in the number of equity shares arising out of share suspense account and conversion of debentures.

VI. Valuation of equity shares as per EPS yield

	Amount in ₹
Profit before tax	3,32,00,000
Less: Interest on convertible debentures	3,90,000
	3,28,10,000
Less: Tax @ 52%	1,70,61,200
Profit after tax	1,57,48,800
Equity Share Capital (in thousands 50,00 + 64,00 + 50,00)	1,64,00,000

Earning per rupee of share capital $= ₹\,\frac{1,57,48,800}{1,64,00,000}$.

= ₹ 0.96

(i) *EPS during 2016-2017:*

Share of ₹ 10 fully paid up 0.96 × 10 = ₹ 9.60

Share of ₹ 10, ₹ 8 paid up 0.96 × 8 = ₹ 7.68

Share of ₹ 5 fully paid up 0.96 × 5 = ₹ 4.80

(ii) *Value of shares:*

Value per share of ₹ 10 fully paid up

$₹\,\frac{9.6}{3}$ x ₹ 10 = ₹ 32

Value per share of ₹ 10, ₹ 8 paid up

$₹\,\frac{7.68}{3}$ x ₹ 10 = ₹ 25.6

Value per share of ₹ 5 fully paid up

$₹\,\frac{4.8}{3}$ x ₹ 10 = ₹ 16

Illustration 5

From the following figures calculate the value of the share of ₹ 100 on (i) yield on capital employed basis, and (ii) dividend basis, the market expectation being 12%.

Year	*Capital employed (₹)*	*Profit (₹)*	*Dividend %*
2013	*5,50,000*	*88,000*	*12*
2014	*8,00,000*	*1,60,000*	*15*
2015	*10,00,000*	*2,20,000*	*18*
2016	*15,00,000*	*3,75,000*	*20*

Solution

The dividend rate on the simple average is 65/4 or 16¼%. But since the dividend has been rising it would be better to take the weighted average which comes to 17.6%:

Year	*Rate*	*Weight*	*Product*
2013	12	1	12
2014	15	2	30
2015	18	3	54
2016	20	4	80
		10	176

The value of the share on the basis of dividend (weighted average) should be 17.6/12 × ₹ 100 or ₹ 146.67

The yield on capital employed for each year and its weighted average is as follows:

Year	*Yield or capital employed (%)*	*Weight*	*Product*
2013	16	1	16
2014	20	2	40
2015	22	3	66
2016	25	4	100
		10	222

Weighted average is 22.2%: on this basis the value should be 22.2/12 × ₹ 100 = ₹ 185.

5.7 Valuation of Preference Shares

For valuation of preference shares the following factors are generally considered:

(i) Risk free rate plus small risk premium (i.e. market expectation rate).

(ii) Ability of the company to pay dividend on a regular basis.

(iii) Ability of the company to redeem preference share capital.

Market expectation about return from preference shares and equity shares cannot be identical because nature of these financial instruments are altogether different. Preference shares are fixed dividend bearing instruments whereas equity shares bear residual right on company's profit. The market expectation rate for preference shares may be influenced by the ability of the company to pay preference dividend. Ability to pay preference dividend may be judged by using the following ratio:

$$\frac{\text{Profit after tax}}{\text{Preference dividend}}$$

The value of each preference shares can be derived as below:

$$\frac{\text{Preference dividend rate}}{\text{Market expectation rate}} \text{ x } 100$$

5.8 Miscellaneous Problems for Practice

Illustration 6

Capital structure of Lot Ltd. as at 31.3.2017 as under:

	(₹ in lakhs)
Equity share capital	*10*
10% preference share capital	*5*
15% debentures	*8*
Reserves	*4*

Lot Ltd. earns profits of ₹ 5 lakhs annually on an average before deduction of interest on debentures and income tax which works out to 40%.

Normal return on equity shares of companies similarly placed is 12% provided:

(a) Profit after tax covers fixed interest and fixed dividends at least 3 times.

(b) Capital gearing ratio is 0.75.

(c) Yield on share is calculated at 50% of profits distributed and at 5% on undistributed profits.

Lot Ltd. has been regularly paying equity dividend of 10%.

Find out the value of an equity share of the Company.

Solution

(i)	**Profit for calculation of interest and fixed dividend coverage:**	**₹**
	Average profit of the Company (before interest and taxation)	5,00,000
	Less: Debenture interest (15% on ₹ 8,00,000)	(1,20,000)
		3,80,000
	Less: Tax @ 40%	(1,52,000)
	Profit after interest and taxation	2,28,000
	Add back: Debenture interest	1,20,000
	Profit before interest but after tax	3,48,000
(ii)	**Calculation of interest and fixed dividend coverage:**	**₹**
	Fixed interest and fixed dividend:	
	Debenture interest	1,20,000
	Preference dividend	50,000
		1,70,000

Fixed interest and fixed dividend coverage = $\frac{3,48,000}{1,70,000}$ = 2.05 times

Interest and fixed dividend coverage 2.05 times is less than the prescribed three times.

(iii) Capital gearing ratio:

Equity share capital + reserves	= ₹ 10,00,000 + ₹ 4,00,000 = ₹ 14,00,000
Preference share capital + debentures	= ₹ 5,00,000 + ₹ 8,00,000 = ₹ 13,00,000
Capital Gearing Ratio	= $\frac{13,00,000}{14,00,000}$ = 0.93 (approximately)

Ratio 0.93 is more than the prescribed ratio of 0.75.

(iv)	Yield on equity shares:		₹
	Average profit after interest and tax		2,28,000
	Less: Preference Dividend	50,000	
	Equity Dividend (10% on ₹ 10,00,000)	1,00,000	(1,50,000)
	Undistributed profit		78,000
	50% of distributed profit (50% of ₹ 1,00,000)		50,000
	5% of undistributed profit (5% of ₹ 78,000)		3,900
			53,900

Yield on equity shares = $\frac{53,900}{10,00,000} \times 100 = 5.39\%$

(v) Expected yield of equity shares:

	%
Normal return	12.00
Add: For low coverage of fixed interest and fixed dividends (2.05 < 3)	0.50*
Add: For high capital gearing ratio (0.93 > 0.75)	0.50**
	13.00

(vi) Value per equity share:

= $\frac{5.39}{13.00}$ × ₹ 100*** = ₹ 41.46

Notes: * When interest and fixed dividend coverage is low, riskiness of equity investors is high. So they should claim additional risk premium over and above the normal rate of return. Here, the additional risk premium is assumed to be 0.50%. Students may make any other reasonable assumption.

** Similarly, higher the ratio of fixed interest and dividend bearing capital to equity share capital plus reserves, higher is the risk and so higher should be risk premium. Here also the additional risk premium has been taken as 0.50%. The students may make any other reasonable assumption.

***Paid up value of a share has been taken as ₹ 100.

Illustration 7

The Capital Structure of M/s XYZ Ltd., on 31st March, 2017 was as follows:

	₹
Equity Capital 18,000 Shares of ₹ 100 each	*18,00,000*
12% Preference Capital 5,000 Shares of ₹ 100 each	*5,00,000*
12% Secured Debentures	*5,00,000*
Reserves	*5,00,000*
Profit earned before Interest and Taxes during the year	*7,20,000*
Tax Rate	*40%*
Generally, the return on equity shares of this type of Industry is 15%.	

Subject to:

(a) The profit after tax covers Fixed Interest and Fixed Dividends at least 4 times.

(b) The Debt Equity ratio is at least 2;

(c) Yield on shares is calculated at 60% of distributed profits and 10% of undistributed profits;

The Company has been paying regularly an Equity dividend of 15%.

The risk premium for Dividends is generally assumed at 1%.

Find out the value of Equity shares of the Company.

Solution

Calculation of profit after tax (PAT)		₹
Profit before interest & tax (PBIT)		7,20,000
Less: Debenture interest (₹ 5,00,000 × 12/100)		(60,000)
Profit before tax (PBT)		6,60,000
Less: Tax @ 40%		(2,64,000)
Profit after tax (PAT)		3,96,000
Less: Preference dividend $\left(₹\,5,00,000 \times \frac{12}{100}\right)$	60,000	
Equity dividend $\left(₹\,18,00,000 \times \frac{15}{100}\right)$	2,70,000	(3,30,000)
Retained earnings (undistributed profit)		66,000

Calculation of Interest and Fixed Dividend Coverage

$$= \frac{\text{PAT} + \text{Debenture interest}}{\text{Debenture interest} + \text{Preference dividend}} = \frac{₹\ 3,96,000 + ₹\ 60,000}{₹\ 60,000 + ₹\ 60,000} = \frac{₹\ 4,56,000}{₹\ 1,20,000} = 3.8 \text{ times}$$

Calculation of Debt Equity Ratio

$$\text{Debt Equity Ratio} = \frac{\text{Debt (long term loans)}}{\text{Equity (shareholders' funds)}}$$

$$= \frac{\text{Debentures}}{\text{Preference share capital} + \text{Equity share capital} + \text{Reserves}}$$

$$= \frac{₹\,5,00,000}{₹\,5,00,000 + ₹18,00,000 + ₹\,5,00,000}$$

$$\text{Debt Equity Ratio} = \frac{₹\ 5,00,000}{₹\ 28,00,000} = 0.179$$

The ratio is less than the prescribed ratio.

Calculation of Yield on Equity Shares

Yield on equity shares is calculated at 60% of distributed profits and 10% of undistributed profits:

60% of distributed profits (60% of ₹ 2,70,000)	1,62,000
10% of undistributed profits (10% of ₹ 66,000)	6,600
	1,68,600

$$\text{Yields on equity shares} = \frac{\text{Yield on shares}}{\text{Equity share capital}} \times 100 = \frac{₹\,1,68,600}{₹\,18,00,000} \times 100 = 9.37\%$$

Calculation of Expected Yield on Equity Shares	
Normal return expected	15%
Add: Risk premium for low interest and fixed dividend coverage (3.8 < 4)	1%*
Risk for debt equity ratio not required	Nil**
	16%
Value of an Equity Share	
$= \frac{\text{Actual yield}}{\text{Expected yield}} \times \text{Paid up value of a share}$	
$= \frac{9.37}{16} \times 100 = ₹\,58.56$	

* When interest and fixed dividend coverage is lower than the prescribed norm, the riskiness of equity investors is high. They should claim additional risk premium over and above the normal rate of return. Hence, the additional risk premium of 1% has been added.

** The debt equity ratio is lower than the prescribed ratio that means outside funds (Debts) are lower as compared to shareholders' funds. Therefore, the risk is less for equity shareholders. Therefore, no risk premium.

Illustration 8

Prosperous Ltd. belongs to an industry in which equity shares are sold at par on the basis of 18% yield provided, the net assets of the company are 250% of the paid up equity capital and the total distribution of profits does not exceed 50% of the profits. The dividend rate fluctuates from year to year in the industry. The balance sheet of Prosperous Ltd. stood as follows on 31st March, 2017:

Liabilities	*₹*	*Assets*	*₹*
6,000, 14% Preference shares of ₹ 100 each, fully paid up	*6,00,000*	*Tangible fixed assets less depreciation*	*16,00,000*
10,000 Equity shares of ₹ 100 each, ₹ 80 paid up	*8,00,000*	*Government securities*	*1,50,000*
General reserve	*2,80,000*	*Current assets*	*11,30,000*
12% Debentures	*4,00,000*		
Current liabilities and provisions	*8,00,000*		
	28,80,000		*28,80,000*

The company has been earning on an average ₹ 8,00,000 as profit after interest but before taxation which is 50%. The rate of dividend on equity shares has been maintained at 25% in the past years and is expected to be maintained.

Determine the probable market value of the equity shares of the company based on actual dividend. The tangible assets may be taken to be worth ₹ 17,20,000.

Solution

Computation of probable market price based on actual dividend

Actual dividend per share	₹ 25
Adjusted yield (W.N.3)	17.98%
Market price for shares of ₹ 100 paid up	₹ 139.04
Market price for shares of ₹ 80 paid up	₹ 111.23

Working Notes:

1. **Asset backing position of Prosperous Ltd**

Particulars	*₹*
Tangible fixed assets	17,20,000
Government securities	1,50,000
Current assets	11,30,000
Total assets	30,00,000
Less: Liabilities	
12% Debentures	(4,00,000)
Current liabilities and provisions	(8,00,000)
Net assets	18,00,000
Less: Preference share capital	(6,00,000)
Net assets available to equity share holders	12,00,000

Ratio of net asset to equity share capital = $\left[\frac{12,00,000}{8,00,000} \times 100\right]$ = 150%

2. Payout ratio

Particulars	₹
Profit available for distribution	
Profit before tax	8,00,000
Less: Tax @ 50%	(4,00,000)
Profit after tax	4,00,000
Total dividend paid	
Preference shareholders (14% of ₹ 6,00,000)	84,000
Equity shareholders (25% of ₹ 8,00,000)	2,00,000
Total dividend paid	2,84,000
Pay-out ratio $\left[\frac{2,84,000}{4,00,000} \times 100\right]$	71%

3. Computation of adjusted yield

	Asset backing ratio	*Pay-out ratio*
Representative Company	250%	50%
Prosperous Ltd. (W.N.1 and 2)	150%	71%
Variation	100%	(21%)
Degree of variation	$\left[\frac{100}{250} \times 100\right]$=40%	$\left[\frac{(21)}{50} \times 100\right]$ = (42%)
Nature of adjustment to yield	May increase	May decrease
Quantum of adjustment (Assuming 100% variance = 1% risk)	0.40	(0.42)

Adjusted yield = 18% + 0.40% - 0.42% = 17.98%

UNIT 6 : VALUATION OF BUSINESS

6.1 Introduction

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to consummate a sale of a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and many other business and legal purposes.

6.2 Need for Valuation of Business

The following represent the need for business valuation:

(i) *Merger and Take-over:* Companies in merger need *valuation of business as a going concern* to settle the purchase consideration. In case of take-over also the acquirer needs the information about total value of the business such that he can determine the value of the proportion which he intends to buy.

(ii) *Sale of Business:* For selling the whole business or any division of it, both the seller and buyer want to know the value of business to fix up the bargaining limit.

(iii) *Liquidation:* In case of liquidation, the shareholders want to know the value of business from the liquidator to understand how much they would get by liquidation.

6.3 Valuation Approaches

Two alternative approaches are available for business valuation: (i) going concern and (ii) liquidation. Under the first approach, it is important to understand what benefit the business is able to generate in future out of its existing Inventory of assets although value of existing assets is not ignored by the accountants. But in liquidation approach, the emphasis is what can be fetched by selling the assets either on piecemeal basis or taking as a whole.

6.4 Valuation Methods

The following methods are used for business valuation taking it as a going concern:

(i) Historical cost valuation

(ii) Current cost valuation

(iii) Economic valuation

(iv) Asset valuation.

For piecemeal sale of the business, only 'net realisable value' basis is appropriate.

♦ **Historical cost valuation**: It is also called book value method. All assets are taken at their respective historical cost. Value of goodwill is ascertained and added to such historical cost of assets.

Historical cost value of business = Historical cost of all assets + Value of goodwill.

- **Current cost valuation**: Current cost of assets are taken for this purpose instead of historical cost. Current cost of various assets can be ascertained as follows:
  - Tangible fixed Assets: Price to be paid to replace such assets at their present condition. If replacement price of the same type of tangible assets is not available, then replacement price of the next best substitute may be taken.
  - Investments: Quoted investments are valued at current market price. Unquoted investments are taken at cost unless the available information is sufficient to determine their current market value.
  - Inventory: Current market value of the Inventory-in-hand is taken up.
  - Trade receivables: At their net collection amount.
  - Intangibles: Trademarks, Patents, Copyright, etc. are valued at current acquisition price less the proportionate value already expired.
- **Economic valuation:** Under this method value of the business is given by the sum of discounted value of future earnings or cash flows.

  (i) *Capitalisation of Future Maintainable Profit:* Value of business as a going concern is dependent on its future earnings. By earning we may mean 'earnings before interest but after tax'.

  $$\text{Value of Business} = \frac{\text{Future Maintainable Profit}}{\text{Capitalisation rate}}$$

  In case of listed company inverse of the price-earning ratio may be used for determining capitalisation rate. For example, if P/E ratio is 12, Capitalisation rate becomes 8.33%, i.e. 100/12

  (ii) *Present value of future earnings*: Under this approach,

  $$Vo = \sum_{t=1}^{\infty} \frac{E_t}{(1+k)^t}$$ Where Vo = Value of business at the present time or zero time,

  E_t is the Earnings at time t, k = appropriate discount factor, t = 1, 2, ...∞

  $$\text{Thus } Vo = \frac{E_1}{(1+k)^1} + \frac{E_2}{(1+k)^2} + \ldots\ldots \frac{E_n}{(1+k)^n} + \ldots\ldots$$

  (iii) *Present value of future cash flows:* Frequently in valuation model cash flows from operations are used instead of earnings. Under this approach value of business is given by

$$\frac{C_1}{(1+k)^1}+\frac{C_2}{(1+k)^2}+.....\frac{C_n}{(1+k)^n}+.....$$

Where V_0 = Value of business.

C_I, C_2, C_n etc. are cash flows from operations at different point of time.

k = Discount rate.

6.5 Book Value

NAV (book value) / break up value of business share are computed as below:

When the calculation starts from the liability side:

Paid up value of equity and preference shares		******
Add: Reserves (excluding reserves not created out of Revenue profit or not realized in cash)		******
Less: Miscellaneous expenditure not written off	******	
Accumulated losses	******	
Arrears of depreciation	******	
Contingent liabilities	******	******
Net Asset Value of the business (A)		******

When the calculation starts from the asset side the balance sheet values are considered:

Tangible fixed assets		******
Intangible assets		******
Trade investments		******
Non-trade investments		******
Net current assets		******
Less: Secured and unsecured loans		
Unrealised reserves	******	
Contingent liabilities	******	
Arrears of depreciation	******	******
Net Asset Value of the business (A)		******

NAV of equity is NAV of business less preference share capital.

6.6 Fair Value

NAV on the basis of fair value of assets and liabilities is computed in the same way as computed on the basis of book value except that the fair values of assets and liabilities are considered instead of balance sheet values. The implication of fair value also varies with the objective of valuation, whether the objective is to find the going concern value or the liquidation value. The methods of computation are shown in the following table:

	Going concern basis	Liquidation basis		
Tangible fixed assets	Current cost	NRV		******
Intangible assets	Cost	NRV		******
Trade investments	Cost	NRV		******
Non-trade investment	Market value if quoted, otherwise book value	NRV		
Finished goods	Market value	NRV		
WIP	Cost	NRV		
Raw Materials	Cost	NRV		
Trade receivables	NRV	NRV		
Other assets	Cost/book value	NRV		******
Fictitious assets	NIL	NIL		
Less: Secured and unsecured loans	Actual amount payable	Actual amount payable	******	
Other liabilities (Including current liabilities)	Actual amount payable	Actual amount payable	******	
Contingent liabilities	Actual amount payable	Actual amount payable	******	******
Net Asset Value of the business (A)				******
Preference share capital (B)	Book value	Book value		******
Net Asset Value of equity (A - B)				******

Here cost means historical cost based value and book value means balance sheet value. NRV means Net Realisable Value which is market value less further costs to be incurred including cost of disposal.

6.7 Earning Based Valuation of Business

Earning based valuation of business = Earning capacity value per share X number of equity shares + Preference share capital + Debt capital.

(Book values of preference capital and debt capital should be taken)

6.8 Market Value Model

This is simply the aggregate of the market capitalization and market value of preference capital and debt capital. Market capitalization means market value of equity multiplied by the number of outstanding share. The quoted price of the stock exchanges provides the market value of equity at any moment.

When valuation is done in the field of financial management, present value of future net cash flows is generally taken as the valuation basis. Based on going concern assumption the cash flows are assumed to generate for infinite time in future and the value of the firm is calculated by finding the present value of future cash flows. The discounting rate applied to find the present value is the weighted average cost of capital to the firm (cost of equity in certain cases).

6.9 Valuation of Investments

Part I of Schedule III to the Companies Act, 2013 requires classification of investments into trade investments and other investments and further to be classified as:

(a) Investments in Property

(b) Investments in Equity instruments

(c) Investments in Preference shares

(d) Investments in Government or trust securities

(e) Investments in Debentures or Bonds

(f) Investments in Mutual funds

(g) Investments in Partnership firms

(h) Others (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

A “trade investment” means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.

AS 13 on Accounting for Investment contains explanation relating to classification of investments, determination of cost of investments, carrying amount of investments, disposal of investments and disclosure requirements.

6.10 Valuation of Current Assets, Loans and Advances

The conservatism principle is applied in valuation of current assets, loans and advances. By this principle, lower of the cost or market value is preferred. This means if the realisable value of these assets is lower than cost, such value is preferred. In other words, all possible losses are accounted for but no estimated profit is taken until it is realised. So in case of current assets like Trade receivables, loans and advances, adequate provision is necessary for doubtful debts. Here cost means current dues from Trade receivables or amount of loans and advances given.

Inventory is an important component of current assets which needs elaboration. The basic principle of inventory valuation is valuation at lower of the cost and net realisable value. Students are advised to refer AS 2 (Revised).

As per AS 2, both fixed and variable overheads that are incurred in converting materials into finished goods are to be allocated.

Rational for using historical cost: Inventories are held for deriving revenue directly or indirectly from their sale or use.

In historical cost accounting system 'cost' means acquisition cost. Although the value of inventories is more than acquisition cost, by following conservative path, no profit is taken until it is realised.

Techniques of determining historical cost: As per AS 2 (Revised) the cost of inventories should be assigned by using only first-in-first-out or weighted average cost formula where the specific identification of cost of inventories is not possible.

Valuation of inventories at net realisable value: If the cost of inventories is higher than net realisable value, the inventories should be valued at lower than cost. Such circumstances may occur due to decline in selling price or obsolescence of the inventory items. Moreover, in some cases inventory piling up may be of high is not possible to be sold within the normal turnover period. That apart there may be risk of physical deterioration of inventory items.

Sometimes by-product cost cannot be determined separately. In such circumstances by-products are valued at their net realisable value.

Inclusion of overheads in Inventory Cost: Production overheads are part of the inventory cost. Since as per AS 2, absorption costing method is followed, fixed as well as variable production overheads become part of inventory cost. Fixed production overheads are absorbed on the basis of normal capacity of the production facilities.

General administration overheads, selling and distribution overheads, and interest are not usually treated as expenses related to putting the inventories to their present location and condition. So these are excluded while computing inventory cost. The abnormal amounts of wasted materials, labour, or other production costs and storage costs, unless these costs are necessary in the production process prior to a further production stage, are also excluded.

But overheads other than production overheads should be included as part of the inventory cost only to the extent they are clearly related to put the inventories to their present location and condition.

Comparison of cost and net realisable value: Comparison of historical cost and net realisable value should be made for each item or a group of items separately. Comparison of aggregate values of dissimilar items may lead to setting off loss against unrealised profit.

Example

Given cost and net realisable value of five groups of inventory items:

Group	*Cost (₹)*	*Net realisable Value (₹)*	*Valuation (₹)*
A	*15,000*	*5,000*	*5,000*
B	*27,000*	*52,000*	*27,000*
C	*54,000*	*74,000*	*54,000*
D	*1,10,000*	*85,000*	*85,000*
E	*68,000*	*62,000*	*62,000*
	2,74,000	*2,78,000*	*2,33,000*

If aggregate values are taken, inventories should be valued at ₹ 2,74,000 instead of ₹ 2,33,000 which would overvalue the inventories. Prudence suggests elimination of all sorts of overvaluation.

Illustration 1

MICO Ltd. gives the following cash flows estimate:

2009 ₹ 20,00 lakhs

2010 to 2012 Compound Growth Rate 6.5%

2013 to 2016 Compound growth rate 9.5%

Apply 20% discount rate and determine the value of business.

Solution

Year	*Cash Flows ₹ in lakhs*	*Discount factor*	*Discounted cash flows (₹)*
2009	20,00.00	0.8333	16,66.60
2010	21,30.00	0.6944	14,79.07
2011	22,68.45	0.5787	13,12.75
2012	24,15.90	0.4823	11,65.19
2013	26,45.41	0.4019	10,63.19
2014	28,96.72	0.3349	9,70.11
2015	31,71.91	0.2791	8,85.28
2016	34,73.24	0.2326	8,07.88
			93,50.07

Value of Business ₹ 93,50.07 lakhs based on discounted value of eight years' cash flows.

The deficiencies of economic valuation are

(i) difficulties involved in estimating future cash flows;

(ii) subjectivity involved in choice of the future period for which cash flows to be estimated;

(iii) subjectivity involved in the selection of discount rate.

Asset valuation method: It may be argued that if a business is acquiring or retaining an asset, the value of that asset to the business must, in the case of acquisition of the asset, be greater than the cost of that asset and, in the case of retention of the asset, be greater than the net realisable value of the asset. If, therefore, all the assets of the business are valued at their net realisable value, the aggregate will be clearly less than value of the business as a whole.

Thus under asset valuation approach, one can get lower bound of the business value using net realisable value of the assets and the upper bound by the current costs of the assets including goodwill.

Valuation of business for amalgamation with another: The valuation of business which is to be amalgamated with another business is a more complex process because it cannot be made in isolation. From the point of view of the potential purchaser, the maximum price that he will be prepared to pay is the difference between the value of the combined business and the value of his existing business.

If the amalgamation gives rise to positive synergy, the value of the amalgamated business will be greater than the sum of the values of the individual business taken in isolation. The purchaser will usually not only have to consider the tangible assets, which can be valued with relative ease, but also the intangible assets which may be particularly influenced by the synergical effect of the amalgamation.

In many amalgamations, all the assets of the acquired business are not retained in the new business. So, the first step in valuing business for acquisition will be to determine the asset structure of the business and to identify the assets which will not be required in the future. Such assets must be valued at their net realisable value at the time at which they are expected to be sold and these figures discounted to the present time to ascertain the present value of the superfluous assets. In many cases, the sale of the superfluous assets will take place immediately and therefore, no discounting becomes necessary and the value of these may be considered to be a deduction from the purchase price of the business.

In practice, the valuation figure is the net realisable value of the surplus assets which are to be sold plus the present value of the additional earnings which will accrue to the acquirer of the business as a result of the acquisition. It is of course, apparent that a major problem arises in determining the rate of interest at which the earnings of the business should be discounted as well as the period for which such earning of estimation should be considered. Also it is possible to take cash flows instead of earnings as discussed earlier.

Illustration 2

Shyam Garments Ltd. is a company which produces and sells to retailers a certain range of fashion clothings. They have made the following estimates of potential cash flows for the next 10 years.

Year	1	2	3	4	5	6	7	8	9	10
Cash flows (₹ in lacs)	15,00	17,00	20,00	25,00	30,00	34,00	38,00	45,00	50,00	60,00

Kiddies Wear Ltd. is a company which owns a series of boutiques in a certain locality. The boutiques buy clothes from various suppliers and retail them. Each boutique has a manager and an assistant but all purchasing and policy decisions are taken centrally. Independent cash flow estimates of Kiddies

Wear Ltd. was as follows:

Year	1	2	3	4	5	6	7	8	9	10
Cash flows (₹ in lacs)	1,20	1,60	2,00	2,80	3,40	4,60	5,20	6,00	6,60	8,00

Shyam Garments Ltd. is interested in acquiring Kiddies Wear Ltd. in order to get some additional retail outlets. They make the following cost-benefit calculations:

(i) *Net value of assets of Kiddies Wear Ltd.*

	₹ in lacs
Fixed Assets	800
Investments	200
Inventory	400
	1400
Less: Trade payables	400
Net Assets	1000

(ii) *Fixed Assets amounting to ₹ 50 lacs cannot be used and their net realisable value is ₹ 45 lacs.*

(iii) *Inventory can be realised immediately at ₹ 470 lacs.*

(iv) *Investments can be disposed off for ₹ 212 lacs.*

(v) *Some workers of Kiddies Wear Ltd. are to be retrenched for which estimated compensation is ₹ 1,30 lacs.*

(vi) *Trade payables are to be discharged immediately.*

(vii) *Liabilities on account of retirement benefits not accounted for in the Balance Sheet by Kiddies Wear Ltd. is ₹ 48 lacs.*

(viii) *Expected cash flows of the combined business will be as follows:*

Year	1	2	3	4	5	6	7	8	9	10
Cash flow (₹ in lacs)	18,00	19,00	23,00	29,50	35,00	40,00	45,00	53,00	58,00	69,00

Find out the maximum value of Kiddies Wear Ltd. which Shyam Garments Ltd. can quote. Also show the difference in valuation had there been no merger. Use 20% as discount factor.

Solution

(1) Calculation of operational synergy expected to arise out of merger

Year (*₹ in lacs*)	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Projected cash flows of Shyam Garments after merger with Kiddies Wear Limited	18,00	19,00	23,00	29,50	35,00	40,00	45,00	53,00	58,00	69,00
Less: Projected cash flows of Shyam Garments Ltd. without merger	(15,00)	(17,00)	(20,00)	(25,00)	(30,00)	(34,00)	(38,00)	(45,00)	(50,00)	(60,00)
	3,00	2,00	3,00	4,50	5,00	6,00	7,00	8,00	8,00	9,00

(2) Valuation of Kiddies Wear Ltd. ignoring merger

Year	*Cash Flows* (*₹* in lacs)	*Discount Factor*	*Discounted Cash Flow* (*₹ in lacs*)
1	120	0.8333	99.996
2	160	0.6944	111.104
3	200	0.5787	115.740
4	280	0.4823	135.044
5	340	0.4019	136.646
6	460	0.3349	154.054
7	520	0.2791	145.132
8	600	0.2326	139.560
9	660	0.1938	127.908
10	800	0.1615	129.200
			1294.384

(3) Valuation of Kiddies Wear Ltd. in case of merger

Year	*Cash Flows From operations* (*₹ in lacs*)	*Discount Factor*	*Discounted Cash Flow* (*₹ in lacs*)
1	300	0.8333	249.990
2	200	0.6944	138.880

3	300	0.5787	173.610
4	450	0.4823	217.035
5	500	0.4019	200.950
6	600	0.3349	200.94
7	700	0.2791	195.370
8	800	0.2326	186.080
9	800	0.1938	155.040
10	900	0.1615	145.350
			1863.245

(4) Maximum value to be quoted

	₹ *in. lacs*	₹ *in lacs*
Value as per discounted cash flows from operations		1863.245
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	45.000	
Investments	2,12.000	
Inventory	4,70.000	7,27.000
		25,90.245
Less: Trade payables	400.000	
Provision for retirement benefits	48.000	
Retrenchment compensations	130.000	(5,78.000)
		20,12.245

So, Shyam Garments Ltd. can quote as high as ₹ 20,12,24,500 for taking over the business of Kiddies Wear Ltd. Here value arrived at in isolation i.e. ₹ 12,94,38,400 is not providing reasonable value estimate.

6.11 Value of Control of the Business

The main difference between the value of a business compared with a minority holding of shares is the value of voting control. The value of control is the present value of the change in cash flows which will be realised from exercising control. The main obvious reason for this higher valuation is that the controlling interest enables the owner of that interest to arrange the affairs of the business in a way that best suits his own circumstances. If a company is efficiently managed at present, the value of control may be very low. However, it is thought that the company is inefficiently managed, then, obtaining control may enable operations and financing to be changed thereby substantially increasing the present value of cash flows generated by a firm.

10

Developments in Financial Reporting

UNIT 1: VALUE ADDED STATEMENT

1.1 Historical Background

The concept of value added is considerably old. It originated in the U.S. Treasury in the 18th Century and periodically accountants have deliberated upon whether the concept should be incorporated in financial accounting practice. But actually, the value added statement has come to be seen with greater frequency in Europe and more particularly in Britain. The discussion paper 'Corporate Report' published in 1975 by the then Accounting Standard Steering Committee (now known as Accounting Standards Board) of the U.K. advocated the publication of value added statement along with the conventional annual corporate report. In 1977, the Department of Trade, U.K. published 'The Future of Company Reports' which stated that all substantially large British companies should include a value added (V.A.) statement in their annual reports. Also, a few companies in the Netherlands include V.A. information in their annual reports, but the disclosures often fall short of being a full V.A. statement and also the method of arriving at V.A. is grossly non-standardized. In India, Britannia Industries Limited and some others prepare value added statement as supplementary financial statement in their annual reports.

1.2 Definitions

1.2.1 Value Added (VA): VA is the wealth a reporting entity has been able to create through the collective effort of capital, management and employees. In economic terms, value added is the market price of the output of an enterprise less the price of the goods and services acquired by transfer from other firms. VA can provide a useful measure in gauging performance and activity of the reporting entity.

1.2.2 Gross Value Added (GVA): GVA is arrived at by deducting from sales revenue the cost of all materials and services which were brought in from outside suppliers. We know that the retained profit of a company for a given accounting year is derived as below:

$$R = S - B - Dep. - W - I - T - Div \qquad (1)$$

Where R = Retained profit, S = Sales revenue, B = Bought in cost of materials and services, Dep = annual depreciation charge, W = Annual wage cost, I = Interest payable for the year, T = Annual corporate tax and Div = Total dividend payable for the year. Rearranging the equation (1) we get GVA as below:

$$S - B = R + Dep. + W + I + T + Div \qquad (2)$$

Each side of equation (2) represents GVA. However, this is a very simple definition of GVA. In practice GVA includes many other things.

Besides sales revenue, any direct income, investment income and extraordinary incomes or expenses are also included in calculation of GVA. Including these items in the above equation No. 2, we get

(S + Di) – B + Inv + EI = R + Dep. + W + T + I + Div. ... (3)

Where Di = Direct incomes, Inv = Investment incomes, EI = Extraordinary items.

The above equation can be shown by way of the following statement.

Gross value added of a manufacturing company

Sales	X	
Add: Royalties and other direct income	X	
Less: Materials and Services used	X	
Value added by trading activities		X
Add : Investment Income	X	
Add/Less: Extraordinary items	X	X
Gross Value Added		X

Applied as follows:

To employees as salaries, wages, etc.	X
To government as taxes, duties, etc.	X
To financiers as interest on borrowings	X
To shareholders as dividends	X
To retained earnings including depreciation	X

1.2.3 Net Value Added (NVA): NVA can be defined as GVA less depreciation. Rearranging the equation (1) we can get NVA as below:

S – B – Dep = R + W + I + T + Div.

1.3 Reporting Value Added

A significant experience regarding the publication of the value added statement is represented by the U.K. In 1975, the Accounting Standard Steering Committee (ASSC) published the Corporate Report containing the suggestions for British companies to present the value added statement in addition to the traditional profit and loss account.

The 'Corporate Report' of the U.K. advised the British companies to report Gross Value Added (GVA). The 'Report' did not consider the possibility of the alternative Net Value Added (NVA). As a result the majority of British companies prefer to set forth their VA statement as a report on GVA, so that depreciation is an application of VA rather than a cost to be deducted in calculating VA. In India also GVA is more popular among reporting companies than NVA. The reasons for reporting GVA are as follows:

(a) GVA can be derived more objectively than NVA. This is because depreciation is more prone to subjective judgement than are bought-in costs.

(b) GVA format involves reporting depreciation along with retained profit. The resultant sub-total usefully shows the portion of the year's VA which has become available for re-investment.

(c) The practice of reporting GVA would lead to a closer correspondence between VA and national income figures. This is because economists generally prefer gross measures of national income to net one.

However, there are also valid reasons for reporting NVA. They are:

(a) Wealth Creation (i.e. VA) will be overstated if no allowance is made for the wearing out or loss of value of fixed assets which occurs as new assets are created.

(b) NVA is a firmer base for calculating productivity bonus than is GVA. The productivity of a company may increase because of additional investments in modernisation of plant and machinery. Consequently, the value added component may improve significantly. The employees of the company will naturally claim and be given some share of additional VA as productivity bonus. But if the share is based on GVA then no recognition is given to the need for an increased depreciation charge.

(c) The concept of matching demands that depreciation be deducted along with bought-in costs to derive NVA. GVA is inconsistent, for costs would be charged under the bought-in heading if the item has a life of less than or one year. But if the item has a longer life it would be treated as a depreciable fixed asset and its cost would never appear as a charge while arriving at GVA.

From the above discourse it can be said that it is better to report on NVA rather than on GVA.

1.4 Necessity of Preparing VA Statements

The debate on the role of value added among accounting measurements has received attention in the last fifty years, with a particular emphasis in the 1970's and 1980's. The analysis of value added can be classified in at least three fields of research: management control (internally oriented), financial reporting (externally oriented), and social reporting (externally oriented).

The first field emphasizes the role of value added as an indicator of efficiency among the tools to appraise the "economic productivity" (Sutherland 1956; Ponzanelli 1967: 186). Therefore, the value added measurement is used as one of the performance indicators in the management control system, particularly in the industrial sector, with the main purpose of controlling costs and the performance of productive factors, especially labour.

The second field of analysis looks at value added reporting as additional information to the traditional income statement, which is focused on earnings and net profit. An externally oriented value added statement can synthesize the contribution of the whole business in different sectors, not only the industrial one.

The third approach considers the value added statement as an embryonic form of social reporting. It is worth noting that the label "value added statement" in the English version of the International Accounting Standard (IAS 1) (2004) is translated into italian by the words "bilancio sociale" (social reporting). It is a means of communication in the overall business reporting process which is added to the traditional and official annual report.

The most relevant concept of income in this broad social responsibility concept of the enterprise is the value added concept. Therefore, the origin of concept of value added lies in the enterprise theory which says that the reporting entity is a social institution, operating for the benefit of many interested groups. Proponents of VA argue that there are advantages in defining income in such a way as to include the rewards of a much wider group than just the shareholders. The various advantages of the VA statement are as follows:

(a) 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.

(b) 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.

(c) 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. However, it may be noted that the VA ratios can be made more useful if the ratios are based on inflation adjusted VA data.

(d) VA provides a very good measure of the size and importance of a company. To use sales figures or capital employed figures as a basis for company 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.

(e) VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.

(f) Finally 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 the VA statement.

1.5 Value Added Statement (VA Statement)

The VA statement is a financial statement which shows how much value (wealth) has been created by an enterprise through utilization of its capacity, capital, manpower and other resources and allocated to the following stakeholders:

The workforce – for wages, salaries and related expenses;

The financiers – for interest on loans and for dividends on share capital.

The government – for corporation tax.

The business – for retained profits.

A statement of VA represents the profit and loss account in different and possibly more useful manner.

The conventional VA statement is divided into two parts – the first part shows how VA is arrived at and the second part shows the application of such VA.

Illustration 1

Given below is the summarised Profit and Loss Account of Creamco Ltd.:

Summarised Profit and Loss Account
for the year ended 31st March, 2017

	Notes	*Amount (₹ '000)*
Income		
Sales	*1*	*28,525*
Other Income		*756*
		29,281
Expenditure		
Operating cost	*2*	*25,658*
Excise duty		*1,718*
Interest on Bank overdraft	*3*	*93*
Interest on 10% Debentures		*1,157*
		28,626
Profit before Depreciation		*655*
Less: Depreciation		*(255)*
Profit before tax		*400*
Provision for tax	*4*	*(275)*
Profit after tax		*125*
Less: Transfer to Fixed Asset Replacement Reserve		*(25)*
		100
Less: Dividend paid and payable		*(45)*
Retained profit		*55*

Notes:

1. *This represents the invoice value of goods supplied after deducting discounts, returns and sales tax.*

2. *Operating cost includes ₹ ('000) 10,247 as wages, salaries and other benefits to employees.*
3. *The bank overdraft is treated as a temporary source of finance.*
4. *The charge for taxation includes a transfer of ₹ ('000) 45 to the credit of deferred tax account.*

You are required to:

(a) Prepare a value added statement for the year ended 31st March, 2017.

(b) Reconcile total value added with profit before taxation.

Solution

(a) **CREAMCO LTD.**

VALUE ADDED STATEMENT

for the year ended March 31, 2017

	₹ ('000)	₹ ('000)	%
Sales		28,525	
Less: Cost of bought in material and services:			
Operating cost	15,411		
Excise duty	1,718		
Interest on bank overdraft	93	(17,222)	
Value added by manufacturing and trading activities		11,303	
Add: Other income		756	
Total value added		12,059	
Application of value added:			
To pay employees:			
Wages, salaries and other benefits		10,247	84.97
To pay government:			
Corporation tax		230	1.91
To pay providers of capital:			
Interest on 10% Debentures	1,157		
Dividends	45	1,202	9.97
To provide for the maintenance and expansion of the company:			
Depreciation	255		
Fixed Assets Replacement Reserve	25		
Deferred Tax Account	45		
Retained profit	55	380	3.15
		12,059	100.00

(b) Reconciliation between Total Value Added and Profit Before Taxation

	₹ ('000)	₹ ('000)
Profit before tax		400
Add back:		
Depreciation	255	
Wages, salaries and other benefits	10,247	
Debenture interest	1,157	11,659
Total Value Added		12,059

Notes:

(1) Deferred tax could alternatively be shown as a part of 'To pay government'.

(2) Bank overdraft, being a temporary source of finance, has been considered as the provision of a banking service rather than of capital. Therefore, interest on bank overdraft has been shown by way of deduction from sales and as a part of 'cost of bought in material and services'.

1.6 Limitation of VA

It is argued that although the VA statement shows the application of VA to several interest groups (like employees, government, shareholders, etc.) the risk associated with the company is only borne by the shareholders. In other words, employees, government and outside financiers are only interested in getting their share on VA but when the company is in trouble, the entire risk associated therein is borne only by the shareholders. Therefore, the concept of showing value added as applied to several interested groups is being questioned by many academics. They advocated that since the shareholders are the ultimate risk takers, the residual profit remaining after meeting the obligations of outside interest groups should only be shown as value added accruing to the shareholders. However, academics have also admitted that from overall point of view value added statement may be shown as supplementary statement of financial information. But in no case can the VA statement substitute the traditional income statement (i.e. Profit & Loss Account).

Another contemporary criticism of VA statement is that such statements are non-standardised. One area of non-standardisation is the inclusion or exclusion of depreciation in the calculation of value added. Another major area of non-standardisation in current VA practice is taxation. Some companies report only tax levied on profits under the heading of "VA applied to governments". Other companies prefer to report on extensive range of taxes and duties under the same heading. In the case of Britannia Industries Limited, it has shown taxes and duties paid under the heading "VA applied to Government". In the illustration given in para 1.5 excise duty has been shown as a part of bought-in cost and deducted while calculating value added. Some academics argued that such excise duty should be shown as an application of VA. However, this practice of non-standardisation can be effectively eliminated by bringing out an accounting standard on value added. Therefore, this criticism is a temporary phenomenon.

We have stated in para 1.3, the reasons for preferring NVA to GVA. We prepare the NVA statement on the basis of the information given in Illustration in para 1.5. It can be mentioned here that in preparing VA statement on NVA basis excise duty has been shown as an application of VA.

(a) **CREAMCO LTD.**

VALUE ADDED STATEMENT

for the year ended March 31, 2017

	₹ ('000)	₹ ('000)	%
Sales		28,525	
Less: Cost of bought in material and services:			
Operating cost	15,411		
Interest on bank overdraft	93	15,504	
Gross Value Added		13,021	
Less: Depreciation		(255)	
Net Value Added		12,766	
Add: Other income		756	
Available for application		13,522	
Applied as follows:			
To pay employees:			
Wages, salaries and other benefits		10,247	75.78
To pay government:			
Corporation tax & excise duty		1948	14.41
To pay providers of capital:			
Interest on 10% Debentures	1,157		
Dividends	45	1,202	8.89
To provide for the maintenance and expansion of the company:			
Fixed Assets Replacement Reserve	25		
Deferred Tax Account	45		
Retained profit	55	125	0.92
		13,522	100.00

(b) **Reconciliation between Total Value Added and Profit before Taxation**

	₹ ('000)	₹ ('000)
Profit before tax		400
Add back:		
Excise duty	1,718	

Wages, salaries and other benefits	10,247	
Debenture interest	1,157	13,122
Total Value Added		13,522

We can see that VA based ratios have changed significantly particularly with respect to payments to employees and government (i.e., Payroll/VA and taxation /VA). Taxation/VA ratio has increased from a meager 1.9% to a significant 14.41%, whereas payroll/VA ratio has come down from 84.97% to 75.78%. It suggests that although the employees are enjoying the major share of VA, government's share has also increased significantly. As a result the retained profit of the company has significantly come down.

Illustration 2

From the following data, prepare a Value Added Statement of Merit Ltd., for the year ended 31.3.2017:

Particulars	*₹*	*Particulars*	*₹*
Decrease in Stock	*24,000*	*Sales*	*40,57,000*
Purchases	*20,20,000*	*Other Income*	*55,000*
Wages & Salaries	*10,00,000*		
Manufacturing & Other Expenses	*2,30,000*		
Finance Charges	*4,69,000*		
Depreciation	*2,44,000*		
Profit Before Taxation	*1,25,000*		
Total	*41,12,000*		*41,12,000*

Particulars	*₹*
Profit Before Taxation	*1,25,000*
Less: Tax Provisions	*(40,000)*
Income Tax Payments (for earlier years)	*(3,000)*
Profit After Taxation	*82,000*
Appropriations of PAT	
Debenture Redemption Reserve	*10,000*
General Reserve	*10,000*
Proposed Dividend	*35,000*
Balance carried to balance Sheet	*27,000*
Total	*82,000*

Solution

Value Added Statement of Merit Ltd. For the year ended 31.03.2017

Particulars		*₹*
Sales/Turnover		40,57,000

Less:	Bought in Materials		
	Decrease in Stock	24,000	
	Purchases	20,20,000	
	Manufacturing and other expenses	2,30,000	(22,74,000)
Value Added by Trading Activities			17,83,000
Add:	Other Income		55,000
Gross Value Added			18,38,000

Applied as follows:

			₹
1.	To Pay Employees		
	- Salaries, Wages, etc		10,00,000
2.	To Pay Government as		
	- Taxes, Duties etc (40,000+3,000)		43,000
3.	To Pay Providers of capital		
	- Interest on borrowings	4,69,000	
	- Dividends	35,000	5,04,000
4.	To Pay for Maintenance and Expenses of the Company		
	- Depreciation	2,44,000	
	- Debenture Redemption Reserve	10,000	
	- General Reserve	10,000	
	- Retained Earnings	27,000	2,91,000
Total Application of Value Added			18,38,000

Illustration 3

Prepare a Gross Value Added Statement from the following summarised Profit and Loss Account of Strong Ltd. Show also the reconciliation between Gross Value Added and Profit before Taxation:

Profit & Loss Account for the year ended 31st March, 2017

Income	*Notes*	*Amount*	
		(₹ in lakhs)	*(₹ in lakhs)*
Sales		*610*	
Other Income		*25*	
			635
Expenditure			
Production & Operational Expenses	*1*	*465*	
Administration Expenses	*2*	*19*	
Interest and Other Charges	*3*	*27*	

Depreciation		*14*	*525*
Profit before Taxes			*110*
Provision for Taxes			*(16)*
			94
Balance as per Last Balance Sheet			*7*
			101
Transferred to:			
General Reserve		*60*	
Proposed Dividend		*11*	*71*
Surplus Carried to Balance Sheet			*30*
			101

Notes:

1. *Production & Operational Expenses* *(₹ in lakhs)*

Decrease in Stock	*112*
Purchases of Raw Materials	*185*
Purchases of Stores	*22*
Salaries, Wages, Bonus & Other Benefits	*41*
Cess and Local Taxes	*11*
Other Manufacturing Expenses	*94*
	465

2. *Administration expenses include inter-alia audit fees of ₹ 4.80 lakhs, salaries & commission to directors ₹ 5 lakhs and provision for doubtful debts ₹ 5.20 lakhs.*

3. *Interest and Other Charges:* *(₹ in lakhs)*

On Working Capital Loans from Bank	*8*
On Fixed Loans from IDBI	*12*
Debentures	*7*
	27

Solution

Strong Limited
Value Added Statement
for the year ended 31st March, 2017

	₹ in lakhs	*₹ in lakhs* %
Sales		610
Less: Cost of bought-in material and services:		
Production and operational expenses	413	

Administration expenses	14	
Interest on working capital loans	8	(435)
Value added by manufacturing and trading activities		175
Add : Other income		25
Total Value Added		200

Application of Value Added:

To Pay Employees :		
Salaries, Wages, Bonus and Other Benefits	41	20.50
To Pay Directors :		
Salaries and Commission	5	2.50
To Pay Government		
Cess and Local Taxes	11	
Income Tax	16	
	27	13.50
To Pay Providers of Capital		
Interest on Debentures	7	
Interest on Fixed Loans	12	
Dividend	11	
	30	15.00
To Provide for Maintenance and Expansion of the Company:		
Depreciation	14	
General Reserve	60	
Retained Profit (30–7)	23	
	97	48.50
Grand Total	200	100.00

Reconciliation between Total Value Added and Profit Before Taxation:

	₹ in lakhs	*₹ in lakhs*
Profit before Tax		110
Add back :		
Depreciation	14	
Salaries, Wages, Bonus and other Benefits	41	
Directors' Remuneration	5	
Cess and Local Taxes	11	
Interest on Debentures	7	
Interest on Fixed Loans	12	
Total Value Added		90
		200

Illustration 4

Hindusthan Corporation Limited (HCL) has been consistently preparing Value Added Statement (VAS) as part of Financial Reporting. The Human Resource department of the Company has come up with a new scheme to link employee incentive with 'Value Added' as per VAS. As per the scheme an Annual Index of Employee cost to Value Added annually (% of employee cost to Value Added rounded off to nearest whole number) shall be prepared for the last 5 years and the best index out of results of the last 5 years shall be selected as the 'Target Index'. The Target Index percentage shall be applied to the figure of 'Value Added' for a given year to ascertain the target employee cost. Any saving in the actual employee cost for the given year compared to the target employee cost will be rewarded as 'Variable incentive' to the extent of 70% of the savings. From the given data, you are requested to ascertain the eligibility of 'Variable Incentive' for the year 2016-2017 for the employees of the HCL.

Value added statement of HCL for last 5 years (₹ in lakhs)

Year	2011-12	2012-13	2013-14	2014-15	2015-16
Sales	3,200	3,250	2,900	3,800	4,900
Less: Bought out goods and services	2,100	2,080	1,940	2,510	3,200
Value added	1,100	1,170	960	1,290	1,700

Application of Value Added

Year	2011-12	2012-13	2013-14	2014-15	2015-16
To Pay Employees	520	480	450	600	750
To Providers of Capital	160	170	120	190	210
To Government Tax	210	190	220	300	250
For Maintenance and expansion	210	330	170	200	490

Summarized Profit and Loss Account of the HCL for 2016-2017 (₹ in lakhs)

Sales		5,970
Less: Material consumed	1,950	
Wages	400	
Production salaries	130	
Production expenses	500	
Production depreciation	150	
Administrative salaries	150	
Administrative expenses	200	
Administrative depreciation	100	
Interest	150	
Selling and distribution salaries	120	
Selling expenses	350	
Selling depreciation	120	4,320
Profit		1,650

Solution

1. Calculation of Target index

					(₹ in lakhs)
Year	*2011-12*	*2012-13*	*2013-14*	*2014-15*	*2015-16*
Employees cost	520	480	450	600	750
Value added	1,100	1,170	960	1,290	1,700
Percentage of 'Employee cost' to 'Value added' (to the nearest whole number)	47%	41%	47%	47%	44%

Target index percentage is taken as least of the above from companies viewpoint on conservative basis i.e. 41%.

2. Value Added Statement for the year 2016-17

	(₹ in lakhs)	*(₹ in lakhs)*
Sales		5,970
Less: Cost of bought in goods & services		
Material consumed	1,950	
Production expenses	500	
Administrative expenses	200	
Selling expenses	350	(3,000)
Added value		2,970

3. Employee cost for 2016-17

	(₹ in lakhs)
Wages	400
Production salaries	130
Administrative salaries	150
Selling salaries	120
	800

4. Calculation of target employee cost = Target Index Percentage x Value added

= 41% x ₹ 2,970 lakhs = ₹ 1217.70 lakhs

5. Calculation of savings

Target employee cost = ₹ 1,217.70 lakhs

Less: Actual Cost = ₹ 800.00 lakhs

Saving = ₹ 417.70 lakhs

6. Calculation of Variable incentive for the year 2016-17:

70% of saving is variable incentive = 70% x ₹ 417.70 lakhs = ₹ 292.39 lakhs.

Illustration 5

Following information is provided in respect of Pradeep Ltd. as on 31st March, 2017:

	(₹ in lakh)
Turnover (including discounts and returns worth ₹ 35 lakh)	2,500
Plant and machinery (net)	785
Depreciation on plant and machinery	132
Debtors	205
Dividend to ordinary shareholders	85
Creditors	180
Stock (net) of all raw materials, WIP, finished goods	
Opening stock	180
Closing stock	240
Raw material purchased	714
Cash at bank	98
Printing and stationery	24
Auditor's remuneration	15
Retained profit (opening balance)	998
Retained profit for the year	445
Transfer to reserve	120
Rent paid	172
Other expenses	88
Ordinary share capital (₹ 100 each)	1700
Interest on borrowings	40
Income tax for the year	280
Wages and salaries	352
Employees state insurance	32
Provident fund contribution	26

You are required to:

(i) Prepare Value Added Statement and its application for the period 31.3.2017.

(ii) Value Added per Employee (If 87 employees work in Pradeep Ltd.)

(iii) Average Earnings per Employee (If 87 employees work in Pradeep Ltd.)

(iv) Sales per Employee (If 87 employees work in Pradeep Ltd.)

Solution

(i) Value Added Statement of Pradeep Ltd. for the period ended on 31.3.2017

		(₹ in lakhs)
Sales (net) (2,500 – 35)		2,465
Less: Cost of Bought in Materials and Services:		
Raw material consumed (180 + 714 – 240)	654	
Printing and stationary	24	
Auditors' remuneration	15	
Rent paid	172	
Other expenses	88	(953)
Value added by manufacturing and trading activities		1,512

Application of Value Added

		(₹ in lakh)	(₹ in lakh)	%
To	Pay Employees:			
	Wages and salaries	352		
	Employees state insurance	32		
	Provident fund contribution	26	410	27.12
To	Pay Government:			
	Income-tax		280	18.52
To	Pay Providers of Capital:			
	Interest on borrowings	40		
	Dividend	85	125	8.27
To	Provide for maintenance and expansion of the company:			
	Depreciation	132		
	Transfer to reserve	120		
	Retained profit	445	697	46.09
			1,512	100

(ii) Value Added Per Employee = Value Added/ No. of Employees

= 1,512 \ 87 = 17.38

(iii) Average Earnings Per Employee = Average Earnings of Employee / No. of Employees

= 410/87 = 4.71

(iv) Sales Per Employee = Sales / No. of Employees

= 2,465 / 87 = 28.33

1.7 Interpretation of VA

While the absolute value of net VA and its proportion to gross output are very important, the factor components of value addition reveal more information. It is generally found that value addition is highest for service companies and lowest for a trading business. Consider a hypothetical situation. There are three companies A, B and C. Each sells the finished product for ₹ 1,000. Company A buys a lump of metal in the market for ₹ 500, performs four operations on it – annealing, forging, trimming and polishing - and sells the finished product for ₹ 1,000. Company B buys the semi-finished product in the market for ₹ 800, performs certain operations and sells the finished product at the said price of ₹ 1,000. Company C buys the finished product from another company for ₹ 950 and sells it for ₹ 1,000.

Thus, even though all the three companies have the same turnover, company A has added highest net value to its product and Company C the least. As a percentage of the gross output, company A's value addition is 50%, company B's 20% and company C's a meager 5%. At this point it appears that company A, having highest value addition, will give highest returns to shareholders. But if it so happens that out of total value addition of ₹ 500 by company A, almost 90% goes out for meeting wage bill, the position is entirely different. Therefore, considering the ratio of net value added to gross output does not yield a complete picture. If much of a company's net value added comes from an unproductive labour force, there will be little left over for future investments or for addition to reserves. Hence, besides considering the ratio of net value addition to gross output, one must consider the contribution of various factor costs to the net value added.

UNIT 2: ECONOMIC VALUE ADDED

2.1 Introduction

In corporate finance, **Economic Value Added** or **EVA**, a registered trademark of Stern Stewart & Co. (*Stern Stewart & Co. is a worldwide management consulting firm founded in New York in 1982. The company developed the Economic value added concept and currently owns the trademark*), is an estimate of a firm's economic profit – being the value created in excess of the required return of the company's investors (being shareholders and debt holders). Quite simply, EVA is the profit earned by the firm less the cost of financing the firm's capital. The idea is that value is created when the return on the firm's economic capital employed is greater than the cost of that capital.

EVA is net operating profit after taxes (or NOPAT) less a capital charge, the latter being the product of the cost of capital and the economic capital. The basic formula is:

$$EVA = (r - C) \times K = NOPAT - C \times K$$

where:

- $r = \frac{NOPAT}{K}$, is the Return on Invested Capital (ROIC);
- C is the weighted average cost of capital (WACC);
- K is the economic capital employed;
- NOPAT is the net operating profit after tax, with adjustments and translations, generally for the amortization of goodwill, the capitalization of brand advertising and other non-cash items.

EVA Calculation:

EVA = Net operating profit after taxes – a capital charge [the residual income method]

Therefore, EVA = NOPAT – (c × capital), or alternatively

EVA = (r x capital) – (c × capital) so that

EVA = (r-c) × capital

where:

r = rate of return, and

c = cost of capital, or the Weighted Average Cost of Capital (WACC).

NOPAT is profits derived from a company's operations after cash taxes but before financing costs and non-cash book-keeping entries. It is the total pool of profits available to provide a cash return to those who provide capital to the firm.

Capital is the amount of cash invested in the business, net of depreciation. It can be calculated as the sum of interest-bearing debt and equity or as the sum of net assets less non-interest-bearing current liabilities.

The capital charge is the cash flow required to compensate investors for the riskiness of the business given the amount of economic capital invested.

The cost of capital is the minimum rate of return on capital required to compensate investors (debt and equity) for bearing risk, their opportunity cost.

Another perspective on EVA can be gained by looking at a firm's return on net assets (RONA). RONA is a ratio that is calculated by dividing a firm's NOPAT by the amount of capital it employs (RONA = NOPAT/Capital) after making the necessary adjustments of the data reported by a conventional financial accounting system.

EVA = (RONA – required minimum return) × net investments

If RONA is above the threshold rate, EVA is positive.

2.2 Cost of Capital

The **cost of capital** is a term used in the field of financial investment to refer to the cost of a company's funds (both debt and equity), or, from an investor's point of view "the shareholder's required return on a portfolio of all the company's existing securities". It is used to evaluate new projects of a company as it is the minimum return that investors expect for providing capital to the company, thus setting a benchmark that a new project has to meet.

For an investment to be worthwhile, the expected return on capital must be greater than the cost of capital. The cost of capital is the rate of return that capital could be expected to earn in an alternative investment of equivalent risk. If a project is of similar risk to a company's average business activities it is reasonable to use the company's average cost of capital as a basis for the evaluation. A company's securities typically include both debt and equity; one must therefore calculate both the cost of debt and the cost of equity to determine a company's cost of capital. However, a rate of return larger than the cost of capital is usually required.

The WACC is the minimum return that a company must earn on an existing asset base to satisfy its creditors, owners, and other providers of capital, or they will invest elsewhere. Companies raise money from a number of sources: common equity, preferred equity, straight debt, convertible debt, exchangeable debt, warrants, options, pension liabilities, executive stock options, governmental subsidies, and so on. Different securities, which represent different sources of finance, are expected to generate different returns. The WACC is calculated taking into account the relative weights of each component of the capital structure. The more complex the company's capital structure, the more laborious it is to calculate the WACC.

Cost of Debt Capital: The **cost of debt** is relatively simple to calculate, as it is composed of the rate of interest paid. The cost of debt is computed by taking the rate on a risk free bond whose duration matches the term structure of the corporate debt, then adding a *default premium*. This default premium will rise as the amount of debt increases (since, all other things being equal, the risk rises as the amount of debt rises). Since in most cases debt expense is a deductible expense, the cost of debt is computed as an after tax cost to make it comparable with the cost of equity (earnings are after-tax as well). Thus, for profitable firms, debt is discounted by the tax rate. The formula can be written as **(Rf + credit risk rate) (1-T)**, where T is the corporate tax rate and Rf is the risk free rate.

Cost of Equity Capital: The **cost of equity** is more challenging to calculate as equity does not pay a set return to its investors. Similar to the cost of debt, the cost of equity is broadly defined as the risk-weighted projected return required by investors, where the return is largely unknown. The cost of equity is therefore *inferred* by comparing the investment to other investments (comparable) with similar risk profiles to determine the "market" cost of equity.

Cost of Equity Capital is the market expected rate of return. Equity capital and accumulated reserves and surpluses which are free to equity shareholders carry the same cost. Because the reserves and surplus are created out of appropriation of profit, that is, by retention of profit attributable to equity shareholders. As it is shareholders' money, the expectation of the shareholders to have value appreciation on this money will be same as in case of equity share capital. Hence, it bears the same cost as the cost of equity share capital.

Cost of Preference Capital is the discount rate that equates the present value of after tax interest payment cash outflows to the current market value of the Preference Share Capital.

2.3 Capital Asset Pricing Model

Cost of Debt Capital and cost of Preference Share Capital are easy to calculate as they depend on actual after tax cash outflows on account of interest payment but calculation of cost of Equity Capital is little tough as it depends on market expected rate of return. There are many theories to calculate cost of Equity Capital. Out of all those theories Capital Asset Pricing Model (CAPM) is the most widely used method of calculating the Cost of Equity Capital. Under CAPM cost of Equity Capital is expressed as

Risk Free Rate + Specific Risk Premium

or Risk Free Rate + Beta x Equity Risk Premium

or Risk Free Rate + Beta x (Market Rate - Risk Free Rate)

The risk free rate represents the most secure return that can be achieved. There is no consensus among the practitioners regarding risk free rate.

Specific Risk Premium is a multiple of Beta and Equity Risk Premium. Equity Risk Premium is almost same for all the listed companies in the stock market. Unless the volatility of share prices and share market indices of two companies are same, their Beta will be different.

2.4 Beta

Beta is a relative measure of volatility that is determined by comparing the return on a share to the return on the stock market. In simple terms, greater the volatility riskier the share and higher the Beta. If a company is affected by the macroeconomic factors in the same way as the market is, then the company will have a Beta of one and will be expected to have returns equal to the market. A company having a Beta of 1.2 implies that if stock market increases by 10% the company's share price will increase by 12% (i.e., 10% × 1.2) and if the stock market decreases by 10% the company's share price will decrease by 12%. Beta is a statistical measure of volatility and is calculated as the Covariance of daily return on stock market indices and the return on daily share prices of a particular company divided by the Variance of the return on daily Stock Market indices. While considering market index a broad based index like S & P 500 should be considered.

For the companies, which are not listed in stock exchanges, beta of the similar industry may be considered after transforming it to un-geared beta and then re-gearing it according to the debt equity ratio of the company. The formula for un-gearing and gearing beta is shown below.

Ungeared Beta = Industry Beta / [1 + (1–Tax Rate) (Industry Debt Equity Ratio)]

Geared Beta = Ungeared Beta x [1 + (1 – tax rate) (Debt Equity Ratio)]

2.5 Equity Risk Premium

Equity Risk Premium is the excess return above the risk free rate that investors demand for holding risky securities. It is calculated as "Market rate of Return (MRR) minus Risk Free Rate". Market rate may be calculated from the movement of share market indices over a period of an economic cycle basing on moving average to smooth out abnormalities. Practitioners do not have a consensus on the methodology of calculation of MRR. Many of them do not calculate the MRR but on an ad-hoc basis they assume 8% to 12% as the equity risk premium.

Example: An hypothetical example of computing cost of capital of a company with a 12.5% Debt Capital of ₹ 2,000 crores (redeemable in 10 years), Equity Capital of ₹ 500 crores, Reserves & Surplus of ₹ 7,500 crores, and without taking Preference Share Capital is shown below. Assuming the return on Tax-free Government Bonds at 11%, a Beta of 1.06, market rate at 18% and corporate tax rate at 30%, the cost of capital employed of the company works out as shown below:

Capital employed = Debt Capital + Equity Capital

= ₹ 2,000 crores + ₹ 500 crores + ₹ 7,500 crores = ₹ 10,000 crores

Equity to Capital Employed = 8,000 / 10,000 = 0.80

Debt to Capital Employed = 2,000 / 10,000 = 0.20

Debt cost after tax = 12.5% – (12.5 x 30%) = 8.75%

Cost of Equity Capital = Risk free rate + Beta (Market rate – Risk free rate)

= 11% + 1.06 (18-11) = 11% + 7.42% = 18.42%

Weighted Average Cost of Capital (WACC) = (0.80 × 18.42%) + (0.20 × 8.75%) = 16.49%

Cost of Capital Employed = 10,000 crores x 16.49% = 1649 crores

Maintenance of shareholders' value (EVA) will require the company to earn a NOPAT over ₹1649 crores i.e., over its cost of capital. In other words, to maintain shareholders' value to positive or zero, the % of NOPAT to Capital Employed should be greater or atleast be equal to the % of WACC. For the sake of simplicity, if we presume NOPAT is equal to Accounting Profit then, to maintain shareholder's value as positive or zero, Return on Capital employed (ROCE) has to be more than or equal to WACC. In case of a banking and financial company, return on Tier I and Tier II capital has to be more than WACC to generate a positive EVA.

Illustration 1

LH Ltd. provides you with the following summarized balance sheet as at 31st March 2017.

(₹ in lakhs)

Liabilities		*Amount*	*Assets*	*Amount*
Share Capital	*981.46*		*Fixed Assets (Net)*	*2,409.90*
Reserves and			*Current Asset*	*50.00*
Surplus	*1,313.62*	*2,295.08*		
Long term Debt		*144.44*		
Sundry Creditors		*20.38*		
		2,459.90		*2,459.90*

Additional information provided is as follows:

(i) Profit before interest and tax is ₹ 2,202.84 lakhs

(ii) Interest paid is ₹ 13.48 lakhs.

(iii) Tax rate is 40%

(iv) Risk Free Rate = 11.32%

(v) Long term Market Rate = 12%

(vi) Beta = 1.62 (highest during the period)

(vii) Cost of equity = 12.42% and cost of debt = 5.6%.

You are required to calculate Economic Value Added of LH Ltd.

Solution

EVA = NOPAT - Weighted Average cost of Capital Employed

$$WACC = \frac{2,295.08}{2,439.52^*} \times 12.42\% + \frac{144.44}{2,439.52^*} \times 5.6\%$$

= 11.69% + 0.33% = 12.02%

* 2,295.08 + 144.44 = ₹2,439.52 lakhs

NOPAT = [PBIT·- Interest – Tax] – Interest (net of tax)

	₹ in lakhs
PBIT	2,202.84
Less: Interest	(13.48)
	2,189.36
Less: Tax @ 40%	(875.74)
	1,313.62
Add: Interest (net of tax) [13.48 x (1 – 0.40)]	8.09
	1,321.71

EVA = NOPAT - WACC x CE

= 1,321.71 lakhs – (12.02% x 2,439.52 lakhs)

= 1,321.71 lakhs - 293.23 lakhs = ₹ 1,028.48 lakhs.

Illustration 2

The Capital Structure of Define Ltd. is as under:

- *80,00,000, Equity Shares of ₹ 10 each* = *₹ 800 lakhs*
- *1,00,000, 12% Preference Shares of ₹ 250 each* = *₹ 250 lakhs*
- *1,00,000, 10% Debentures of ₹ 500 each* = *₹ 500 lakhs*
- *Terms Loan from Bank @ 10%* = *₹ 450 lakhs*

The Company's Statement of Profit and Loss for the year showed PAT of ₹ 100 lakhs, after appropriating Equity Dividend @ 20%. The Company is in the 40% tax bracket. Treasury Bonds carry 6.5% interest and beta factor for the Company may be taken as 1.5. The long run market rate of return may be taken as 16.5%. Calculate Economic Value Added.

Solution

Computation of Economic Value Added

Particulars		*₹ in lakhs*
Profit before Interest and Taxes (from W.N.1)		578.33
Less: Interest (50 + 45)		(95.00)
		483.33
Less: Taxes		(193.33)
		290
Add: Interest (net of tax) [95 x (1 - 0.40)]		57
Net Operating Profit After Taxes		347
Less: Cost of Capital (WACC x Capital Employed)	(2,000 x 12.95%)	(259.00)
Economic Value Added		88.00

Working Notes:

1. Calculation of Profit Before Tax

Particulars	*Computation*	*₹ in lakhs*
Profit before Interest and Taxes	Balancing figure	578.33
Less: Interest on Debentures	10% x ₹ 500 lakhs	(50.00)
Interest on Bank Term Loan	10% x ₹ 450 lakhs	(45.00)
Profit Before Tax	(₹ 290.00 ÷ 60%)	483.33
Less: Tax @ 40%	(₹ 290.00 ÷ 60%) x 40%	(193.33)
Profit after Tax		290.00
Less: Preference Dividend	12% x ₹ 250 lakhs	(30.00)
Residual earnings for equity shareholders		260.00
Less: Equity Dividend	20% x ₹ 800 lakhs	(160.00)
Net balance in Profit and Loss Account	Given	100.00

2. Computation of Cost of Equity:

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

= 6.5% + 1.5 (16.5% - 6.5%) = 21.5%

3. Cost of Debt

Interest	₹ 45 lakhs
Less: Tax (40%)	(₹ 18 lakhs)
Interest after Tax	₹ 27 lakhs

Cost of Debt = $\frac{27}{450} \times 100 = 6\%$

4. Computation of Weighted Average Cost of Capital

Component	*Amount*	*Ratio*	*Individual Cost*	*WACC*
Equity	₹ 800 lakhs	800 ÷ 2000 =0.40	K_e = 21.5	8.6
Preference	₹ 250 lakhs	250 ÷2000 = 0.125	K_e = 12	1.5
Debt (500+ 450)	₹ 950 lakhs	950 ÷ 2000 = 0.475	K_e = 6	2.85
Total	₹ 2,000 lakhs		K_e	12.95%

Illustration 3

The following information (as of 31-03-2017) is supplied to you by Fox Ltd.:

			(₹ in crores)
(i)	*Profit after tax (PAT)*		*205.90*
(ii)	*Interest*		*4.85*

(iii)	*Equity Share Capital*	*40.00*	
	Accumulated surplus	*700.00*	
	Shareholders fund	*740.00*	
	Loans (Long term)	*37.00*	
	Total long term funds		*777.00*
(iv)	*Market capitalization*		*2,892.00*
Additional information:			
(a)	*Risk free rate*		*12.00 percent*
(b)	*Long Term Market Rate (Based on BSE Sensex)*		*15.50 percent*
(c)	*Effective tax rate for the company*		*25.00 percent*
(d)	*Beta (β) for last few years*		
	Year		
	1	*0.48*	
	2	*0.52*	
	3	*0.60*	
	4	*1.10*	
	5	*0.99*	

Using the above data you are requested to calculate the Economic Value Added of Fox Ltd. as on 31st March, 2017.

Solution

Net Operating Profit After Tax (NOPAT) = Profit After Tax (PAT) + Interest (net of tax)

= 205.90 + 4.85 x (1-0.25) = ₹ 209.54 crores

Debt Capital		₹ 37 crores
Equity capital (40 + 700)	=	₹ 740 crores
Capital employed	=	₹ 37 + ₹ 740 = ₹ 777 crores
Debt to capital employed	=	₹ 37 crores/₹ 777 crores = 0.0476
Equity to capital employed	=	₹ 740 crores /₹ 777 crores =0.952
Interest cost before Tax		₹ 4.85 crores
Less: Tax (25% of ₹ 4.85 crores)		(₹ 1.21 crores)
Interest cost after tax		₹ 3.64 crores
Cost of debt	=	(₹ 3.64 crores/ ₹ 37 crores) x 100
	=	9.83%

According to Capital Asset Pricing Model (CAPM)

Beta for calculation of EVA should be the highest of the given beta for the last few years. Accordingly,

Cost of Equity Capital = Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 12% + 1.10 × (15.50% - 12%)

= 12% + 1.10 × 3.5% = 15.85%

Weighted Average Cost of Capital (WACC) = Equity to Capital Employed (CE) x Cost of Equity Capital + Debt to CE x Cost of Debt

= 0.952× 15.85% + 0.0476 × 9.83%

= 15.09% + 0.47% = 15.56%

Cost of Capital Employed (COCE) = WACC × Capital Employed

= 15.56% × ₹ 777 crores = ₹ 120.90 crores

Economic Value Added (E.V.A.) = NOPAT – COCE

= ₹ 209.54 crores – ₹ 120.90 crores = ₹ 88.64 crores

2.6 EVA – As a Management Tool

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.

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 shareholder's wealth and is superior to traditional financial metrics such as PAT or percentage rate of return measures such as ROCE, or ROE.

In addition, EVA is a management tool to focus managers on the impact of their decisions in increasing shareholder's 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's 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.

EVA companies typically find benefits come from three main areas: better asset efficiency; improved business and financial literacy at all levels, and more owner-like behaviour by managers. The EVA approach to management has been endorsed by many influential investors and independent experts. EVA has already become the primary focus in many companies around the world across a wide range of industry sectors. In India NIIT, Tata

Consultancy Services and the Godrej Group and number of other companies have formally adopted the EVA framework.

However, the practitioners differ with one another in regard to the methodology of calculation of adjustments required for conversion of accounting profit to NOPAT, market rate, beta and risk free rate.

The technique of computing EVA requires making several adjustments in arriving at the NOPAT. The developers of the concept have identified 164 potential adjustments to obtain a ‘real’ reflection of a company’s performance.

Omitting even a few may lead to serious errors. A large number of adjustments tend to complicate the concept and put off the management. Thus, it has been suggested that companies identify four-five critical adjustments that are simple to implement.

There are also no standard ways or statutory guidelines for making the adjustments. Consequently, different companies can adopt ways of adjusting the NOPAT. This could impair seriously the comparability of EVA figures of different companies. Though a useful measure, until proper standards are evolved, EVA will remain at best an internal measure of shareholder value.

UNIT 3: MARKET VALUE ADDED

3.1 Introduction

Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors (both bondholders and shareholders). In other words, it is the sum of all capital claims held against the company plus the market value of debt and equity. If MVA is positive, the firm has added value. If it is negative the firm has destroyed value.

The formula for MVA is:

MVA = V – K

where:

- *MVA* is market value added
- *V* is the market value of the firm, including the value of the firm's equity and debt
- *K* is the amount invested in the firm

MVA is the present value of a series of EVA values. MVA is economically equivalent to the traditional net present value measure of worth for evaluating an after-tax cash flow profile of a project if the cost of capital is used for discounting.

The higher the MVA, the better it is. A high MVA indicates the company has created substantial wealth for the shareholders. A negative MVA means that the value of the actions and investments of management is less than the value of the capital contributed to the company by the capital markets, meaning wealth or value has been destroyed.

The aim of the company should be to maximize MVA. The aim should not be to maximize the value of the firm, since this can be easily accomplished by investing ever-increasing amounts of capital.

Illustration 1

The capital structure of W Ltd. whose shares are quoted on the NSE is as under:

Equity Shares of ₹ 100 each fully paid	*₹ 505 lakhs*
9% Convertible Pref. Shares of ₹ 10 each	*₹ 150 lakhs*
12% Secured Debentures of ₹ 10 each	*5,00,000*
Reserves	*₹ 101 lakhs*
Statutory Fund	*₹ 50,50,000*

The Statutory Fund is compulsorily required to be invested in Government Securities. The ordinary shares are quoted at a premium of 500%; Preference Shares at ₹ 30 per share and debentures at par value.

You are required to ascertain the Market Value added of the company and also give your assessment on the market value added as calculated by you.

Solution

Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors (both debenture holders and shareholders). In other words, it is the sum of all capital claims held against the company plus market value of debt and equity. If MVA is positive, firm has added value.

Market Value Added = Market value of firm less amount invested in the firm

		₹ in lakhs
Equity Share Capital (market value)		
(505 lakhs x 600%)		3030
Preference share capital (15,00,000 x 30)		450
Debentures		50
Current market value of firm		3,530
Less: Equity Share Capital	505	
Preference share capital	150	
Reserves	101	
Debentures	50	
Statutory Reserve	50.50	(856.50)
Market Value Added		2,673.50
The significant Market Value addition implies that the management of W Ltd. has created wealth for its shareholders and that market investors are willing to pay a price greater than the historical net worth of the company.		

3.2 Relationship between EVA and Market Value Added

1) EVA and MVA tend to go in the same direction (pos. correlation). However, MVA depends on stock prices/future expectations of investors.
2) EVA is used for managerial assessment more than MVA. EVA reflects performance over a year, while MVA reflects performance over the company's whole life. EVA can be applied to individual decisions or other units of a large corporation, while MVA must be applied to the whole company.
3) The relationship between EVA and Market Value Added is more complicated than the one between EVA and Firm Value.
4) The market value of a firm reflects not only the Expected EVA of Assets in Place but also the Expected EVA from Future Projects
5) To the extent that the actual economic value added is smaller than the expected EVA the market value can decrease even though the EVA is higher.

This does not imply that increasing EVA is bad from a corporate finance standpoint. In fact, given a choice between delivering a "below-expectation" EVA and no EVA at all, the firm should deliver the "below-expectation" EVA. It does suggest that the correlation between increasing year-to-year EVA and market value will be weaker for firms with high anticipated growth (and excess returns) than for firms with low or no anticipated growth. It does suggest also that "investment strategies" based upon EVA have to be carefully constructed, especially for firms where there is an expectation built into prices of "high" surplus returns.

3.3 Benefits of Market Value Added

Market value is the first thing that an investor should look for while looking into purchasing a new stock. The market value will always determine what an investment such as a stock can be sold for. When market value is added to an investment, the value of the investment will be increased. The MVA benefits the company by -

1. **Indicating a Company's Worth:** Market value is generally determined by subtracting a company's debt from the value of the company's assets. The difference between a company's assets and the debt is the market value. Always try to determine a company's debt load before purchasing a stock, because the amount of the debt will affect the company's value. A company with a lot of debt will be worth less, while a company with little or no debt will be worth more. Debt decreases the market value of a company because companies with a lot of debt will have less capital available for expansion and other profit-making activities. The more debt a company has the less money it can invest in itself. A company's market value will be increased when the company's debt is reduced or paid off. The company's market value will fall when it takes on more debt.

2. **Making shares easier to sell:** An investor will always have a fairly easy time selling a share with high market value. One may not be able to sell a share with little market value. Share prices often rise considerably after a well-publicized event; that indicates that market value has increased. An example of this would be the release of a new product by Apple which usually increases the value of that company's share. The best time to sell shares is usually after the stock's market value publicly increases. A bad time to sell share would be after an event that would lower the market value, such as a reported drop in sales figures.

3. **Making good investment opportunities:** It can often be very difficult for investors to spot companies that are adding or losing market value. A careful and good research of market will help an investor to locate companies that are adding market value. This will enable an investor to reap the advantages of added market value. A company's ability to add market value should always be the first criteria by which shares are evaluated.

The More Appropriate Measure: MVA is an ideal measure of wealth creation in the long term, but at the same time it suffers from the short- term vagaries of share-market sentiments. If the markets are in the midst of a bull run, companies find their MVA zooming up to stratospheric proportions; if they do a sudden flip and enter the bear- mode, companies find their MVA plummeting. That is one reason why companies should focus on improving their fundamental economic performance as measures by EVA.

Over the long-term, it is improvement in EVA and not accounting results that drives wealth creation. For the mathematically inclined, the MVA of a company is the net present value (NPV) of all its future EVAs. Thus, a company that continues to improve economic value added, year after year will, sooner than later, find favour with investors. EVA tells us how much shareholder wealth the business has created in a given time period (this is usually a year, but companies can and do use shorter time periods to aid the decision- making process) and provides a road- map to creating wealth at a business unit level within a company. Simply defined, EVA is the economic profit that remains after deducting the cost of all the capital employed (both debt and equity). The power of EVA comes from the fact that it marries both the income statement and the balance sheet and reflects the economic reality after eliminating accounting distortions.

The role EVA in driving a company's ability to create wealth is evident in a comparison of Reliance Industries Ltd (RIL) and Indian Oil Corporation (IOC) from the case study. As per the case study, Indian Oil Corporation employs around twice as much capital as RIL, has five times the revenues, and is comparable in terms of market value (RIL ranks second and IOC fourth). Purely from this perspective, there seems to be nothing very different between the two companies. However, RIL, with its MVA of ₹ 19,346 crore ranks fourth on the wealth- creators list while IOC, with its MVA of a negative ₹ 8,153 crore, comes at number 499. The difference in their wealth creation is driven by their fundamental economic performance. RIL has an EVA of ₹ 308 crores while IOC's EVA is a negative 1,500 crore. EVA is superior to conventional measures because it replicates the discipline of the capital markets within the firm by explicitly measuring Return on Capital Employed (ROCE) relative to the cost of capital. ROCE is, in turn, driven by a company's net profit margin and the efficiency of asset use. It is not a surprise to see that the wealth- creator's ROCE is nearly one and a half times higher than that of wealth destroyers. However, it is interesting to note that the profit margins earned by both the wealth creators and the destroyers are pretty much the same and it is the ability to utilise capital efficiently that differentiates these two groups. That's why investors who choose where to put their money by simply looking at net profits often go wrong. And that's why wealth destroyers would greatly benefit from the discipline of making EVA - maximising tradeoffs between margins and capital efficiency in their various strategic and operational decisions.

3.4 Limitations of Market Value Added

1. MVA does not take into account the opportunity costs of the invested capital.
2. MVA does not consider the interim cash returns to the shareholders.
3. MVA cannot be calculated at divisional or business unit levels.

UNIT 4: SHAREHOLDERS' VALUE ADDED

4.1 Introduction

Shareholders' Value Added is a value-based performance measure of a company's worth to shareholders. The basic calculation is net operating profit after tax (NOPAT) minus the cost of capital from the issuance of debt and equity, based on the company's weighted average cost of capital (WACC).

4.2 Implications

Shareholder value is a term used in many ways:

- To refer to the market capitalization of a company (rarely used)
- To refer to the concept that the primary goal for a company is to enrich its shareholders (owners) by paying dividends and/or causing the stock price to increase
- To refer to the more specific concept that planned actions by management and the returns to shareholders should outperform certain bench-marks such as the cost of capital concept. In essence, the idea is that shareholders money should be used to earn a higher return then they could earn themselves by investing in risk free bonds.

  For example - For a publicly traded company, SV is the part of its capitalization that is equity as opposed to long-term debt. In the case of only one type of stock, this would roughly be the number of outstanding shares times current share price. Things like dividends augment shareholder value while issuing of shares (stock options) lower it. This *Shareholder value added* should be compared to average/required increase in value, i.e. cost of capital.

  For a privately held company, the value of the firm after debt must be estimated using one of several valuation methods, such as discounted cash flow or others.

  This management principle, also known under value based management, states that management should first and foremost consider the interests of shareholders in its business decisions. Although this is built into the legal premise of a publicly traded company, this concept is usually highlighted in opposition to alleged examples of CEO's and other management actions which enrich themselves at the expense of shareholders. Examples of this include acquisitions which are dilutive to shareholders, that is, they may cause the combined company to have twice the profits for example but these might have to be split amongst three times the shareholders

  As shareholder value is difficult to influence directly by any manager, it is usually broken down in components, so called value drivers. A widely used model comprises 7 drivers of shareholder value, giving some guidance to managers:

- Revenue, Operating Margin, Cash Tax Rate, Incremental Capital Expenditure, Investment in Working Capital, Cost of Capital, Competitive Advantage Period.

  Based on these seven components, all functions of a business plan and show how they influence shareholder value. A prominent tool for any department or function to prove its value are so called shareholder value maps that link their activities to one or several of these seven components.

UNIT 5: HUMAN RESOURCE REPORTING

5.1 Introduction

Human beings are considered central to achievement of productivity, well above equipment, technology and money. Human Resource Reporting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

The necessity of Human resource reporting arose primarily as a result of the growing concern for human relations management in industry since the sixties of this century. Behavioural scientists (like R Likert, 1960), concerned with the management of organisations, pointed out that the failure of accountants to value human resources was a serious handicap for effective management.

Many people pointed out that it is very difficult to value human resources. Some others have cautioned that people are sensitive to the value others place on them. A machine never reacts to an over or under-valuation of its capacity, but an employee will certainly react to such distortion. Conventionally human resources are treated just as any other services purchased from outside the business unit. As a result, conventional balance sheets fail to reflect the value of human assets and hence distort the value of the business. The treatment of human resources as assets is desirable with a view to ensuring comparability and completeness of financial statements and more efficient allocation of funds as well as providing more useful information to management for decision-making purposes.

The committee on HRA of the American Accounting Association defined HRA as "the process of identifying and measuring data about human resources and communicating this information to interested parties". However, "Human Resources" are not yet recognised as 'assets' in the Balance Sheet. The measures of net income which are provided in the conventional financial statement do not accurately reflect the level of business performance. Expenses relating to the human organisation are charged to current revenue instead of being treated as investments to be amortised over the economic service life, with the result that the magnitude of net income is significantly distorted.

However, Human Resource Accounting (HRA) involves accounting for the company's management and employees as human capital that provides future benefits. In the HRA approach, expenditures related to human resources are reported as assets on the balance sheet as opposed to the traditional accounting approach which treats costs related to a company's human resources as expenses on the income statement that reduce profit.

5.2 Models of HRA

Quite a few models have been suggested from time to time for the measurement and valuation of human assets. Some of these models are briefly discussed below:

(A) Cost Based Models

(1) Capitalisation of historical costs: R. Likert and his associates at R.G. Barry Corporation in Ohio, Columbia (USA) developed this model in 1967. It was first adopted for managers in 1968 and then extended to other employees of R.G. Barry Corporation. The method involves capitalising of all costs related with making an employee ready for providing service – recruitment training, development etc. The sum of such costs for all the employees of the enterprise is taken to represent the total value of human resources. The value is amortised annually over the expected length of service of individual employees. The unamortised cost is shown as investment in human assets. If an employee leaves the firm (i.e. human assets expire) before the expected service life period, the net asset value to that extent is charged to current revenue.

This model is simple and easy to understand and satisfies the basic principle of matching cost and revenues. But historical costs are sunk costs and are irrelevant for decision- making. This model was severely criticised because it failed to provide a reasonable value to human assets. It capitalises only training and development costs incurred on employees and ignores the future expected cost to be incurred for their maintenance. This model distorts the value of highly skilled human resources. Skilled employees require less training and therefore, according to this model, will be valued at a lesser cost. For all these reasons, this model has now been totally rejected.

(2) Replacement Cost: The Flamholtz Model (1973): Replacement cost indicates the value of sacrifice that an enterprise has to make to replace its human resource by an identical one. Flamholtz has referred to two different concepts of replacement cost *viz* 'individual replacement cost' and 'positional replacement cost'. The 'individual replacement cost' refers to the cost that would have to be incurred to replace an individual by a substitute who can provide the same set of services as that of the individual being replaced. The 'positional replacement cost', on the other hand, refers to the cost of replacing the set of services required of any incumbent in a defined position. Thus the positional replacement cost takes into account the position in the organisation currently held by an employee and also future positions expected to be held by him.

However, determination of replacement cost of an employee is highly subjective and often impossible. Particularly at the management cadre, finding out an exact replacement is very difficult. The exit of a top management person may substantially change the human asset value.

(B) Economic Value Models

(1) Opportunity Cost: The Hekimian and Jones Model (1967): This model uses the opportunity cost that is the value of an employee in his alternative use, as a basis for estimating the value of human resources. The 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, therefore, will have a value only if it is a scarce resource, that is, when its employment in one division denies it to another division.

One of the serious drawbacks of this method is that it excludes employees of the type which can be 'hired' readily from outside the firm, so that the approach seems to be concerned with only one section of a firm's human resources, having special skills within the firm or in the labour market. Secondly, circumstances in which managers may like to bid for an employee would be rare, in any case, not very numerous.

(2) Discounted wages and salaries: The Lev and Schwartz Model (1971): This model involves determining the value of human resources as the present value of estimated future earnings of employees (in the form of wages, salaries etc.) discounted by the rate of return on investment (cost of capital). According to Lev and Schwartz, the value of human capital embodied in a person of age τ is the present value of his remaining future earnings from employment. Their valuation model for a discrete income stream is given by the following:

$$V\tau = \sum_{t=\tau}^{T} \frac{I(t)}{(1+r)^{r-\tau}}$$

Where,

$V\tau$ = the human capital value of a person τ years old.

I(t) = the person's annual earnings upto retirement.

r = a discount rate specific to the person.

T = retirement age.

However, the above expression is an ex-post computation of human capital value at any age of the person, since only after retirement can the series I(t) be known. Lev and Schwartz, therefore, converted their ex-post valuation model to an ex-ante model by replacing the observed (historical) values of I(t) with estimates of future annual earnings denoted by I*(t). Accordingly, the estimated value of human capital of a person years old is given by:

$$V_\tau^* = \sum_{t=\tau}^{T} \frac{I^*(t)}{(1+r)^{t-\tau}}$$

Lev and Schwartz again pointed out the limitation of the above formulation in the sense that the above model ignored the possibility of death occurring prior to retirement age. They suggested that the death factor can be incorporated into the above model with some modification and accordingly they recommended the following expression for calculating the expected value of a person's human capital:

$$E(V_\tau^*) = \sum_{t=\tau}^{T} P_\tau(t+1) \sum_{t=\tau}^{T} \frac{I_i^*}{(1+r)^{t-\tau}}$$

Where, P (t) is the probability of a person dying at age 't'.

Lev and Schwartz have shown in the form of a hypothetical example the method of computing the firm's value of human capital. Employees of the hypothetical firm have been decomposed by age groups and degrees of skill and the average annual earnings for each age and skill group have been ascertained. Finally, the present values of future earnings for each group of employees have been calculated on the basis of a capitalisation rate. The sum of all such present value of future earnings was taken as the firm's value of human capital.

In this model, wages and salaries are taken as surrogate for the value of human assets and therefore it provides a measure of 'future estimated cost'. Although according to economic theory, the value of an asset to a firm lies in the rate of return to be derived by the firm from its employment, Lev and Schwartz model surrogated wages and salaries of the employees for the income to be derived from their employment. They felt that income generated by the workforce is very difficult to measure because income is the result of group effort of all factors of production.

However, this model is subject to the following criticisms:

(a) A person's value to an organisation is determined not only by the characteristics of the person himself (as suggested by Lev and Schwartz) but also by the organisational role in which the individual is utilised. An individual's knowledge and skill is valuable only if these are expected to serve as a means to given organisational ends.

(b) The model ignores the possibility and probability that the individual may leave an organisation for reasons other than death or retirement. The model's expected value of human capital is actually a measure of the expected 'conditional value' of a person's human capital – the implicit condition is that the person will remain in an organisation until death or retirement. This assumption is not practically social.

(c) It ignores the probability that people may make role changes during their careers. For example, an Assistant Engineer will not remain in the same position throughout his expected service life in an organisation.

In spite of the above limitations, this model is the most popular measure of human capital both in India and abroad.

(3) Stochastic process with service rewards: Flamholtz (1971) Model: Flamholtz (1971) advocated that an individual's value to an organisation is determined by the services he is expected to render. An individual move through a set of mutually exclusive organisational roles or service states during a time interval. Such movement can be estimated probabilistically. The expected service to be derived from an individual is given by:

$$E(S) = \sum_{i=1}^{n} S_i P(S_i)$$

Where S_i represent the quantity of services expected to be derived in each state and $P(S_i)$ is the probability that they will be obtained.

However, economic valuation requires that the services of the individuals are to be presented in terms of a monetary equivalent. This monetary representation can be derived in one of the two ways:

(a) by determining the product of their quantity and price, and

(b) by calculating the income expected to be derived from their use.

The present worth of human capital may be derived by discounting the monetary equivalent of expected future services at a specified rate (e.g. interest rate).

The major drawback of this model is that it is difficult to estimate the probabilities of likely service states of each employee. Determining monetary equivalent of service states is also very difficult and costly affair. Another limitation of this model arises from the narrow view taken of an organisation. Since the analysis is restricted to individuals, it ignores the added value element of individuals operating as groups.

(4) Valuation on group basis: Jaggi and Lau Model: Jaggi and Lau realised that 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 tried to simplify 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.

5.3 Implications of Human Capital Reporting

The relevance of the human resource information lies in the fact that it concerns organisational changes in the firm's human resources. The ratio of human to non-human capital indicates the degree of labour intensity of the enterprise. Reported human capital values provide information about changes in the structure of labour force. Difference between general and specific values of human capital is another source for management analysis – the specific value of human capital is based on firm's wage scale while the general value is based on industry-wise wage scale. The difference between the two is an indicator of the level of the firm's wage scale as compared to the industry.

5.4 HRA in India

HRA is a recent phenomenon in India. Leading public sector units like OIL, BHEL, NTPC, MMTC, SAIL etc. have started reporting 'Human Resources' in their Annual Reports as additional information from late seventies or early eighties. The Indian companies basically adopted the model of human resource valuation advocated by Lev and Schwartz (1971). This is because the Indian companies focused their attention on the present value of employee earnings as a measure of their human capital. However, the Indian companies have suitably modified the Lev and Schwartz model to suit their individual circumstances. For example, BHEL applied Lev and Schwartz model with the following assumptions:

(i) Present pattern of employee compensation including direct and indirect benefits;

(ii) Normal career growth as per the present policies, with vacancies filled from the levels immediately below;

(iii) Weightage for changes in efficiency due to age, experience and skills;

(iv) Application of a discount factor of 12% per annum on the future earnings to arrive at the present value.

However, the application of Lev and Schwartz model by the public sector companies has in many cases, led to over ambitious and arbitrary value of the human assets without giving any scope for interpreting along with the financial results of the corporation. In the Indian context, more particularly in the Public Sector, the payments made to the employees are not directly linked to productivity. The fluctuations in the value of employees' contributions to the organisation are seldom proportional to the changes in the payments to employees. All qualitative factors like the attitude and morale of the employees are out of the purview of Lev and Schwartz model of human resource valuation.

Illustration 1

From the following information in respect of Exe Ltd., calculate the total value of human capital by following Lev and Schwartz model:

Distribution of employees of Exe Ltd.

Age	*Unskilled*		*Semi-skilled*		*Skilled*	
	No	*Av. Annual earnings (₹ '000)*	*No.*	*Av. Annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹'000)*
30-39	*70*	*3*	*50*	*3.5*	*30*	*5*
40-49	*20*	*4*	*15*	*5*	*15*	*6*
50-54	*10*	*5*	*10*	*6*	*5*	*7*

Apply 15% discount factor.

Solution

The present value of earnings of each category of employees by applying 15% discount factor is ascertained as below:

(A) Unskilled employees:

Age group 30-39. Assume that all 70 employees are just 30 years old:

	Present value ₹
₹ 3,000 p.a. for next 10 years	15,057
₹ 4,000 p.a. for years 11 to 20	4,960
₹ 5,000 p.a. for years 21 to 25	1,025
	21,042

Age group 40-49. Assume that all 20 employees are just 40 years old:

₹ 4,000 p.a. for next 10 years	20,076
₹ 5,000 p.a. for years 11 to 15	4,140
	24,216

Age group 50-54: Assume that all 10 employees are just 50 years old:

₹ 5,000 p.a. for next 5 years	16,760

Similarly, present value of each employee under other categories will be calculated.

(B) Semi-skilled employees:

Age group 30-39

	Present value ₹
₹ 3,500 p.a. for next 10 years	17,567
₹ 5,000 p.a. for years 11 to 20	6,200
₹ 6,000 p.a. for years 21 to 25	1,230
	24,997

Age group 40-49

₹ 5,000 p.a. for next 10 years	25,095
₹ 6,000 p.a. for years 11 to 15	4,968
	30,063

Age group 50-54

₹ 6,000 p.a. for next 5 years	20,112

(C) Skilled employees:

Age group 30-39

	Present value ₹
₹ 5,000 p.a. for next 10 years	25,095
₹ 6,000 p.a. for years 11 to 20	7,440
₹ 7,000 p.a. for years 21 to 25	1,435
	33,970

Age group 40-49

₹ 6,000 p.a. for next 10 years	30,114
₹ 7,000 p.a. for years 11 to 15	5,796
	35,910

Age group 50-54

₹ 7,000 p.a. for next 5 years	23,464

Total value of Human Capital

Age	*Unskilled*		*Semi-skilled*		*Skilled*		*Total*	
	No.	Av. Annual *earnings* *(₹ '000)*	No.	Av. Annual *earnings* *(₹ '000)*	No.	Av. Annual *earnings* *(₹ '000)*	No.	Av. Annual *earnings* *(₹ '000)*
30-39	70	14,72,940	50	12,49,850	30	10,19,100	150	37,41,890
40-49	20	4,84,320	15	4,50,945	15	5,38,650	50	14,73,915
50-54	10	1,67,600	10	2,01,120	5	1,17,320	25	4,86,040
	100	21,24,860	75	19,01,915	50	16,75,070		57,01,845

Illustration 2

From the following details, compute the total value of human resources of skilled and unskilled group of employees according to Lev and Schwartz (1971) model:

		Skilled	*Unskilled*
(i)	*Annual average earning of an employee till the retirement age.*	*60,000*	*40,000*
(ii)	*Age of retirement*	*65 years*	*62 years*
(iii)	*Discount rate*	*15%*	*15%*
(iv)	*No. of employees in the group*	*30*	*40*
(v)	*Average age*	*62 years*	*60 years*

Solution

Value of Employees as per Lev and Schwartz method:

$$V = \sum_{t=\tau}^{t} \frac{I(t)}{(1+r)^{t-\tau}}$$

Where,

V = the human capital value of a person.

I(t) = the person's annual earnings up to retirement.

r = a discount rate specific to the person.

t = retirement age.

Value of Skilled Employees:

$$= \frac{60,000}{(1+0.15)^{65\text{-}62}} + \frac{60,000}{(1+0.15)^{65\text{-}63}} + \frac{60,000}{(1+0.15)^{65\text{-}64}}$$

$$= \frac{60{,}000}{(1+0.15)^3} + \frac{60{,}000}{(1+0.15)^2} + \frac{60{,}000}{(1+0.15)^1}$$

= ₹ 39,450.97 + ₹ 45,368.62 + ₹ 52,173.91 = ₹ 1,36,993.50

Total value of skilled employees is

₹ 1,36,993.50 x 30 employees= ₹ 41,09,805

Value of Unskilled Employees:

$$= \frac{40{,}000}{(1+0.15)^{62\text{-}60}} + \frac{40{,}000}{(1+0.15)^{62\text{-}61}}$$

$$= \frac{40{,}000}{(1+0.15)^2} + \frac{40{,}000}{(1+0.15)^1}$$

= ₹ 30,245.74 + ₹ 34,782.60 = ₹ 65,028.34

Total value of unskilled employees = ₹ 65,028.34 x 40 employees= ₹ 26,01,133.60

Total value of human resources (skilled and unskilled)

= ₹ 41,09,805 + ₹ 26,01,133.60= ₹ 67,10,938.60.

Illustration 3

The following information is supplied to you about Lookdown Ltd.

Capital & Reserves	
Equity Shares of ₹ 100 each of which ₹ 75 has been called up	*5,00,000*
Equity Shares in respect of which calls are in arrear @ 25 per share	*₹ 1,00,000*
General Reserve	*₹ 10,00,000*
Profit & Loss account (balance at beginning of the year)	*(₹ 25,00,000)*
Profit/(loss) for the year	*(₹ 1,80,000)*
Industry Average Profitability	*12.50%*
8% Debentures of ₹ 10 each	*8,00,000*
Lookdown Ltd. is proposing to hire the services of Mr. X to turn the company around.	
Minimum take home salary per month demanded by Mr. X	*₹ 4,00,000*
Average Income tax rate on salaries after considering the impact of ₹ 3 lakhs p.a. i.e., the exemption amount	*25%*
Provident Fund contribution by Employer per month	*₹ 50,000*
Profits over and above target expected by hiring Mr. X	*10%*

You are required to analyze the proposal and see whether it is worthwhile to employ Mr. X and also suggest the maximum emoluments that could be paid to him.

Note:

(i) PF contributions are tax exempt.

(ii) Take home salary is that remaining after employee's contribution to PF @ ₹ 50,000 per month and after deduction of Income-tax on salary.

Solution

Cost to Company in employing Mr. X

	₹
Salary before tax ₹ 4,00,000 x 12 = $\frac{48,00,000}{0.75}$	64,00,000*
Add: Employee's PF contribution (50,000 x 12)	6,00,000
	70,00,000
Add: Employer's PF contribution (50,000 x 12)	6,00,000
	76,00,000

Capital base

	₹
Equity Share Capital paid up (5,00,000 shares of ₹ 75 each)	3,75,00,000
Less: Calls in arrears	(1,00,000)
	3,74,00,000
General Reserve	10,00,000
Profit & Loss A/c (balance) at the beginning of the year	(25,00,000)
Loss for the year	(1,80,000)
8% Debentures	80,00,000
Capital base	4,37,20,000
Target Profit 12.5% of capital base (4,37,20,000)	54,65,000
Profits achieved due to Mr. X 54,65,000 + 10% (54,65,000)	60,11,500

Maximum emoluments that can be paid to Mr. X = 60,11,500

Thus, the company is advised not to hire him as his CTC ₹ 76,00,000 is more than ₹ 60,11,500.

Illustration 4

Rose Limited provides you the following information on 31st March, 2017:

Capital and Reserves	
Equity share capital of ₹ 10 each of which ₹ 8 has been called up	*8,00,000 shares*
Calls in arrears	*₹ 1,00,000*
General Reserve	*₹ 7,50,000*

50,000, 9% Debentures of ₹ 100 each	*₹ 50,00,000*
Profit/(loss) for the year	*(₹ 2,50,000)*
Industry Average Profitability rate	*12.5%*

The company is proposing to hire the service of Mr. Raman to turn around the company. You are required to determine the maximum salary that could be offered to him if it is expected that after his appointment, the profits of the company will increase by 10% over and above the target profit.

Solution

Calculation of Capital base

	₹
Equity Share Capital paid up (8,00,000 shares of ₹ 8 each)	64,00,000
Less: Calls in arrears	(1,00,000)
	63,00,000
General Reserve	7,50,000
Loss for the year	(2,50,000)
9% Debentures	50,00,000
Capital base	1,18,00,000
Target Profit 12.5% of capital base	14,75,000

Expected profits to be achieved by taking the services of Mr. Raman is ₹ 16,22,500 (i.e. 14,75,000 + 10% of 14,75,000). Therefore, the maximum salary that can be paid to Mr. Raman will be ₹ 16,22,500 p.a.

5.5 Limitations of Human Resource Accounting

The central problem in HRA is not what kind of resources should be treated, but rather when the resources should be recognised. This timing issue is particularly important because human resources are not owned by the firm, while many physical resources are. However, the firm also uses many services from physical resources which it does not own. The accounting treatment for such services should, therefore, be the same as the treatment used for human resources.

Traditional accounting involves treatment of human capital and non-human capital differently. While non-human capital is represented by the recorded value of assets, the only reference to be found in financial statement about human resources are entries in the income statement in respect of wages and salaries, directors' fees etc. But it should be kept in mind that measuring and reporting the value of human assets in financial statements would prevent management from liquidating human resources or overlooking profitable investments in human resources in a period of profit squeeze. But while valuing human assets one should not lose sight of the fact that human beings are highly sensitive to external forces and human skills in an organisation do not remain static. Skill formation, skill obsolescence or utilisation may take a continuous process. Besides, employee attitude, loyalty, commitment, job satisfaction etc. may also influence the way in which human resource skills are utilised. Therefore, human resources should be valued in such a way so as to cover the qualitative aspects of human beings. As human beings are highly susceptible to certain behavioural factors (unlike physical assets), any human resource valuation model without behavioural features can hardly present the value of human assets in an objective manner. However, while attaching respective weightage to behavioural factors, care should be taken to avoid excessive subjectiveness.

FINAL COURSE STUDY MATERIAL

ACCOUNTING PRONOUNCEMENTS

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

The objective of this material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. Students should also supplement their study by reference to the recommended text books. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, this material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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A WORD ABOUT ACCOUNTING PRONOUNCEMENTS

Accounting Standards, and Guidance Notes and other accounting pronouncement issued by the Institute form the strong foundation to act as pillars of sound financial reporting system of a country, which is an integral part of good corporate governance and provides the stakeholders useful information about the entity to make their economic and financial decisions. It may be noted that significant changes are taking place in the area of Accounting Standards and Guidance Notes. Many new Accounting Standards and Guidance Notes have been formulated by the Institute of Chartered Accountants of India keeping in mind the growing importance of financial reporting in the corporate scenario. Existing Accounting Standards and Guidance Notes are also revised from time to time.

Keeping all this in view, it has been decided to publish a separate book containing the Framework for Preparation and Presentation of Financial Statements, Accounting Standards and relevant Guidance Notes. This book is quite handy and will be highly useful for the students since they will get all the relevant accounting pronouncements at one place for easy reference.

This handbook has been divided into three parts for the convenience of the students.

- First part contains the Framework for Preparation and Presentation of Financial Statements which sets out the concepts that underlie the preparation and presentation of financial statements for external users.
- Second part comprises of the existing Accounting Standards, presently applicable to students at CA Final Level by incorporating the relevant announcements issued from time to time.
- Third part of the book carries the applicable Guidance Notes prescribed at CA Final Level.

Happy Reading and Best Wishes!

CONTENTS

PART – I

Framework for the Preparation and Presentation of Financial Statements*

The following is the text of the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India.

Introduction

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:

   (a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

   (b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

   (c) assist the Accounting Standards Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;

   (d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

   (e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

   (f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

2 This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.

3. The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.

4. The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

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*Issued in July 2000.

Scope

5. The Framework deals with:

   (a) the objective of financial statements;

   (b) the qualitative characteristics that determine the usefulness of information provided in financial statements;

   (c) definition, recognition and measurement of the elements from which financial statements are constructed; and

   (d) concepts of capital and capital maintenance.

6. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

7. Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

8. The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

9. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their information needs. These needs include the following:

   (a) *Investors*. The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

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

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

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

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

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

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

10. While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework.

The Objective of Financial Statements

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

13. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information.

14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

18. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

20. The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

Underlying Assumptions

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Consistency

24. In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

Qualitative Characteristics of Financial Statements

25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

26. An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

28. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

29. Information about financial position and past performance is frequently used as the basis for

predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

30. The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal

formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37. The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

Completeness

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

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

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and Fair View

46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

The Elements of Financial Statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

48. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

49. The elements directly related to the measurement of financial position are assets, liabilities and

equity. These are defined as follows:

(a) An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

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

(c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities.

50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 82 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

53. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the enterprise.

55. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential;

thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

57. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

59. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

61. The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

62. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

65. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

66. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

67. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

68. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. These concepts are discussed in paragraphs 101 to 109.

69. Income and expenses are defined as follows:

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

70. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of profit and loss. Criteria for recognition of income and expenses are discussed in paragraphs 81 to 97.

71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

72. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness.

For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

73. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

74. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

75. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

76. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form

of an outflow or depletion of assets or enhancement of liabilities.

78. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

79. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

80. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 101 to 109 of this Framework.

Recognition of the Elements of Financial Statements

81. Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 82. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

82. An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

83. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraph 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

85. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

86. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 82 may qualify for recognition at a later date as a result of subsequent circumstances or events.

87. An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. Thus, in the example given in paragraph 85, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

90. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

93. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

94. Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

97. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

Measurement of the Elements of Financial Statements

98. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

99. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) *Historical cost*. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost*. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value*. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) *Present value*. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

100. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of Capital and Capital Maintenance

Concepts of Capital

101. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

102. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

103. The concepts of capital described in paragraph 101 give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance*. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance*. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

104. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return *on* capital and its return *of* capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

105. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

106. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

107. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

108. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

109. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

PART – II

AS 1 : Disclosure of Accounting Policies*

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

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

2. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed, is necessary if the view presented is to be properly appreciated.

3. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

4. The Institute of Chartered Accountants of India has, in Standards issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.

5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.

6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.

7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as supplementary information.

8. The purpose of this Standard is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

***** Issued in November, 1979.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

Explanation

Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

10. The following have been generally accepted as fundamental accounting assumptions:

a. *Going Concern*

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. *Consistency*

It is assumed that accounting policies are consistent from one period to another.

c. *Accrual*

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard.)

Nature of Accounting Policies

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

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

13. The various standards of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

Areas in which Differing Accounting Policies are Encountered

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

(a) Methods of depreciation, depletion and amortisation

(b) Treatment of expenditure during construction

(c) Conversion or translation of foreign currency items

(d) Valuation of inventories

(e) Treatment of goodwill

(f) Valuation of investments

(g) Treatment of retirement benefits

(h) Recognition of profit on long-term contracts

(i) Valuation of fixed assets

(j) Treatment of contingent liabilities.

15. The above list of examples is not intended to be exhaustive.

Considerations in the Selection of Accounting Policies

16. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

17. For this purpose, the major considerations governing the selection and application of accounting policies are:

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

b. Substance over Form

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

c. Materiality

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

Disclosure of Accounting Policies

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

19. Such disclosure should form part of the financial statements.

20 It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

Main Principles

24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

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

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

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

AS 2 : Valuation of Inventories*

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Standard deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

1. This Standard should be applied in accounting for inventories other than:

- ***(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);***
- ***(b) work in progress arising in the ordinary course of business of service providers;***
- ***(c) shares, debentures and other financial instruments held as stock-in-trade; and***
- ***(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.***

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*.Revised in 1999.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1. Inventories are assets:

- ***(a) held for sale in the ordinary course of business;***
- ***(b) in the process of production for such sale; or***
- ***(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.***

3.2. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) 10, Property, Plant and Equipment.

Measurement of Inventories

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

Cost of Inventories

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. 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. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those cost are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

Cost Formulas

14. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

21. Inventories are usually written down to net realisable value on an item- by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a

classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net 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.

25. An assessment is made of net realisable value as at each balance sheet date.

Disclosure

26. The financial statements should disclose:

- ***(a) the accounting policies adopted in measuring inventories, including the cost formula used; and***
- ***(b) the total carrying amount of inventories and its classification appropriate to the enterprise.***

27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are:

(a) Raw materials and components

(b) Work-in-progress

(c) Finished goods

(d) Stock-in-trade (in respect of goods acquired for trading)

(e) Stores and spares

(f) Loose tools

(g) Others (specify nature)”.

AS 3 : Cash Flow Statements*

Cash Flow Statements

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

This Accounting Standard is not mandatory for Small and Medium Sized Companies and non-corporate entities falling in Level II and Level III as defined in 'Applicability of Accounting Standards to Various Entities.' Such entities are however encouraged to comply with this standard.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

Scope

1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

2. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information

3. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

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*Revised in 1997

[1]Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

4. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions

5. The following terms are used in this Standard with the meanings specified:

5.1. <u>Cash</u> comprises cash on hand and demand deposits with banks

5.2 <u>Cash equivalents</u> are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

5.3. <u>Cash flows</u> are inflows and outflows of cash and cash equivalents.

5.4. <u>Operating activities</u> are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

5.5. <u>Investing activities</u> are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

5.6. <u>Financing activities</u> are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Cash and Cash Equivalents

6. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

7. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

8. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

9. An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

10. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

11. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

13. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

14. An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

15. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles).

These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

16. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

17. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other similar instruments;

(b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

(c) cash repayments of amounts borrowed.

Reporting Cash Flows from Operating Activities

18. An enterprise should report cash flows from operating activities using either:

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) 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.

19. 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.

20. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

(c) 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.

Reporting Cash Flows from Investing and Financing Activities

21. An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis.

Reporting Cash Flows on a Net Basis

22. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

23. Examples of cash receipts and payments referred to in paragraph 22(a) are:

(a) the acceptance and repayment of demand deposits by a bank;

(b) funds held for customers by an investment enterprise; and

(c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayments of:

(a) principal amounts relating to credit card customers;

(b) the purchase and sale of investments; and

(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

24. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;

(b) the placement of deposits with and withdrawal of deposits from other financial enterprises; and

(c) cash advances and loans made to customers and the repayment of those advances and loans.

Foreign Currency Cash Flows

25. Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

26. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

27. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extraordinary Items

28. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

29. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Interest and Dividends

30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

31. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

32. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash

flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

33. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income

34. Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

35. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Subsidiaries, Associates and Joint Ventures

36. When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

37. The aggregate cash flows arising from acquisitions and from disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

38. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

- ***(a) the total purchase or disposal consideration; and***
- ***(b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.***

39. The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-cash Transactions

40. Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

41. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions

from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

(a) the acquisition of assets by assuming directly related liabilities;

(b) the acquisition of an enterprise by means of issue of shares; and

(c) the conversion of debt to equity.

Components of Cash and Cash Equivalents

42. An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

43. In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

44. The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Other Disclosures

45. An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

46. There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

47. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

48. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

Illustration I

Cash Flow Statement for an Enterprise other than a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.

2. Information from the statement of profit and loss and balance sheet is provided to show how the statements of cash flows under the direct method and the indirect method have been derived. Neither the statement of profit and loss nor the balance sheet is presented in conformity with the disclosure and presentation requirements of applicable laws and accounting standards. The working notes given towards the end of this illustration are intended to assist in understanding the manner in which the various figures appearing in the cash flow statement have been derived. These working notes do not form part of the cash flow statement and, accordingly, need not be published.

3. The following additional information is also relevant for the preparation of the statement of cash flows (figures are in ₹ '000).

(a) An amount of 250 was raised from the issue of share capital and a further 250 was raised from long term borrowings.

(b) Interest expense was 400 of which 170 was paid during the period. 100 relating to interest expense of the prior period was also paid during the period.

(c) Dividends paid were 1,200.

(d) Tax deducted at source on dividends received (included in the tax expense of 300 for the year) amounted to 40.

(e) During the period, the enterprise acquired fixed assets for 350. The payment was made in cash.

(f) Plant with original cost of 80 and accumulated depreciation of 60 was sold for 20.

(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign-currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Balance Sheet as at 31.12.1996

(₹ '000)

		1996		*1995*
Assets				
Cash on hand and balances with banks		200		25
Short-term investments		670		135
Sundry debtors		1,700		1,200
Interest receivable		100		–
Inventories		900		1,950
Long-term investments		2,500		2,500
Fixed assets at cost	2,180		1,910	
Accumulated depreciation	(1,450)		(1,060)	
Fixed assets (net)		730		850
Total assets		6,800		6,660
Liabilities				
Sundry creditors		150		1,890

Interest payable	230		100
Income taxes payable	400		1,000
Long-term debt	1,110		1,040
Total liabilities	1,890		4,030
Shareholders' Funds			
Share capital	1,500		1,250
Reserves	3,410		1,380
Total shareholders' funds	4,910		2,630
Total liabilities and shareholders' funds	6,800		6,660

Statement of Profit and Loss for the period ended 31.12.1996

	(₹ '000)
Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administrative and selling expenses	(910)
Interest expense	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item – Insurance proceeds from earthquake disaster settlement	180
Net profit after extraordinary item	3,530
Income-tax	(300)
Net profit	3,230

Direct Method Cash Flow Statement [Paragraph 18(a)]

		(₹ '000)
		1996
Cash flows from operating activities		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	

Net cash from operating activities		1,870
Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (see Note 1)		160
Cash and cash equivalents at end of period (see Note 1)		910

Indirect Method Cash Flow Statement [Paragraph 18(b)]

		(₹ '000)
		1996
Cash flows from operating activities		
Net profit before taxation, and extraordinary item	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expense	400	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(500)	
Decrease in inventories	1,050	
Decrease in sundry creditors	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30

Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (see Note 1)		160
Cash and cash equivalents at end of period (see Note 1)		910

Notes to the cash flow statement (direct method and indirect method)

1. *Cash and Cash Equivalents*

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	1996	**1995**
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	870	160
Effect of exchange rate changes	40	–
Cash and cash equivalents as restated	910	160

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions.

The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

Alternative Presentation (indirect method)

As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometimes presented as follows:

Revenues excluding investment income	30,650
Operating expense excluding depreciation	(26,910)
Operating profit before working capital changes	3,740

Working Notes

The working notes given below do not form part of the cash flow statement and, accordingly, need not be published. The purpose of these working notes is merely to assist in understanding the manner in which various figures in the cash flow statement have been derived. (Figures are in ₹ '000)

1. Cash receipts from customers

Sales	30,650
Add: Sundry debtors at the beginning of the year	1,200

	31,850
Less : Sundry debtors at the end of the year	1,700
	30,150

2. Cash paid to suppliers and employees

Cost of sales		26,000
Administrative and selling expenses		910
		26,910
Add: Sundry creditors at the beginning of the year	1,890	
Inventories at the end of the year	900	2,790
		29,700
Less: Sundry creditors at the end of the year	150	
Inventories at the beginning of the year	1,950	2,100
		27,600

3. Income taxes paid (including tax deducted at source from dividends received)

Income tax expense for the year (including tax deducted at source from dividends received)	300
Add : Income tax liability at the beginning of the year	1,000
	1,300
Less: Income tax liability at the end of the year	400
	900

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities (see paragraph 34).

4. Repayment of long-term borrowings

Long-term debt at the beginning of the year	1,040
Add : Long-term borrowings made during the year	250
	1,290
Less : Long-term borrowings at the end of the year	1,110
	180

5. Interest paid

Interest expense for the year	400
Add: Interest payable at the beginning of the year	100
	500
Less: Interest payable at the end of the year	230
	270

Illustration II

Cash Flow Statement for a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.
2. The illustration is presented using the direct method.

		(₹ '000)
		1996
Cash flows from operating activities		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
Operating profit before changes in operating assets	4,224	
(Increase) decrease in operating assets:		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term securities	(120)	
Increase (decrease) in operating liabilities:		
Deposits from customers	600	
Certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
Net cash from operating activities		3,340
Cash flows from investing activities		
Dividends received	250	
Interest received	300	
Proceeds from sales of permanent investments	1,200	
Purchase of permanent investments	(600)	
Purchase of fixed assets	(500)	
Net cash from investing activities		650
Cash flows from financing activities		
Issue of shares	1,800	
Repayment of long-term borrowings	(200)	
Net decrease in other borrowings	(1,000)	

Dividends paid	(400)	
Net cash from financing activities		200
Net increase in cash and cash equivalents		4,190
Cash and cash equivalents at beginning of period		4,650
Cash and cash equivalents at end of period		8,840

AS 4* : Contingencies[1] and Events Occurring After the Balance Sheet Date

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with the treatment in financial statements of
   (a) contingencies, and
   (b) events occurring after the balance sheet date.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Standard in view of special considerations applicable to them:
   (a) liabilities of life assurance and general insurance enterprises arising from policies issued;
   (b) obligations under retirement benefit plans; and
   (c) commitments arising from long-term lease contracts.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1 A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

3.2 Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

Two types of events can be identified:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

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* Revised in 1995.

[1] All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard.

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(b) ***those which are indicative of conditions that arose subsequent to the balance sheet date.***

Explanation

4. Contingencies

4.1 The term "contingencies" used in this Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

4.2 Estimates are required for determining the amounts to be stated in the financial statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. Accounting Treatment of Contingent Losses

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. Determination of the Amounts at which Contingencies are included in Financial Statements

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. Events Occurring after the Balance Sheet Date

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. Disclosure

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Main Principles

Contingencies[4]

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

> ***(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and***
>
> ***(b) a reasonable estimate of the amount of the resulting loss can be made.***

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.

12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the

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[4] See also footnote 1

balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

14. If an enterprise declares dividends to shareholders after the balance sheet date, the enterprise should not recognise those dividends as a liability at the balance sheet date unless a statute requires otherwise. Such dividends should be disclosed in notes.

15. 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.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Standard, the following information should be provided:

- ***(a) the nature of the contingency;***
- ***(b) the uncertainties which may affect the future outcome;***
- ***(c) an estimate of the financial effect, or a statement that such an estimate cannot be made.***

17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Standard, the following information should be provided:

- ***(a) the nature of the event;***
- ***(b) an estimate of the financial effect, or a statement that such an estimate cannot be made.***

AS 5* : Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

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* Revised in 1997. A limited revision was made in 2001, pursuant to which paragraph 33 has been added in this standard (see footnote 2).

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

Scope

1. This Standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

2. This Standard deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

3. This Standard does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

4. The following terms are used in this Standard with the meanings specified:

4.1. Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

4.2. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

4.3. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

4.4. Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

- ***(a) profit or loss from ordinary activities; and***
- ***(b) extraordinary items.***

Extraordinary Items

8. Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

– attachment of property of the enterprise; or

– an earthquake.

Profit or Loss from Ordinary Activities

12. 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.

13. Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items 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. Disclosure of such information is sometimes made in the notes to the financial statements.

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include:

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Prior Period Items

15. 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.

16. The term ‘prior period items’, as defined in this Standard, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial

statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- ***(a) the period of the change, if the change affects the period only; or***
- ***(b) the period of the change and future periods, if the change affects both.***

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

31. The following are not changes in accounting policies:

(a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

33. A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32 of this Standard should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard.[2]

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[2] As a limited revision to AS 5, the Council of the Institute decided to add this paragraph in AS 5 in 2001. This revision came into effect in respect of accounting periods commencing on or after 1.4.2001 (see 'The Chartered Accountant', September 2001, pp. 342).

AS 7*: Construction Contracts

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

Scope

1. This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

Definitions

2. The following terms are used in this Standard with the meanings specified:

2.1 A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

2.2 A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

2.3 A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

4. For the purposes of this Standard, construction contracts include:

   (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

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* Revised in 2002 and came into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

5. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 22 and 23 in order to determine when to recognise contract revenue and expenses.

Combining and Segmenting Construction Contracts

6. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

7. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

8. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

9. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue

10. Contract revenue should comprise:

(a) the initial amount of revenue agreed in the contract; and

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured.

11. Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events.

The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

12. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

(b) the amount of revenue can be reliably measured.

13. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when:

(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

(b) the amount that it is probable will be accepted by the customer can be measured reliably.

14. Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

(a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(b) the amount of the incentive payment can be measured reliably.

Contract Costs

15. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

16. Costs that relate directly to a specific contract include:

(a) site labour costs, including site supervision;

(b) costs of materials used in construction;

(c) depreciation of plant and equipment used on the contract;

(d) costs of moving plant, equipment and materials to and from the contract site;

(e) costs of hiring plant and equipment;

(f) costs of design and technical assistance that is directly related to the contract;

(g) the estimated costs of rectification and guarantee work, including expected warranty costs; and

(h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance;

(b) costs of design and technical assistance that is not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs.

18. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract;

(b) selling costs;

(c) research and development costs for which reimbursement is not specified in the contract; and

(d) depreciation of idle plant and equipment that is not used on a particular contract.

20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of Contract Revenue and Expenses

21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

22. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) total contract revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;

(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

23. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) it is probable that the economic benefits associated with the contract will flow to the enterprise; and

(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

24. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

26. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

27. When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

28. An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:

(a) each party's enforceable rights regarding the asset to be constructed;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

31. When the outcome of a construction contract cannot be estimated reliably:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

32. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

33. Contract costs recovery of which is not probable are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may, therefore, need to be recognised as an expense immediately include contracts:

(a) which are not fully enforceable, that is, their validity is seriously in question;

(b) the completion of which is subject to the outcome of pending litigation or legislation;

(c) relating to properties that are likely to be condemned or expropriated;

(d) where the customer is unable to meet its obligations; or

(e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

34. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 21 rather than in accordance with paragraph 31.

Recognition of Expected Losses

35. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

36. The amount of such a loss is determined irrespective of:

(a) whether or not work has commenced on the contract;

(b) the stage of completion of contract activity; or

(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 8.

Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

38. An enterprise should disclose:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

39. An enterprise should disclose the following for contracts in progress at the reporting date:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

40. Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

41. An enterprise should present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

42. The gross amount due from customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

43. The gross amount due to customers for contract work is the net amount of:

(a) the sum of recognised losses and progress billings; less

(b) costs incurred plus recognised profits

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

44. An enterprise discloses any contingencies in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[2]. Contingencies may arise from such items as warranty costs, penalties or possible losses.

Illustration

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Disclosure of Accounting Policies

The following are illustrations of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred upto the reporting date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred upto the reporting date bear to the estimated total costs of the contract.

The Determination of Contract Revenue and Expenses

The following illustration illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 21 to 34 of the Standard). (Amounts shown here in below are in ₹ lakhs)

A construction contractor has a fixed price contract for ₹ 9,000 to build a bridge. The initial amount of revenue agreed in the contract is ₹ 9,000. The contractor's initial estimate of contract costs is ₹ 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to ₹ 8,050.

[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

In year 2, the customer approves a variation resulting in an increase in contract revenue of ₹ 200 and estimated additional contract costs of ₹ 150. At the end of year 2, costs incurred include ₹ 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed upto the reporting date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

(amount in ₹ lakhs)

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200
Total contract revenue	9,000	9,200	9,200
Contract costs incurred upto the reporting date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	—
Total estimated contract costs	8,050	8,200	8,200
Estimated Profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed upto the reporting date, ₹ 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the statement of profit and loss in the three years are as follows:

		Recognised in Prior years	Recognised in current year
Year 1			
Revenue (9,000x .26)		2,340	2,340
Expenses (8,050x .26)		2,093	2,093
Profit		247	247
Year 2			
Revenue (9,200x .74)	6,808	2,340	4,468
Expenses (8,200x .74)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200x 1.00)	9,200	6,808	2,392
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance upto the reporting date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

Contract

(amount in ₹ lakhs)

	A	B	C	D	E	Total
Contract Revenue recognised in accordance with paragraph 21	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 21	110	450	350	250	55	1,215
Expected Losses recognised in accordance with paragraph 35	—	—	—	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period in accordance with paragraph 21	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 26	—	60	100	—	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 40)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	—	—	20	—	65
Advances (paragraph 40)	—	80	20	—	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period [paragraph 38(a)]	1,300
Contract costs incurred and recognised profits (less recognised losses) upto the reporting date [paragraph 39(a)]	1,435
Advances received [paragraph 39(b)]	125
Gross amount due from customers for contract work — presented as an asset in accordance with paragraph 41(a)	220
Gross amount due to customers for contract work — presented as a liability in accordance with paragraph 41(b)	(20)

The amounts to be disclosed in accordance with paragraphs 39(a), 41(a) and 41(b) are calculated as follows:

(amount in ₹ lakhs)

	A	B	C	D	E	Total
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15

	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	—	15	220
Due to customers	—	—	—	(20)	—	(20)

The amount disclosed in accordance with paragraph 39(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

AS 9* : Revenue Recognition[1]

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

—the sale of goods,

—the rendering of services, and

—the use by others of enterprise resources yielding interest, royalties and dividends.

2. This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts[3]

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

3. Examples of items not included within the definition of "revenue" for the purpose of this Standard are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

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* Issued in 1985

[1] It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[3] Refer to AS 7 on 'Construction Contracts'.

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Definitions

4. The following terms are used in this Standard with the meanings specified:

4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise[4] from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

4.2 Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

4.3 Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

Explanation

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

6. Sale of Goods

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

6.2 At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a

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[4]The Institute has issued an Announcement in 2005 titled 'Treatment of Inter-divisional Transfers'. As per the Announcement, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9.

government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Standard, are sometimes recognised in the statement of profit and loss and appropriately described.

7. Rendering of Services

7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) ***Proportionate completion method—***Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) ***Completed service contract method—***Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

8.1 The use by others of such enterprise resources gives rise to:

(i) interest—charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties—charges for the use of such assets as know-how, patents, trademarks and copyrights;

(iii) dividends—rewards from the holding of investments in shares.

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8.3 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

8.4 Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

8.5 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

9. Effect of Uncertainties on Revenue Recognition

9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 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.

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.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 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.

Main Principles

10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

Explanation:

The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit or loss :

Turnover (Gross)	*XX*	
Less: Excise Duty	*XX*	
Turnover (Net)		*XX*

The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference between the closing start and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit or loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be

regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends 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 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.***
(iii)	***Dividends from investments in shares***	***:***	***when the owner's right to receive payment is established.***

Disclosure

14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Illustrations

These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

A. Sale of Goods

1. *Delivery is delayed at buyer's request and buyer takes title and accepts billing*

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2. *Delivered subject to conditions*

(a) installation and inspection i.e. goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor.

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

3. Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale

Revenue from such sales can generally be recognised if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. Subscriptions for publications

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. Instalment sales

When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. *Trade discounts and volume rebates*

Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

B. Rendering of Services

1. *Installation Fees*

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. *Advertising and insurance agency commissions*

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. *Financial service commissions*

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

(a) whether the service has been provided “once and for all” or is on a “continuing” basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. *Admission fees*

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. *Tuition fees*

Revenue should be recognised over the period of instruction.

6. *Entrance and membership fees*

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

AS 10 : Property, Plant and Equipment

(This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the General Instructions contained in part A of the Annexure to the Notification.)

Objective

1. The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about investment made by an enterprise in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Scope

2. This Standard should be applied in accounting for property, plant and equipment except when another Accounting Standard requires or permits a different accounting treatment.

3. This Standard does not apply to:

(a) biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants but it does not apply to the produce on bearer plants; and

(b) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (a) and (b) above.

4. Other Accounting Standards may require recognition of an item of property, plant and equipment based on an approach different from that in this Standard. For example, AS 19, Leases, requires an enterprise to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

5. Investment property, as defined in AS 13, Accounting for Investments, should be accounted for only in accordance with the cost model prescribed in this standard.

Definitions

6. The following terms are used in this Standard with the meanings specified:

Agricultural Activity is the management by an enterprise of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Agricultural Produce is the harvested product of biological assets of the enterprise.

Bearer plant is a plant that

(a) ***is used in the production or supply of agricultural produce;***

(b) ***is expected to bear produce for more than a period of twelve months; and***

(c) ***has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.***

The following are not bearer plants:

(i) plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber);

(ii) plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales (for example, trees that are cultivated both for their fruit and their lumber); and

(iii) annual crops (for example, maize and wheat).

When bearer plants are no longer used to bear produce they might be cut down and sold as scrap, for example, for use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant.

Biological Asset is a living animal* or plant.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Accounting Standards.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Enterprise -specific value is the present value of the cash flows an enterprise expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Gross carrying amount of an asset is its cost or other amount substituted for the cost in the books of account, without making any deduction for accumulated depreciation and accumulated impairment losses.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months. Recoverable amount is the higher of an asset's net selling price and its value in use.

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* An Accounting Standard on Agriculture is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on Agriculture is issued, accounting for livestock meeting the definition of Property, Plant and Equipment, will be covered as per AS 10 (Revised), Property, Plant and Equipment.

The <u>residual value</u> of an asset is the estimated amount that an enterprise would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

<u>Useful life</u> is:

(a) the period over which an asset is expected to be available for use by an enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by an enterprise.

Recognition

7. The cost of an item of property, plant and equipment should be recognised as an asset if, and only if:

(a) ***it is probable that future economic benefits associated with the item will flow to the enterprise; and***

(b) ***the cost of the item can be measured reliably.***

8. Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Standard when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

9. This Standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to specific circumstances of an enterprise. An example of a 'unit of measure' can be a 'project' of construction of a manufacturing plant rather than individual assets comprising the project in appropriate cases for the purpose of capitalisation of expenditure incurred during construction period. Similarly, it may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as property, plant and equipment, because the amount of the expenditure is not material.

10. An enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred. These costs include costs incurred:

(a) initially to acquire or construct an item of property, plant and equipment; and

(b) subsequently to add to, replace part of, or service it.

Initial Costs

11. The definition of 'property, plant and equipment' covers tangible items which are held for use or for administrative purposes. The term 'administrative purposes' has been used in wider sense to include all business purposes other than production or supply of goods or services or for rental for others. Thus, property, plant and equipment would include assets used for selling and distribution, finance and accounting, personnel and other functions of an enterprise. Items of property, plant and equipment may also be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an enterprise to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals. The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28, *Impairment of Assets*.

Subsequent Costs

12. Under the recognition principle in paragraph 7, an enterprise does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the statement of profit and loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

13. Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Similarly, major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an enterprise recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 74-80).

14. A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

15. The derecognition of the carrying amount as stated in paragraphs 13-14 occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

Measurement at Recognition

16. An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

Elements of Cost

17. The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

18. Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

19. An enterprise applies AS 2, Valuation of Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. The obligations for costs accounted for in accordance with AS 2 or AS 10 are recognised and measured in accordance with AS 29, Provisions, Contingent Liabilities and Contingent Assets.

20. Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility or business, such as, inauguration costs;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

21. Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the output of an item builds up; and

(c) costs of relocating or reorganising part or all of the operations of an enterprise.

22. Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the statement of profit and loss and included in their respective classifications of income and expense.

23. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self- constructing an asset is not included in the cost of the asset. AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

24. Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

Measurement of Cost

25. The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with AS 16.

26. One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

27. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;

(c) and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the enterprise - specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result of these analyses may be clear without an enterprise having to perform detailed calculations.

28. The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If an enterprise is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

29. Where several items of property, plant and equipment are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition. In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

30. The cost of an item of property, plant and equipment held by a lessee under a finance lease is determined in accordance with AS 19, Leases.

31. The carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with AS 12, Accounting for Government Grants.

Measurement after Recognition

32. An enterprise should choose either the cost model in paragraph 33 or the revaluation model in paragraph 34 as its accounting policy and should apply that policy to an entire class of property, plant and equipment.

Cost Model

33. After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model

34. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

35. The fair value of items of property, plant and equipment is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.

36. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach (for example, based on discounted cash flow projections) or a depreciated replacement cost approach which aims at making a realistic estimate of the current cost of acquiring or constructing an item that has the same service potential as the existing item.

37. The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

38. When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

(b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with paragraphs 42 and 43.

39. If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

40. A class of property, plant and equipment is a grouping of assets of a similar nature and use in operations of an enterprise. The following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures;

(h) office equipment; and

(i) bearer plants.

41. The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

42. An increase in the carrying amount of an asset arising on revaluation should be credited directly to owners' interests under the heading of revaluation surplus However, the increase should be recognised in the statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the statement of profit and loss.

43. A decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

44. The revaluation surplus included in owners' interests in respect of an item of property, plant and equipment may be transferred to the revenue reserves when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an enterprise. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost. Transfers from revaluation surplus to the revenue reserves are not made through the statement of profit and loss.

Depreciation

45. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.

46. An enterprise allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates each such part separately. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

47. A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

48. To the extent that an enterprise depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an enterprise has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

49. An enterprise may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

50. The depreciation charge for each period should be recognised in the statement of profit and loss unless it is included in the carrying amount of another asset.

51. The depreciation charge for a period is usually recognised in the statement of profit and loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see AS 2). Similarly, the depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26, *Intangible Assets*.

Depreciable Amount and Depreciation Period

52. The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

53. The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

54. Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

55. The depreciable amount of an asset is determined after deducting its residual value.

56. The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

57. Depreciation of an asset begins when it is available for use, *i.e.*, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is retired from active use and is held for disposal and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

58. The future economic benefits embodied in an asset are consumed by an enterprise principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

59. The useful life of an asset is defined in terms of its expected utility to the enterprise. The asset management policy of the enterprise may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the enterprise with similar assets.

60. Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

61. If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Depreciation Method

62. The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

63. The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

64. A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the residual value of the asset does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The enterprise selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits or that the method is changed in accordance with the statute to best reflect the way the asset is consumed.

65. A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

Changes in Existing Decommissioning, Restoration and Other Liabilities

66. The cost of property, plant and equipment may undergo changes subsequent to its acquisition or construction on account of changes in liabilities, price adjustments, changes in duties, changes in initial estimates of amounts provided for dismantling, removing, restoration and similar factors and included in the cost of the asset in accordance with paragraph 16. Such changes in cost should be accounted for in accordance with paragraphs 67–68 below.

67. If the related asset is measured using the cost model:

(a) ***subject to (b), changes in the liability should be added to, or deducted from, the cost of the related asset in the current period.***

(b) ***the amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the statement of profit and loss.if the adjustment results in an addition to the cost of an asset, the enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with AS 28.***

68. If the related asset is measured using the revaluation model:

(a) ***changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:***

(i) a decrease in the liability should (subject to (b)) be credited directly to revaluation surplus in the owners' interest, except that it should be recognised in the statement of profit and loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in the statement of profit and loss;

(ii) an increase in the liability should be recognised in the statement of profit and loss, except that it should be debited directly to revaluation surplus in the owners' interest to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

(b) ***in the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess should be recognised immediately in the statement of profit and loss.***

(c) ***a change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Any such revaluation should be taken into account in determining the amounts to be taken to the statement of profit and loss and the owners' interest under (a). If a revaluation is necessary, all assets of that class should be revalued.***

69. The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability should be recognised in the statement of profit and loss as they occur. This applies under both the cost model and the revaluation model.

Impairment

70. To determine whether an item of property, plant and equipment is impaired, an enterprise applies AS 28, Impairment of Assets. AS 28 explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss.

Compensation for Impairment

71. Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up should be included in the statement of profit and loss when the compensation becomes receivable.

72. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of items of property, plant and equipment are recognised in accordance with AS 28;

(b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

(c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

(d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

Retirements

73. Items of property, plant and equipment retired from active use and held for disposal should be stated at the lower of their carrying amount and net realisable value. Any write-down in this regard should be recognised immediately in the statement of profit and loss.

Derecognition

74. The carrying amount of an item of property, plant and equipment should be derecognised

(a) ***on disposal; or***

(b) ***when no future economic benefits are expected from its use or disposal.***

75. The gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognised (unless AS 19, Leases, requires otherwise on a sale and leaseback). Gains should not be classified as revenue, as defined in AS 9, Revenue Recognition.

76. However, an enterprise that in the course of its ordinary activities, routinely sells items of property, plant and equipment that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9, Revenue Recognition.

77. The disposal of an item of property, plant and equipment may occur in a variety of ways (e.g. by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods. AS 19, Leases, applies to disposal by a sale and leaseback.

78. If, under the recognition principle in paragraph 7, an enterprise recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an enterprise to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

79. The gain or loss arising from the derecognition of an item of property, plant and equipment should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

80. The consideration receivable on disposal of an item of property, plant and equipment is recognised in accordance with the principles enunciated in AS 9.

Disclosure

81. The financial statements should disclose, for each class of property, plant and equipment:

(a) ***the measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;***

(b) ***the depreciation methods used;***

(c) ***the useful lives or the depreciation rates used. In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;***

(d) ***the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and***

(e) ***a reconciliation of the carrying amount at the beginning and end of the period showing:***

(i) additions;

(ii) assets retired from active use and held for disposal;

(iii) acquisitions through business combinations;

(iv) increases or decreases resulting from revaluations under paragraphs 34, 42 and 43 and from impairment losses recognised or reversed directly in revaluation

surplus in accordance with AS 28;

(v) ***impairment losses recognised in the statement of profit and loss in accordance with AS 28;***

(vi) ***impairment losses reversed in the statement of profit and loss in accordance with AS 28;***

(vii) ***depreciation;***

(viii) ***the net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11, The Effects of Changes in Foreign Exchange Rates; and***

(ix) ***other changes.***

82. The financial statements should also disclose:

(a) ***the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;***

(b) ***the amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;***

(c) ***the amount of contractual commitments for the acquisition of property, plant and equipment;***

(d) ***if it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and***

(e) ***the amount of assets retired from active use and held for disposal.***

83. Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other enterprises. For similar reasons, it is necessary to disclose:

(a) depreciation, whether recognised in the statement of profit and loss or as a part of the cost of other assets, during a period; and

(b) accumulated depreciation at the end of the period.

84. In accordance with AS 5, an enterprise discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

(a) residual values;

(b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;

(c) useful lives; and

(d) depreciation methods.

85. If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) ***the effective date of the revaluation;***

(b) ***whether an independent valuer was involved;***

(c) ***the methods and significant assumptions applied in estimating fair values of the items;***

(d) ***the extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and***

(e) ***the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.***

86. In accordance with AS 28, an enterprise discloses information on impaired property, plant and equipment in addition to the information required by paragraph 81 (e), (iv), (v) and (vi).

87. An enterprise is encouraged to disclose the following:

(a) the carrying amount of temporarily idle property, plant and equipment;

(b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

(c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model;

(d) the carrying amount of property, plant and equipment retired from active use and not held for disposal.

Transitional Provisions

88. Where an entity has in past recognized an expenditure in the statement of profit and loss which is eligible to be included as a part of the cost of a project for construction of property, plant and equipment in accordance with the requirements of paragraph 9, it may do so retrospectively for such a project. The effect of such retrospective application of this requirement, should be recognised net-of-tax in revenue reserves.

89. The requirements of paragraphs 26-28 regarding the initial measurement of an item of property, plant and equipment acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.

90. On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2, Valuation of Inventories, and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts. The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

91. The requirements of paragraph 32 and paragraphs 34 – 44 regarding the revaluation model should be applied prospectively. In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of item(s) of property, plant and equipment reflects any previous revaluation it should adjust the amount outstanding in the revaluation reserve against the carrying amount of that item. However, the carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as revaluation reserve over the carrying amount of that item should be adjusted in revenue reserves.

AS 11*: The Effects of Changes in Foreign Exchange Rates

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Standard should be applied:

   (a) in accounting for transactions in foreign currencies; and

   (b) in translating the financial statements of foreign operations.

2. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.[2]

3. This Standard does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Standard requires disclosure of the reason for using that currency. This Standard also requires disclosure of the reason for any change in the reporting currency.

4. This Standard does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

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* Originally issued in 1989 and revised in 1994. The standard was revised again in 2003 and came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] This Standard is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risk of future transactions in respect of which a firm commitments are made or which are highly probable forecast transactions. A 'firm commitment' is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates and a 'forecast transaction' is an uncommitted but anticipated future transaction.

5. This Standard does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).

6. This Standard does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

Definitions

7. The following terms are used in this Standard with the meanings specified:

7.1 <u>Average rate</u> is the mean of the exchange rates in force during a period.

7.2 <u>Closing rate</u> is the exchange rate at the balance sheet date.

7.3 <u>Exchange difference</u> is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

7.4 <u>Exchange rate</u> is the ratio for exchange of two currencies.

7.5 <u>Fair value</u> is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

7.6 <u>Foreign currency</u> is a currency other than the reporting currency of an enterprise.

7.7 <u>Foreign operation</u> is a subsidiary[3], associate[4], joint venture[5] or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

7.8 <u>Forward exchange contract</u> means an agreement to exchange different currencies at a forward rate.

7.9 <u>Forward rate</u> is the specified exchange rate for exchange of two currencies at a specified future date.

7.10 <u>Integral foreign operation</u> is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

7.11 <u>Monetary items</u> are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

7.12 <u>Net investment in a non-integral foreign operation</u> is the reporting enterprise's share in the net assets of that operation.

7.13 <u>Non-integral foreign operation</u> is a foreign operation that is not an integral foreign operation.

7.14 <u>Non-monetary items</u> are assets and liabilities other than monetary items.

7.15 <u>Reporting currency</u> is the currency used in presenting the financial statements.

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[3] As defined in AS 21, Consolidated Financial Statements.

[4] As defined in AS 23, Accounting for Investments in Associates in Consolidated Financial Statements.

[5] As defined in AS 27, Financial Reporting of Interests in Joint Ventures.

Foreign Currency Transactions

Initial Recognition

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;

(c) becomes a party to an unperformed forward exchange contract; or

(d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Standard. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.

14. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non- integral foreign operation rather than an integral foreign operation:

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non- integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Integral Foreign Operations

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.

23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in

each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

- ***(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;***
- ***(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***
- ***(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.***

25. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

- (a) translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;
- (b) translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and
- (c) other changes to equity in the non-integral foreign operation. These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non- integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non- integral foreign operation is translated at the closing rate in accordance with paragraph 24.

28. A contingent liability disclosed in the financial statements of a non- integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra- group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares,

for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write- down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts[6]

36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.

39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Disclosure

40. An enterprise should disclose:

- ***(a) the amount of exchange differences included in the net profit or loss for the period; and***
- ***(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.***

41. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

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[6] See footnote 2.

42. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

- ***(a) the nature of the change in classification;***
- ***(b) the reason for the change;***
- ***(c) the impact of the change in classification on shareholders' funds; and***
- ***(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.***

43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Transitional Provisions

45. On the first time application of this Standard, if a foreign branch is classified as a non-integral foreign operation in accordance with the requirements of this Standard, the accounting treatment prescribed in paragraphs 33 and 34 of the Standard in respect of change in the classification of a foreign operation should be applied.

Paragraphs 46 and 46A for Companies

46[7] In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011,[8] at the option of the enterprise (such option to be irrevocable and to be exercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later, and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed in so far as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by

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[7] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 31st March, 2009, which is relevant for companies. Necessary process is being followed to make this paragraph with subsequent modifications indicated in footnote 8 below applicable to non-corporate entities also.

[8] 31st March, 2011" was substituted by "31st March, 2012" by Notification dated 11th May, 2011, published by Ministry of Corporate Affairs, Government of India. Thereafter, "31st March, 2012" was substituted by "31st March, 2020" by Notification dated 29th December, 2011, published by Ministry of Corporate Affairs, Government of India.

transfer to "Foreign Currency Monetary Item Translation Difference Account" in both cases, by debit or credit, as the case may be, to the general reserve. If the option stated in this paragraph is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

46A.[9] (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long- term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a ''Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Paragraphs 46 for entities other than Companies

46[7] (1) In respect of accounting periods commencing on or after 7th December, 2006 (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

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[9] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 29th December, 2011, which is relevant for companies. Necessary process is being followed to make this paragraph applicable to non-corporate entities also.

[7] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 31st March, 2009, which is relevant for companies. Necessary process is being followed to make this paragraph with subsequent modifications indicated in footnote 8 below applicable to non-corporate entities also.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Clarification on Para 46A of notification number G.S.R. 914(E) dated 29.12.2011 on Accounting Standard 11 relating to "The Effects of Changes in Foreign Exchange Rates"

The Ministry has received several representations from industry associations that Para 6 of AS 11 and Para 4(e) of AS 16 are posing problems in proper implementation of Para 46A of AS 11 inserted vide notification 914(E) dated 29.12.2011. In order to resolve the problems faced by industry, MCA had further clarified vide Circular No. 25/2012 dated 09.08.2012 that Para 6 of AS 11 and Para 4(e) of the AS 16 shall not apply to a company which is applying clause Para 46A of AS 11.

Announcement

Presentation of Foreign Currency Monetary Item Translation Difference Account

In the Revised Schedule VI[!] format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Therefore, the Council of the Institute at its 324th meeting held on March 24-26, 2013 at New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet.

The Council noted that the Framework on Preparation and Presentation of Financial Statements issued by ICAI defines an asset as follows:

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

Where the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Accordingly, such balance cannot be reflected as an asset.

Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

[!] Now Schedule III to the Companies Act 2013.

AS 12* – Accounting for Government Grants

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

2. This Standard does not deal with:

(i) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;

(ii) government assistance other than in the form of government grants;

(iii) government participation in the ownership of the enterprise.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1 <u>Government</u> refers to government, government agencies and similar bodies whether local, national or international.

3.2 <u>Government grants</u> are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

4. The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefor is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

5. Capital Approach versus Income Approach

5.1 Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods.

5.2 Those in support of the 'capital approach' argue as follows:

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* issued in 1991

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

5.3 Arguments in support of the 'income approach' are as follows:

(i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

5.4 It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standard (AS) 1, Disclosure of Accounting Policies).

5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

6. Recognition of Government Grants

6.1 Government grants available to the enterprise are considered for inclusion in accounts:

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

6.2 An appropriate amount in respect of such earned benefits, estimated on a prudent basis, is credited to income for the year even though the actual amount of such benefits may be finally settled and received after the end of the relevant accounting period.

6.3 A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date. [2]

6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

6.5 Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

7. Non-monetary Government Grants

7.1 Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

8. Presentation of Grants Related to Specific Fixed Assets

8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after

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[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

9. Presentation of Grants Related to Revenue

9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

9.2 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

10. Presentation of Grants of the nature of Promoters' contribution

10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

11. Refund of Government Grants

11.1 Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

11.2 The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

11.3 The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

11.4 Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12. Disclosure

12.1 The following disclosures are appropriate:

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Main Principles

13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

17. Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

18. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

19. A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date. 3

20. Government grants that become refundable should be accounted for as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

[3] See footnote 2.

21. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

22. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

23. The following should 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 statements, including grants of non-monetary assets given at a concessional rate or free of cost.***

AS 13*: Accounting for Investments

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.[2]

2. This Standard does not deal with:

   (a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;

   (b) operating or finance leases;

   (c) investments of retirement benefit plans and life insurance enterprises; and

* This standard was issued in 1993. A limited revision to this Standard was made in 2003, pursuant to which paragraph 2 (d) of this Standard has been revised to include 'and venture capital funds'.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] Shares, debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are not 'investments' as defined in this Standard. However, the manner in which they are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments. Accordingly, the provisions of this Standard, to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in this Standard.

(d) mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Definitions

3. The following terms are used in this Standard with the meanings assigned:

3.1 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'.

3.2 A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

3.3 A long term investment is an investment other than a current investment.

3.4 An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

3.5 Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

3.6 Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Explanation

Forms of Investments

4. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

5. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). The nature of an investment may be that of a debt, other than a short or long term loan or a trade debt, representing a monetary amount owing to the holder and usually bearing interest; alternatively, it may be a stake in the results and net assets of an enterprise such as an equity share. Most investments represent financial rights, but some are tangible, such as certain investments in land or buildings.

6. For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments

7. Enterprises present financial statements that classify fixed assets, investments and current assets into separate categories. Investments are classified as long term investments and current investments. Current investments are in the nature of current assets, although the common practice may be to include them in investments. [3]

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[3] Shares, debentures and other securities held for sale in the ordinary course of business are disclosed as 'stock-in-trade' under the head 'current assets'.

8. Investments other than current investments are classified as long term investments, even though they may be readily marketable.

Cost of Investments

9. The cost of an investment includes acquisition charges such as brokerage, fees and duties.

10. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

11. If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

12. Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

13. When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

Current Investments

14. The carrying amount for current investments is the lower of cost and fair value. In respect of investments for which an active market exists, market value generally provides the best evidence of fair value. The valuation of current investments at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

15. Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed categorywise (i.e. equity shares, preference shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

16. For current investments, any reduction to fair value and any reversals of such reductions are included in the profit and loss statement.

Long-term Investments

17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the

decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment.

18. Long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis.

19. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

20. An investment property is accounted for in accordance with cost model as prescribed in Accounting Standard (AS) 10, Property, Plant and Equipment. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

21. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

22. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.[4]

Reclassification of Investments

23. Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

24. Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

25. The following disclosures in financial statements in relation to investments are appropriate:

(a) the accounting policies for the determination of carrying amount of investments;

(b) the amounts included in profit and loss statement for:

(i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;

(ii) profits and losses on disposal of current investments and changes in carrying amount of such investments;

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[4] In respect of shares, debentures and other securities held as stock-in-trade, the cost of stocks disposed of is determined by applying an appropriate cost formula (e.g. first-in, first-out; average cost, etc.). These cost formulae are the same as those specified in Accounting Standard (AS) 2, in respect of Valuation of Inventories.

(iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;

(c) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;

(d) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(e) other disclosures as specifically required by the relevant statute governing the enterprise.

Main Principles

Classification of Investments

26. An enterprise should disclose current investments and long term investments distinctly in its financial statements.

27. Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

(a) Government or Trust securities

(b) Shares, debentures or bonds

(c) Investment properties

(d) Others—specifying nature.

Cost of Investments

28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.

29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

Investment Properties

30. An enterprise holding investment properties should account for them in accordance with cost model as prescribed in AS 10, Property, Plant and Equipment.

Carrying Amount of Investments

31. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

32. 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.

Changes in Carrying Amounts of Investments

33. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

Disposal of Investments

34. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

Disclosure

35. The following information should be disclosed in the financial statements:

- ***(a) the accounting policies for determination of carrying amount of investments;***
- ***(b) classification of investments as specified in paragraphs 26 and 27 above;***
- ***(c) the amounts included in profit and loss statement for:***
  - ***(i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;***
  - ***(ii) profits and losses on disposal of current investments and changes in the carrying amount of such investments; and***
  - ***(iii) profits and losses on disposal of long term investments and changes in the carrying amount of such investments;***
- ***(d) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;***
- ***(e) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;***
- ***(f) other disclosures as specifically required by the relevant statute governing the enterprise.***

Effective Date

36. This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

AS 14*: Accounting for Amalgamations

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities').]*

Introduction

1. This standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This Standard is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

2. This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or

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* Issued in 1994. A limited revision to this Standard was made in 2004, pursuant to which paragraphs 23 and 42 of this Standard were revised.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Definitions

3. ***The following terms are used in this standard with the meanings specified:***

   (a) ***Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies and includes 'merger'.***

   (b) ***Transferor company means the company which is amalgamated into another company.***

   (c) ***Transferee company means the company into which a transferor company is amalgamated.***

   (d) ***Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.***

   (e) ***Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.***

      (i) ***All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.***

      (ii) ***Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.***

      (iii) ***The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.***

      (iv) ***The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.***

      (v) ***No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.***

   (f) ***Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.***

   (g) ***Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.***

(h) ***Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.***

(i) ***Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.***

Explanation

Types of Amalgamations

4. Generally speaking, amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

5. An amalgamation is classified as an 'amalgamation in the nature of merger' when all the conditions listed in paragraph 3(e) are satisfied. There are, however, differing views regarding the nature of any further conditions that may apply. Some believe that, in addition to an exchange of equity shares, it is necessary that the shareholders of the transferor company obtain a substantial share in the transferee company even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one company for an insignificant share in a larger company does not amount to a mutual sharing of risks and benefits.

6. Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating companies, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation.

Methods of Accounting for Amalgamations

7. There are two main methods of accounting for amalgamations:

(a) the pooling of interests method; and

(b) the purchase method.

8. The use of the pooling of interests method is confined to circumstances which meet the criteria referred to in paragraph 3(e) for an amalgamation in the nature of merger.

9. The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

The Pooling of Interests Method

10. Under the pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustments required in paragraph 11).

11. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

The Purchase Method

12 Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

13. Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company. For example, the transferee company may have a specialised use for an asset, which is not available to other potential buyers. The transferee company may intend to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g. planned employee termination and plant relocation costs.

Consideration

14. The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair value. For example, when the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

15. Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

Treatment of Reserves on Amalgamation

16. If the amalgamation is an ‘amalgamation in the nature of merger’, the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company

and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

17. If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves dealt with in paragraph 18, is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated in paragraphs 19-20. If the result of the computation is positive, the difference is credited to Capital Reserve.

18. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill Arising on Amalgamation

19. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

20. Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

(a) the foreseeable life of the business or industry;

(b) the effects of product obsolescence, changes in demand and other economic factors;

(c) the service life expectancies of key individuals or groups of employees;

(d) expected actions by competitors or potential competitors; and

(e) legal, regulatory or contractual provisions affecting the useful life.

Balance of Profit and Loss Account

21. In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

22. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Treatment of Reserves Specified in a Scheme of Amalgamation

23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed. In some cases, the scheme of amalgamation sanctioned under a statute may prescribe a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme. In such cases, the following disclosures are made in the first financial statements following the amalgamation:

(a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Standard.

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation.

Disclosure

24. For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

25. For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

26. For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

Main Principles

28. An amalgamation may be either –

(a) an amalgamation in the nature of merger, or

(b) an amalgamation in the nature of purchase.

29. An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

30. An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified in paragraph 29 is not satisfied.

31. When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method described in paragraphs 33–35.

32. When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method described in paragraphs 36–39.

The Pooling of Interests Method

33. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

34. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

35. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.

The Purchase Method

36. In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in paragraph 39.

37. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

38. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

39. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which should be presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Common Procedures

40. The consideration for the amalgamation should include any non- cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

41. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

Treatment of Reserves Specified in a Scheme of Amalgamation

42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

- ***(a) A description of the accounting treatment given to the reserves and reasons for following the treatment different from that prescribed in this Standard.***
- ***(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.***
- ***(c) The financial effect, if any, arising due to such deviation.***

Disclosure

43. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

- ***(a) names and general nature of business of the amalgamating companies;***
- ***(b) effective date of amalgamation for accounting purposes;***
- ***(c) the method of accounting used to reflect the amalgamation; and***
- ***(d) particulars of the scheme sanctioned under a statute.***

44. For amalgamations accounted for under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation:

- ***(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;***
- ***(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.***

45. For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation:

- ***(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and***
- ***(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.***

Amalgamation after the Balance Sheet Date

46. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

AS 15* – Employee Benefits

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Scope

1. This Standard should be applied by an employer in accounting for all employee benefits, except employee share-based payments [2].

2. This Standard does not deal with accounting and reporting by employee benefit plans.

3. The employee benefits to which this Standard applies include those provided:

   (a) under formal plans or other formal agreements between an enterprise and individual employees, groups of employees or their representatives;

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* Originally issued in 1995 and titled as 'Accounting for Retirement Benefits in the Financial Statements of Employers'. AS 15 (revised 2005) was originally published in the March 2005 issue of the Institute's Journal. Subsequently, the Institute, in January 2006, made a Limited Revision to AS 15 (revised 2005) primarily with a view to bring the disclosure requirements of the standard relating to the defined benefit plans in line with the corresponding International Accounting Standard (IAS) 19, *Employee Benefits*; to clarify the application of the transitional provisions; and to provide relaxation/ exemptions to the Small and Medium-sized Enterprises (SMEs). Thereafter, another Limited Revision to AS 15 (revised 2005) was made primaily with a view to provide an option to an entity to charge additional liability arising upon the first application of the standard as an expense over a period up to five years with a disclosure of unrecognised amount. An entity was allowed to exercise this option only during the first accounting year commencing on or after 7th December 2006. These Limited Revisions have been duly incorporated in AS 15 (revised 2005).

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to items which are material.

[2] The accounting for such benefits is dealt with in the Guidance Note on Accounting for Employee Share-based Payments issued by the Institute of Chartered Accountants of India.

(b) under legislative requirements, or through industry arrangements, whereby enterprises are required to contribute to state, industry or other multi-employer plans; or

(c) by those informal practices that give rise to an obligation. Informal practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.

4. Employee benefits include:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefit, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Standard establishes separate requirements for each category.

5. Employee benefits include benefits provided to either employees or their spouses, children or other dependants and may be settled by payments (or the provision of goods or services) made either:

(a) directly to the employees, to their spouses, children or other dependants, or to their legal heirs or nominees; or

(b) to others, such as trusts, insurance companies.

6. An employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include whole-time directors and other management personnel.

Definitions

7. The following terms are used in this Standard with the meanings specified:

7.1 <u>Employee benefits</u> are all forms of consideration given by an enterprise in exchange for service rendered by employees.

7.2 <u>Short-term employee benefits</u> are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

7.3 <u>Post-employment benefits</u> are employee benefits (other than termination benefits) which are payable after the completion of employment.

7.4 <u>Post-employment benefit plans</u> are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees.

7.5 <u>Defined contribution plans</u> are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

7.6 <u>Defined benefit plans</u> are post-employment benefit plans other than defined contribution plans.

7.7 <u>Multi-employer plans</u> are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

- ***(a) pool the assets contributed by various enterprises that are not under common control; and***
- ***(b) use those assets to provide benefits to employees of more than one enterprise, on the basis that contribution and benefit levels are determined without regard to the identity of the enterprise that employs the employees concerned.***

7.8 <u>Other long-term employee benefits</u> are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

7.9 <u>Termination benefits</u> are employee benefits payable as a result of either:

- ***(a) an enterprise's decision to terminate an employee's employment before the normal retirement date; or***
- ***(b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).***

7.10 <u>Vested employee benefits</u> are employee benefits that are not conditional on future employment.

7.11 <u>The present value of a defined benefit obligation</u> is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

7.12 <u>Current service cost</u> is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

7.13 <u>Interest cost</u> is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

7.14 <u>Plan assets</u> comprise:

- ***(a) assets held by a long-term employee benefit fund; and***
- ***(b) qualifying insurance policies.***

7.15 <u>Assets held by a long-term employee benefit fund</u> are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:

- ***(a) are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and***

> ***(b)*** ***are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:***
>
> ***(i)*** ***the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or***
>
> ***(ii)*** ***the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.***

7.16 A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

> ***(a)*** ***can be used only to pay or fund employee benefits under a defined benefit plan; and***
>
> ***(b)*** ***are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:***
>
> ***(i)*** ***the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or***
>
> ***(ii)*** ***the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.***

7.17 Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

7.18 The return on plan assets is interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any costs of administering the plan and less any tax payable by the plan itself.

7.19 Actuarial gains and losses comprise:

> ***(a)*** ***experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and***
>
> ***(b)*** ***the effects of changes in actuarial assumptions.***

7.20 Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

Short-term Employee Benefits

8. Short-term employee benefits include items such as:

   (a) wages, salaries and social security contributions;

   (b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;

   (c) profit-sharing and bonuses payable within twelve months after the end of the period in which the employees render the related service; and

   (d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

9. Accounting for short-term employee benefits is generally straight- forward because no actuarial assumptions are required to measure the obligation or the cost and there is no possibility of any actuarial gain or loss. Moreover, short-term employee benefit obligations are measured on an undiscounted basis.

Recognition and Measurement

All Short-term Employee Benefits

10. When an employee has rendered service to an enterprise during an accounting period, the enterprise should recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

- ***(a) as a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an enterprise should recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and***
- ***(b) as an expense, unless another Accounting Standard requires or permits the inclusion of the benefits in the cost of an asset (see, for example, AS 10 Accounting for Fixed Assets).***

Paragraphs 11, 14 and 17 explain how an enterprise should apply this requirement to short-term employee benefits in the form of compensated absences and profit-sharing and bonus plans.

Short-term Compensated Absences

11. An enterprise should recognise the expected cost of short-term employee benefits in the form of compensated absences under paragraph 10 as follows:

- ***(a) in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences; and***
- ***(b) in the case of non-accumulating compensated absences, when the absences occur.***

12. An enterprise may compensate employees for absence for various reasons including vacation, sickness and short-term disability, and maternity or paternity. Entitlement to compensated absences falls into two categories:

- (a) accumulating; and
- (b) non-accumulating.

13. Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Accumulating compensated absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the enterprise) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving). An obligation arises as employees render service that increases their entitlement to future compensated absences. The obligation exists, and is recognised, even if the compensated absences are non-vesting, although the possibility that employees may leave before they use an accumulated non-vesting entitlement affects the measurement of that obligation.

14. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

15. The method specified in the previous paragraph measures the obligation at the amount of the additional payments that are expected to arise solely from the fact that the benefit accumulates. In many cases, an enterprise may not need to make detailed computations to estimate that there is no material obligation for unused compensated absences. For example, a leave obligation is likely to be material only if there is a formal or informal understanding that unused leave may be taken as paid vacation.

Example Illustrating Paragraphs 14 and 15

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31 December 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31 December 20X4, equal to 12 days of pay.

16. Non-accumulating compensated absences do not carry forward they lapse if the current period's entitlement is not used in full and do not entitle employees to a cash payment for unused entitlement on leaving the enterprise. This is commonly the case for maternity or paternity leave. An enterprise recognises no liability or expense until the time of the absence, because employee service does not increase the amount of the benefit.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), may not comply with paragraphs 11 to 16 of the Standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment of unused entitlement on leaving).

Profit-sharing and Bonus Plans

17. An enterprise should recognise the expected cost of profit-sharing and bonus payments under paragraph 10 when, and only when:

(a) the enterprise has a present obligation to make such payments as a result of past events; and

(b) a reliable estimate of the obligation can be made.

A present obligation exists when, and only when, the enterprise has no realistic alternative but to make the payments.

18. Under some profit-sharing plans, employees receive a share of the profit only if they remain with the enterprise for a specified period. Such plans create an obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.

Example Illustrating Paragraph 18

A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.

The enterprise recognises a liability and an expense of 2.5% of net profit.

19. An enterprise may have no legal obligation to pay a bonus. Nevertheless, in some cases, an enterprise has a practice of paying bonuses. In such cases also, the enterprise has an obligation because the enterprise has no realistic alternative but to pay the bonus. The measurement of the obligation reflects the possibility that some employees may leave without receiving a bonus.

20. An enterprise can make a reliable estimate of its obligation under a profit-sharing or bonus plan when, and only when:

(a) the formal terms of the plan contain a formula for determining the amount of the benefit; or

(b) the enterprise determines the amounts to be paid before the financial statements are approved; or

(c) past practice gives clear evidence of the amount of the enterprise's obligation.

21. An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the enterprise's owners. Therefore, an enterprise recognises the cost of profit-sharing and bonus plans not as a distribution of net profit but as an expense.

22. If profit-sharing and bonus payments are not due wholly within twelve months after the end of the period in which the employees render the related service, those payments are other long-term employee benefits (see paragraphs 127-132).

Disclosure

23. Although this Standard does not require specific disclosures about short-term employee benefits, other Accounting Standards may require disclosures. For example, where required by AS 18 *Related Party Disclosures* an enterprise discloses information about employee benefits for key management personnel.

Post-employment Benefits: Defined Contribution Plans and Defined Benefit Plans

24. Post-employment benefits include:

(a) retirement benefits, e.g., gratuity and pension; and

(b) other benefits, e.g., post-employment life insurance and post- employment medical care.

Arrangements whereby an enterprise provides post-employment benefits are post-employment benefit plans. An enterprise applies this Standard to all such arrangements whether or not they involve the establishment of a separate entity to receive contributions and to pay benefits.

25. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:

(a) the enterprise's obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an enterprise (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and

(b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

26. Examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:

(a) a plan benefit formula that is not linked solely to the amount of contributions; or

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) informal practices that give rise to an obligation, for example, an obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

27. Under defined benefit plans:

(a) the enterprise's obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise's obligation may be increased.

28. Paragraphs 29 to 43 below deal with defined contribution plans and defined benefit plans in the context of multi-employer plans, state plans and insured benefits.

Multi-employer Plans

29. An enterprise should classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any obligation that goes beyond the formal terms). Where a multi-employer plan is a defined benefit plan, an enterprise should:

(a) account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan; and

(b) disclose the information required by paragraph 120.

30. When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an enterprise should:

(a) account for the plan under paragraphs 45-47 as if it were a defined contribution plan;

(b) disclose:

(i) the fact that the plan is a defined benefit plan; and

(ii) the reason why sufficient information is not available to enable the enterprise to account for the plan as a defined benefit plan; and

(c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose in addition:

(i) any available information about that surplus or deficit;

(ii) the basis used to determine that surplus or deficit; and

(iii) the implications, if any, for the enterprise.

31. One example of a defined benefit multi-employer plan is one where:

(a) the plan is financed in a manner such that contributions are set at a level that is expected to be sufficient to pay the benefits falling due in the same period; and future benefits earned during the current period will be paid out of future contributions; and

(b) employees' benefits are determined by the length of their service and the participating enterprises have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned by employees up to the date of withdrawal. Such a plan creates actuarial risk for the enterprise; if the ultimate cost of benefits already earned at the balance sheet date is more than expected, the enterprise will have to either increase its contributions or persuade employees to accept a reduction in benefits. Therefore, such a plan is a defined benefit plan.

32. Where sufficient information is available about a multi-employer plan which is a defined benefit plan, an enterprise accounts for its proportionate share of the defined benefit obligation, plan assets and post- employment benefit cost associated with the plan in the same way as for any other defined benefit plan. However, in some cases, an enterprise may not be able to identify its share of the underlying financial position and performance of the plan with sufficient reliability for accounting purposes. This may occur if:

(a) the enterprise does not have access to information about the plan that satisfies the requirements of this Standard; or

(b) the plan exposes the participating enterprises to actuarial risks associated with the current and former employees of other enterprises, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual enterprises participating in the plan.

In those cases, an enterprise accounts for the plan as if it were a defined contribution plan and discloses the additional information required by paragraph 30.

33. Multi-employer plans are distinct from group administration plans. A group administration plan is merely an aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes and reduce investment management and administration costs, but the claims of different employers are segregated for the sole benefit of their own employees. Group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan and because such plans do not expose the participating enterprises to actuarial risks associated with the current and former employees of other enterprises. The definitions in this Standard require an enterprise to classify a group administration plan as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan (including any obligation that goes beyond the formal terms).

34. Defined benefit plans that share risks between various enterprises under common control, for example, a parent and its subsidiaries, are not multi-employer plans.

35. In respect of such a plan, if there is a contractual agreement or stated policy for charging the net defined benefit cost for the plan as a whole to individual group enterprises, the enterprise recognises, in its separate financial statements, the net defined benefit cost so charged. If there is no such agreement or policy, the net defined benefit cost is recognised in the separate financial statements of the group enterprise that is legally the sponsoring employer for the plan. The other group enterprises recognise, in their separate financial statements, a cost equal to their contribution payable for the period.

36. AS 29 *Provisions, Contingent Liabilities and Contingent Assets* requires an enterprise to recognise, or disclose information about, certain contingent liabilities. In the context of a multi-employer plan, a contingent liability may arise from, for example:

(a) actuarial losses relating to other participating enterprises because each enterprise that participates in a multi-employer plan shares in the actuarial risks of every other participating enterprise; or

(b) any responsibility under the terms of a plan to finance any shortfall in the plan if other enterprises cease to participate.

State Plans

37. An enterprise should account for a state plan in the same way as for a multi-employer plan (see paragraphs 29 and 30).

38. State plans are established by legislation to cover all enterprises (or all enterprises in a particular category, for example, a specific industry) and are operated by national or local government or by another body (for example, an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting enterprise. Some plans established by an enterprise provide both compulsory benefits which substitute for benefits that would otherwise be covered under a state plan and additional voluntary benefits. Such plans are not state plans.

39. State plans are characterised as defined benefit or defined contribution in nature based on the enterprise's obligation under the plan. Many state plans are funded in a manner such that contributions are set at a level that is expected to be sufficient to pay the required benefits falling due in the same period; future benefits earned during the current period will be paid out of future contributions. Nevertheless, in most state plans, the enterprise has no obligation to pay those future benefits: its only obligation is to pay the contributions as they fall due and if the enterprise ceases to employ members of the state plan, it will have no obligation to pay the benefits earned by such employees in previous years. For this reason, state plans are normally defined contribution plans. However, in the rare cases when a state plan is a defined benefit plan, an enterprise applies the treatment prescribed in paragraphs 29 and 30.

Insured Benefits

40. An enterprise may pay insurance premiums to fund a post- employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have (either directly, or indirectly through the plan) an obligation to either:

(a) pay the employee benefits directly when they fall due; or

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the enterprise retains such an obligation, the enterprise should treat the plan as a defined benefit plan.

41. The benefits insured by an insurance contract need not have a direct or automatic relationship with the enterprise's obligation for employee benefits. Post-employment benefit plans involving insurance contracts are subject to the same distinction between accounting and funding as other funded plans.

42. Where an enterprise funds a post-employment benefit obligation by contributing to an insurance policy under which the enterprise (either directly, indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer) retains an obligation,

the payment of the premiums does not amount to a defined contribution arrangement. It follows that the enterprise:

(a) accounts for a qualifying insurance policy as a plan asset (see paragraph 7); and

(b) recognises other insurance policies as reimbursement rights (if the policies satisfy the criteria in paragraph 103).

43. Where an insurance policy is in the name of a specified plan participant or a group of plan participants and the enterprise does not have any obligation to cover any loss on the policy, the enterprise has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits. The payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Consequently, the enterprise no longer has an asset or a liability. Therefore, an enterprise treats such payments as contributions to a defined contribution plan.

Post-employment Benefits: Defined Contribution Plans

44. Accounting for defined contribution plans is straightforward because the reporting enterprise's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Recognition and Measurement

45. When an employee has rendered service to an enterprise during a period, the enterprise should recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the balance sheet date, an enterprise should recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, unless another Accounting Standard requires or permits the inclusion of the contribution in the cost of an asset (see, for example, AS 10, Accounting for Fixed Assets).

46. Where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they should be discounted using the discount rate specified in paragraph 78.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), may not discount contributions that fall due more than 12 months after the balance sheet date.

Disclosure

47. An enterprise should disclose the amount recognised as an expense for defined contribution plans.

48. Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about contributions to defined contribution plans for key management personnel.

Post-employment Benefits: Defined Benefit Plans

49. Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service. While the Standard requires that it is the responsibility of the reporting enterprise to measure the obligations under the defined benefit plans, it is recognised that for doing so the enterprise would normally use the services of a qualified actuary.

Recognition and Measurement[3]

50. Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an enterprise, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting enterprise and from which the employee benefits are paid. The payment of funded benefits when they fall due depends not only on the financial position and the investment performance of the fund but also on an enterprise's ability to make good any shortfall in the fund's assets. Therefore, the enterprise is, in substance, underwriting the actuarial and investment risks associated with the plan. Consequently, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.

51. Accounting by an enterprise for defined benefit plans involves the following steps:

(a) using actuarial techniques to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods. This requires an enterprise to determine how much benefit is attributable to the current and prior periods (see paragraphs 68-72) and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will influence the cost of the benefit (see paragraphs 73-91);

(b) discounting that benefit using the Projected Unit Credit Method in order to determine the present value of the defined benefit obligation and the current service cost (see paragraphs 65-67);

(c) determining the fair value of any plan assets (see paragraphs 100-102);

(d) determining the total amount of actuarial gains and losses (see paragraphs 92-93);

(e) where a plan has been introduced or changed, determining the resulting past service cost (see paragraphs 94-99); and

(f) where a plan has been curtailed or settled, determining the resulting gain or loss (see paragraphs 110-116).

Where an enterprise has more than one defined benefit plan, the enterprise applies these procedures for each material plan separately.

52. For measuring the amounts under paragraph 51, in some cases, estimates, averages and simplified computations may provide a reliable approximation of the detailed computations.

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[3] For applicability of paragraphs 50 to 116 to Small and Medium-sized Companies and Small and Medium-sized Enterprises, refer to the provisos appearing after paragraph 116.

Accounting for the Obligation under a Defined Benefit Plan

53. An enterprise should account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any other obligation that arises from the enterprise's informal practices. Informal practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.

54. The formal terms of a defined benefit plan may permit an enterprise to terminate its obligation under the plan. Nevertheless, it is usually difficult for an enterprise to cancel a plan if employees are to be retained. Therefore, in the absence of evidence to the contrary, accounting for post-employment benefits assumes that an enterprise which is currently promising such benefits will continue to do so over the remaining working lives of employees.

Balance Sheet

55. The amount recognised as a defined benefit liability should be the net total of the following amounts:

- ***(a) the present value of the defined benefit obligation at the balance sheet date (see paragraph 65);***
- ***(b) minus any past service cost not yet recognised (see paragraph 94);***
- ***(c) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102).***

56. The present value of the defined benefit obligation is the gross obligation, before deducting the fair value of any plan assets.

57. An enterprise should determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date.

58. The detailed actuarial valuation of the present value of defined benefit obligations may be made at intervals not exceeding three years. However, with a view that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date, the most recent valuation is reviewed at the balance sheet date and updated to reflect any material transactions and other material changes in circumstances (including changes in interest rates) between the date of valuation and the balance sheet date. The fair value of any plan assets is determined at each balance sheet date.

59. The amount determined under paragraph 55 may be negative (an asset). An enterprise should measure the resulting asset at the lower of:

- ***(a) the amount determined under paragraph 55; and***
- ***(b) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan. The present value of these economic benefits should be determined using the discount rate specified in paragraph 78.***

60. An asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are recognised. An enterprise recognises an asset in such cases because:

- (a) the enterprise controls a resource, which is the ability to use the surplus to generate future benefits;

(b) that control is a result of past events (contributions paid by the enterprise and service rendered by the employee); and

(c) future economic benefits are available to the enterprise in the form of a reduction in future contributions or a cash refund, either directly to the enterprise or indirectly to another plan in deficit.

Example Illustrating Paragraph 59

A defined benefit plan has the following characteristics:

	(Amount in ₹.)
Present value of the obligation	1,100
Fair value of plan assets	(1,190)
	(90)
Unrecognised past service cost	(70)
Negative amount determined under paragraph 55	(160)
Present value of available future refunds and reductions in future contributions	90
Limit under paragraph 59 (b)	90

₹ 90 is less than ₹ 160. Therefore, the enterprise recognises an asset of ₹ 90 and discloses that the limit reduced the carrying amount of the asset by ₹ 70 (see paragraph 120(f)(ii)).

Statement of Profit and Loss

61. An enterprise should recognise the net total of the following amounts in the statement of profit and loss, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

(a) current service cost (see paragraphs 64-91); (b) interest cost (see paragraph 82);

(c) the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement rights (see paragraph 103);

(d) actuarial gains and losses (see paragraphs 92-93);

(e) past service cost to the extent that paragraph 94 requires an enterprise to recognise it;

(f) the effect of any curtailments or settlements (see paragraphs 110 and 111); and

(g) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined under paragraph 55 (if negative) exceeds the amount determined under paragraph 59 (b).

62. Other Accounting Standards require the inclusion of certain employee benefit costs within the cost of assets such as tangible fixed assets (see AS 10 *Accounting for Fixed Assets*). Any post-employment benefit costs included in the cost of such assets include the appropriate proportion of the components listed in paragraph 61.

Illustration

63. Illustration I attached to the Standard illustrates describing the components of the amounts recognised in the balance sheet and statement of profit and loss in respect of defined benefit plans.

Recognition and Measurement: Present Value of Defined Benefit Obligations and Current Service Cost

64. The ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, medical cost trends and, for a funded plan, the investment earnings on the plan assets. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time. In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary to:

(a) apply an actuarial valuation method (see paragraphs 65-67);

(b) attribute benefit to periods of service (see paragraphs 68-72); and

(c) make actuarial assumptions (see paragraphs 73-91).

Actuarial Valuation Method

65. An enterprise should use the Projected Unit Credit Method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

66. The Projected Unit Credit Method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) considers each period of service as giving rise to an additional unit of benefit entitlement (see paragraphs 68-72) and measures each unit separately to build up the final obligation (see paragraphs 73-91).

67. An enterprise discounts the whole of a post-employment benefit obligation, even if part of the obligation falls due within twelve months of the balance sheet date.

Example Illustrating Paragraph 66

A lump sum benefit, equal to 1% of final salary for each year of service, is payable on termination of service. The salary in year 1 is ₹ 10,000 and is assumed to increase at 7% (compound) each year resulting in ₹ 13,100 at the end of year 5. The discount rate used is 10% per annum. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the enterprise at an earlier or later date.

(Amount in ₹)

Year	*1*	*2*	*3*	*4*	*5*
Benefit attributed to:					
- prior years	*0*	*131*	*262*	*393*	*524*
- current year (1% of final salary)	*131*	*131*	*131*	*131*	*131*
- current and prior years	*131*	*262*	*393*	*524*	*655*
Opening Obligation (see note 1)	*-*	*89*	*196*	*324*	*476*
Interest at 10%	*-*	*9*	*20*	*33*	*48*
Current Service Cost (see note 2)	*89*	*98*	*108*	*119*	*131*
Closing Obligation (see note 3)	*89*	*196*	*324*	*476*	*655*

Notes:

1. *The Opening Obligation is the present value of benefit attributed to prior years.*
2. *The Current Service Cost is the present value of benefit attributed to the current year.*
3. *The Closing Obligation is the present value of benefit attributed to current and prior years.*

Attributing Benefit to Periods of Service

68. In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an enterprise should attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an enterprise should attribute benefit on a straight-line basis from:

(a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until

(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

69. The Projected Unit Credit Method requires an enterprise to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations). An enterprise attributes benefit to periods in which the obligation to provide post-employment benefits arises. That obligation arises as employees render services in return for post-employment benefits which an enterprise expects to pay in future reporting periods. Actuarial techniques allow an enterprise to measure that obligation with sufficient reliability to justify recognition of a liability.

Examples Illustrating Paragraph 69

1. A defined benefit plan provides a lump-sum benefit of ₹ 100 payable on retirement for each year of service.

A benefit of ₹ 100 is attributed to each year. The current service cost is the present value of ₹ 100. The present value of the defined benefit obligation is the present value of ₹ 100, multiplied by the number of years of service up to the balance sheet date.

If the benefit is payable immediately when the employee leaves the enterprise, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the balance sheet date.

2. A plan provides a monthly pension of 0.2% of final salary for each year of service. The pension is payable from the age of 60.

Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.2% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit. The present value of the defined benefit obligation is the present value of monthly pension payments of 0.2% of final salary, multiplied by the number of years of service up to the balance sheet date. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 60.

70. Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to an obligation because, at each successive balance sheet date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an enterprise considers the probability that some employees may not satisfy any vesting requirements. Similarly, although certain post- employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an

employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

Examples Illustrating Paragraph 70

1. A plan pays a benefit of ₹ 100 for each year of service. The benefits vest after ten years of service.

A benefit of ₹ 100 is attributed to each year. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service.

2. A plan pays a benefit of ₹ 100 for each year of service, excluding service before the age of 25. The benefits vest immediately.

No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of ₹ 100 is attributed to each subsequent year.

71. The obligation increases until the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date. Benefit is attributed to individual accounting periods under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an enterprise attributes benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

Examples Illustrating Paragraph 71

1. A plan pays a lump-sum benefit of ₹ 1,000 that vests after ten years of service. The plan provides no further benefit for subsequent service.

A benefit of ₹ 100 (₹ 1,000 divided by ten) is attributed to each of the first ten years. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. No benefit is attributed to subsequent years.

2. A plan pays a lump-sum retirement benefit of ₹ 2,000 to all employees who are still employed at the age of 50 after twenty years of service, or who are still employed at the age of 60, regardless of their length of service.

For employees who join before the age of 30, service first leads to benefits under the plan at the age of 30 (an employee could leave at the age of 25 and return at the age of 28, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 50 will lead to no material amount of further benefits. For these employees, the enterprise attributes benefit of ₹ 100 (₹ 2,000 divided by 20) to each year from the age of 30 to the age of 50.

For employees who join between the ages of 30 and 40, service beyond twenty years will lead to no material amount of further benefits. For these employees, the enterprise attributes benefit of ₹ 100 (₹ 2,000 divided by 20) to each of the first twenty years.

For an employee who joins at the age of 50, service beyond ten years will lead to no material amount of further benefits. For this employee, the enterprise attributes benefit of ₹ 200 (₹ 2,000 divided by 10) to each of the first ten years.

For all employees, the current service cost and the present value of the obligation reflect the probability that the employee may not complete the necessary period of service.

3. A post-employment medical plan reimburses 40% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

Under the plan's benefit formula, the enterprise attributes 4% of the present value of the expected medical costs (40% divided by ten) to each of the first ten years and 1% (10% divided by ten) to each of the second ten years. The current service cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits. For employees expected to leave within ten years, no benefit is attributed.

4. A post-employment medical plan reimburses 10% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

Service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the enterprise attributes benefit on a straight-line basis under paragraph 69. Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% of the present value of the expected medical costs (50% divided by twenty).

For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 1% of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

72. Where the amount of a benefit is a constant proportion of final salary for each year of service, future salary increases will affect the amount required to settle the obligation that exists for service before the balance sheet date, but do not create an additional obligation. Therefore:

(a) for the purpose of paragraph 68(b), salary increases do not lead to further benefits, even though the amount of the benefits is dependent on final salary; and

(b) the amount of benefit attributed to each period is a constant proportion of the salary to which the benefit is linked.

Example Illustrating Paragraph 72

Employees are entitled to a benefit of 3% of final salary for each year of service before the age of 55.

Benefit of 3% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

Actuarial Assumptions

73. Actuarial assumptions comprising demographic assumptions and financial assumptions should be unbiased and mutually compatible. Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled.

74. Actuarial assumptions are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. Actuarial assumptions comprise:

(a) demographic assumptions about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:

  (i) mortality, both during and after employment;

  (ii) rates of employee turnover, disability and early retirement; (iii) the proportion of plan members with dependants who will be eligible for benefits; and

  (iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

  (i) the discount rate (see paragraphs 78-82);

  (ii) future salary and benefit levels (see paragraphs 83-87);

  (iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments (see paragraphs 88-91); and

  (iv) the expected rate of return on plan assets (see paragraphs 107-109).

75. Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.

76. Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, rates of salary increase, the return on plan assets and discount rates. For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.

77. An enterprise determines the discount rate and other financial assumptions in nominal (stated) terms, unless estimates in real (inflation- adjusted) terms are more reliable, for example, where the benefit is index- linked and there is a deep market in index-linked bonds of the same currency and term.

Actuarial Assumptions: Discount Rate

78. The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds. The currency and term of the government bonds should be consistent with the currency and estimated term of the post-employment benefit obligations.

79. One actuarial assumption which has a material effect is the discount rate. The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the enterprise-specific credit risk borne by the enterprise's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.

80. The discount rate reflects the estimated timing of benefit payments. In practice, an enterprise often achieves this by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

81. In some cases, there may be no government bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an enterprise uses current market rates of the appropriate term to discount shorter term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a

defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available government bonds.

82. Interest cost is computed by multiplying the discount rate as determined at the start of the period by the present value of the defined benefit obligation throughout that period, taking account of any material changes in the obligation. The present value of the obligation will differ from the liability recognised in the balance sheet because the liability is recognised after deducting the fair value of any plan assets and because some past service cost are not recognised immediately. [Illustration I attached to the Standard illustrates the computation of interest cost, among other things]

Actuarial Assumptions: Salaries, Benefits and Medical Costs

83. Post-employment benefit obligations should be measured on a basis that reflects:

- ***(a) estimated future salary increases;***
- ***(b) the benefits set out in the terms of the plan (or resulting from any obligation that goes beyond those terms) at the balance sheet date; and***
- ***(c) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:***
  - ***(i) those changes were enacted before the balance sheet date; or***
  - ***(ii) past history, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.***

84. Estimates of future salary increases take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

85. If the formal terms of a plan (or an obligation that goes beyond those terms) require an enterprise to change benefits in future periods, the measurement of the obligation reflects those changes. This is the case when, for example:

- (a) the enterprise has a past history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future; or
- (b) actuarial gains have already been recognised in the financial statements and the enterprise is obliged, by either the formal terms of a plan (or an obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants (see paragraph 96(c)).

86. Actuarial assumptions do not reflect future benefit changes that are not set out in the formal terms of the plan (or an obligation that goes beyond those terms) at the balance sheet date. Such changes will result in:

- (a) past service cost, to the extent that they change benefits for service before the change; and
- (b) current service cost for periods after the change, to the extent that they change benefits for service after the change.

87. Some post-employment benefits are linked to variables such as the level of state retirement benefits or state medical care. The measurement of such benefits reflects expected changes in such variables, based on past history and other reliable evidence.

88. Assumptions about medical costs should take account of estimated future changes in the cost of medical services, resulting from both inflation and specific changes in medical costs.

89. Measurement of post-employment medical benefits requires assumptions about the level and frequency of future claims and the cost of meeting those claims. An enterprise estimates future medical costs on the basis of historical data about the enterprise's own experience, supplemented where necessary by historical data from other enterprises, insurance companies, medical providers or other sources. Estimates of future medical costs consider the effect of technological advances, changes in health care utilisation or delivery patterns and changes in the health status of plan participants.

90. The level and frequency of claims is particularly sensitive to the age, health status and sex of employees (and their dependants) and may be sensitive to other factors such as geographical location. Therefore, historical data is adjusted to the extent that the demographic mix of the population differs from that of the population used as a basis for the historical data. It is also adjusted where there is reliable evidence that historical trends will not continue.

91. Some post-employment health care plans require employees to contribute to the medical costs covered by the plan. Estimates of future medical costs take account of any such contributions, based on the terms of the plan at the balance sheet date (or based on any obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers (see paragraphs 83(c) and 87).

Actuarial Gains and Losses

92. Actuarial gains and losses should be recognised immediately in the statement of profit and loss as income or expense (see paragraph 61).

92A. Paragraph 145(b)(iii) explains the need to consider any unrecognised part of the transitional liability in accounting for subsequent actuarial gains.

93. Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets. Causes of actuarial gains and losses include, for example:

(a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(b) the effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(c) the effect of changes in the discount rate; and

(d) differences between the actual return on plan assets and the expected return on plan assets (see paragraphs 107-109).

Past Service Cost

94. In measuring its defined benefit liability under paragraph 55, an enterprise should recognise past service cost as an expense on a straight- line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately.

95. Past service cost arises when an enterprise introduces a defined benefit plan or changes the benefits payable under an existing defined benefit plan. Such changes are in return for employee service over the period until the benefits concerned are vested. Therefore, past service cost is

recognised over that period, regardless of the fact that the cost refers to employee service in previous periods. Past service cost is measured as the change in the liability resulting from the amendment (see paragraph 65).

Example Illustrating Paragraph 95

An enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after five years of service. On 1 January 20X5 the enterprise improves the pension to 2.5% of final salary for each year of service starting from 1 January 20X1. At the date of the improvement, the present value of the additional benefits for service from 1 January 20X1 to 1 January 20X5 is as follows:

Employees with more than five years' service at 1/1/X5	₹ .150
Employees with less than five years' service at 1/1/X5	
(average period until vesting: three years)	₹ 120
	₹ 270

The enterprise recognises ₹ 150 immediately because those benefits are already vested. The enterprise recognises ₹ 120 on a straight-line basis over three years from 1 January 20X5.

96. Past service cost excludes:

(a) the effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries);

(b) under and over estimates of discretionary pension increases where an enterprise has an obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases);

(c) estimates of benefit improvements that result from actuarial gains that have already been recognised in the financial statements if the enterprise is obliged, by either the formal terms of a plan (or an obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded (the resulting increase in the obligation is an actuarial loss and not past service cost, see paragraph 85(b));

(d) the increase in vested benefits (not on account of new or improved benefits) when employees complete vesting requirements (there is no past service cost because the estimated cost of benefits was recognised as current service cost as the service was rendered); and

(e) the effect of plan amendments that reduce benefits for future service (a curtailment).

97. An enterprise establishes the amortisation schedule for past service cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Moreover, the effect is likely to be material only where there is a curtailment or settlement. Therefore, an enterprise amends the amortisation schedule for past service cost only if there is a curtailment or settlement.

98. Where an enterprise reduces benefits payable under an existing defined benefit plan, the resulting reduction in the defined benefit liability is recognised as (negative) past service cost over the average period until the reduced portion of the benefits becomes vested.

99. Where an enterprise reduces certain benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable under the plan for the same employees, the enterprise treats the change as a single net change.

Recognition and Measurement: Plan Assets

Fair Value of Plan Assets

100. The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 55. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

101. Plan assets exclude unpaid contributions due from the reporting enterprise to the fund, as well as any non-transferable financial instruments issued by the enterprise and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

102. Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, as described in paragraph 55 (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

Reimbursements

103. When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.

104. Sometimes, an enterprise is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation. Qualifying insurance policies, as defined in paragraph 7, are plan assets. An enterprise accounts for qualifying insurance policies in the same way as for all other plan assets and paragraph 103 does not apply (see paragraphs 40-43 and 102).

105. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 103 deals with such cases: the enterprise recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability recognised under paragraph 55; in all other respects, including for determination of the fair value, the enterprise treats that asset in the same way as plan assets. Paragraph 120(f)(iii) requires the enterprise to disclose a brief description of the link between the reimbursement right and the related obligation.

Example Illustrating Paragraphs 103-105

	(Amount in ₹)
Liability recognised in balance sheet being the present value of obligation	1,258
Rights under insurance policies that exactly match the amount and timing of some of the benefits payable under the plan.	
Those benefits have a present value of ₹ 1,092	1,092

106. If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation, as described in paragraph 55 (subject to any reduction required if the reimbursement is not recoverable in full).

Return on Plan Assets

107. The expected return on plan assets is a component of the expense recognised in the statement of profit and loss. The difference between the expected return on plan assets and the actual return on plan assets is an actuarial gain or loss.

108. The expected return on plan assets is based on market expectations, at the beginning of the period, for returns over the entire life of the related obligation. The expected return on plan assets reflects changes in the fair value of plan assets held during the period as a result of actual contributions paid into the fund and actual benefits paid out of the fund.

109. In determining the expected and actual return on plan assets, an enterprise deducts expected administration costs, other than those included in the actuarial assumptions used to measure the obligation.

Example Illustrating Paragraph 108

At 1 January 20X1, the fair value of plan assets was ₹ 10,000. On 30 June 20X1, the plan paid benefits of ₹ 1,900 and received contributions of ₹ 4,900. At 31 December 20X1, the fair value of plan assets was ₹ 15,000 and the present value of the defined benefit obligation was ₹ 14,792. Actuarial losses on the obligation for 20X1 were ₹ 60.

At 1 January 20X1, the reporting enterprise made the following estimates, based on market prices at that date:

	%
Interest and dividend income, after tax payable by the fund	9.25
Realised and unrealised gains on plan assets (after tax)	2.00
Administration costs	(1.00)
Expected rate of return	10.25

For 20X1, the expected and actual return on plan assets are as follows:

	(Amount in ₹)
Return on ₹ 10,000 held for 12 months at 10.25%	*1,025*
Return on ₹ 3,000 held for six months at 5%	
(equivalent to 10.25% annually, compounded every six months)	150
Expected return on plan assets for 20X1	*1,175*
Fair value of plan assets at 31 December 20X1	*15,000*
Less fair value of plan assets at 1 January 20X1	*(10,000)*
Less contributions received	*(4,900)*
Add benefits paid	*1,900*
Actual return on plan assets	*2,000*

The difference between the expected return on plan assets (₹ 1,175) and the actual return on plan assets (₹ 2,000) is an actuarial gain of ₹ 825. Therefore, the net actuarial gain of ₹ 765 [₹ 825 – ₹ 60 (actuarial loss on the obligation)] would be recognised in the statement of profit and loss.

The expected return on plan assets for 20X2 will be based on market expectations at 1/1/X2 for returns over the entire life of the obligation.

Curtailments and Settlements

110. An enterprise should recognise gains or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs. The gain or loss on a curtailment or settlement should comprise:

- ***(a) any resulting change in the present value of the defined benefit obligation;***
- ***(b) any resulting change in the fair value of the plan assets;***
- ***(c) any related past service cost that, under paragraph 94, had not previously been recognised.***

111. Before determining the effect of a curtailment or settlement, an enterprise should remeasure the obligation (and the related plan assets, if any) using current actuarial assumptions (including current market interest rates and other current market prices).

112. A curtailment occurs when an enterprise either:

- (a) has a present obligation, arising from the requirement of a statute/ regulator or otherwise, to make a material reduction in the number of employees covered by a plan; or
- (b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements. Curtailments are often linked with a restructuring. Therefore, an enterprise accounts for a curtailment at the same time as for a related restructuring.

113. A settlement occurs when an enterprise enters into a transaction that eliminates all further obligations for part or all of the benefits provided under a defined benefit plan, for example, when a lump-sum cash payment is made to, or on behalf of, plan participants in exchange for their rights to receive specified post-employment benefits.

114. In some cases, an enterprise acquires an insurance policy to fund some or all of the employee benefits relating to employee service in the current and prior periods. The acquisition of such a policy is not a settlement if the enterprise retains an obligation (see paragraph 40) to pay further amounts if the insurer does not pay the employee benefits specified in the insurance policy. Paragraphs 103-106 deal with the recognition and measurement of reimbursement rights under insurance policies that are not plan assets.

115. A settlement occurs together with a curtailment if a plan is terminated such that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a curtailment or settlement if the plan is replaced by a new plan that offers benefits that are, in substance, identical.

116. Where a curtailment relates to only some of the employees covered by a plan, or where only part of an obligation is settled, the gain or loss includes a proportionate share of the previously unrecognised past service cost (and of transitional amounts remaining unrecognised under paragraph 145(b)). The proportionate share is determined on the basis of the present value of the obligations before and after the curtailment or settlement, unless another basis is more rational in the circumstances.

Example Illustrating Paragraph 116

An enterprise discontinues a business segment and employees of the discontinued segment will earn no further benefits. This is a curtailment without a settlement. Using current actuarial assumptions (including current market interest rates and other current market prices) immediately before the curtailment, the enterprise has a defined benefit obligation with a net present value of ₹ 1,000 and plan assets with a fair value of ₹ 820 and unrecognised past service cost of ₹ 50. The enterprise had first adopted this Standard one year before. This increased the net liability by ₹ 100, which the enterprise chose to recognise over five years (see paragraph 145(b)). The curtailment reduces the net present value of the obligation by ₹ 100 to ₹ 900.

Of the previously unrecognised past service cost and transitional amounts, 10% (₹ 100/₹ 1000) relates to the part of the obligation that was eliminated through the curtailment. Therefore, the effect of the curtailment is as follows:

(Amount in ₹)

	Before curtailment	*Curtailment gain*	*After curtailment*
Net present value of obligation	*1,000*	*(100)*	*900*
Fair value of plan assets	*(820)*	*-*	*(820)*
	180	*(100)*	*80*
Unrecognised past service cost	*(50)*	*5*	*(45)*
Unrecognised transitional amount (100x4/5)	*(80)*	*8*	*(72)*
Net liability recognised in balance sheet	*(50)*	*(87)*	*(37)*

An asset of ₹ 37 will be recognised (it is assumed that the amount under paragraph 59(b) is higher than ₹ 37).

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), whose average number of persons employed during the year is 50 or more, may not apply the recognition and measurement principles laid down in paragraphs 50 to 116 in respect of accounting for defined benefit plans. However, such companies/enterprises should actuarially determine and provide for accrued liability in respect of defined benefit plans as follows:

- ***The method used for actuarial valuation should be the Projected***
- ***Unit Credit Method; and***
- ***The discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standards.***
- ***Provided further that a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), whose average number of persons employed during the year is less than 50 may not apply the recognition and measurement principles as laid down in paragraphs 50 to 116 in respect of accounting for defined benefit plans. However, such enterprises may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.***

Presentation

Offset

117. An enterprise should offset an asset relating to one plan against a liability relating to another plan when, and only when, the enterprise:

(a) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

(b) intends either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.

Financial Components of Post-employment Benefit Costs

118. This Standard does not specify whether an enterprise should present current service cost, interest cost and the expected return on plan assets as components of a single item of income or expense on the face of the statement of profit and loss.

Provided that a Small and Medium-sized company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), may not apply the presentation requirements laid down in paragraphs 117 to 118 of the Standard in respect of accounting for defined benefit plans.

Disclosure

119. An enterprise should disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

120. An enterprise should disclose the following information about defined benefit plans:

(a) the enterprise's accounting policy for recognising actuarial gains and losses.

(b) a general description of the type of plan.

(c) a reconciliation of opening and closing balances of the present value of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:

(i) current service cost, (ii) interest cost,

(iii) contributions by plan participants, (iv) actuarial gains and losses,

(v) foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,

(vi) benefits paid,

(vii) past service cost, (viii) amalgamations,

(ix) curtailments, and

(x) settlements.

(d) an analysis of the defined benefit obligation into amounts arising from plans that are wholly unfunded and amounts arising from plans that are wholly or partly funded.

(e) a reconciliation of the opening and closing balances of the fair value of plan assets and of the opening and closing balances of any reimbursement right recognised as an asset in accordance with paragraph 103 showing separately, if applicable, the effects during the period attributable to each of the following:

(i) expected return on plan assets,

- *(ii) actuarial gains and losses,*
- *(iii) foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,*
- *(iv) contributions by the employer,*
- *(v) contributions by plan participants, (vi) benefits paid,*
- *(vii) amalgamations, and*
- *(viii) settlements.*

(f) a reconciliation of the present value of the defined benefit obligation in (c) and the fair value of the plan assets in (e) to the assets and liabilities recognised in the balance sheet, showing at least:

- *(i) the past service cost not yet recognised in the balance sheet (see paragraph 94);*
- *(ii) any amount not recognised as an asset, because of the limit in paragraph 59(b);*
- *(iii) the fair value at the balance sheet date of any reimbursement right recognised as an asset in accordance with paragraph 103 with a brief description of the link between the reimbursement right and the related obligation); and*
- *(iv) the other amounts recognised in the balance sheet.*

(g) the total expense recognised in the statement of profit and loss for each of the following, and the line item(s) of the statement of profit and loss in which they are included:

- *(i) current service cost;*
- *(ii) interest cost;*
- *(iii) expected return on plan assets;*
- *(iv) expected return on any reimbursement right recognised as an asset in accordance with paragraph 103;*
- *(v) actuarial gains and losses; (vi) past service cost;*
- *(vii) the effect of any curtailment or settlement; and*
- *(viii) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined in accordance with paragraph 55 (if negative) exceeds the amount determined in accordance with paragraph 59 (b).*

(h) for each major category of plan assets, which should include, but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major category constitutes of the fair value of the total plan assets.

(i) the amounts included in the fair value of plan assets for:

- *(i) each category of the enterprise's own financial instruments; and*
- *(ii) any property occupied by, or other assets used by, the enterprise.*

(j) a narrative description of the basis used to determine the overall expected rate of return on assets, including the effect of the major categories of plan assets.

(k) the actual return on plan assets, as well as the actual return on any reimbursement right recognised as an asset in accordance with paragraph 103.

(l) the principal actuarial assumptions used as at the balance sheet date, including, where applicable:

(i) the discount rates;

(ii) the expected rates of return on any plan assets for the periods presented in the financial statements;

(iii) the expected rates of return for the periods presented in the financial statements on any reimbursement right recognised as an asset in accordance with paragraph 103;

(iv) medical cost trend rates; and

(v) any other material actuarial assumptions used.

An enterprise should disclose each actuarial assumption in absolute terms (for example, as an absolute percentage) and not just as a margin between different percentages or other variables.

Apart from the above actuarial assumptions, an enterprise should include an assertion under the actuarial assumptions to the effect that estimates of future salary increases, considered in actuarial valuation, take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

(m) the effect of an increase of one percentage point and the effect of a decrease of one percentage point in the assumed medical cost trend rates on:

(i) the aggregate of the current service cost and interest cost components of net periodic post-employment medical costs; and

(ii) the accumulated post-employment benefit obligation for medical costs.

For the purposes of this disclosure, all other assumptions should be held constant. For plans operating in a high inflation environment, the disclosure should be the effect of a percentage increase or decrease in the assumed medical cost trend rate of a significance similar to one percentage point in a low inflation environment.

(n) the amounts for the current annual period and previous four annual periods of:

(i) the present value of the defined benefit obligation, the fair value of the plan assets and the surplus or deficit in the plan; and

(ii) the experience adjustments arising on:

(A) the plan liabilities expressed either as (1) an amount or (2) a percentage of the plan liabilities at the balance sheet date, and

(B) the plan assets expressed either as (1) an amount or (2) a percentage of the plan assets at the balance sheet date.

(o) the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date.

121. Paragraph 120(b) requires a general description of the type of plan. Such a description distinguishes, for example, flat salary pension plans from final salary pension plans and from post-employment medical plans. The description of the plan should include informal practices that give rise

to other obligations included in the measurement of the defined benefit obligation in accordance with paragraph 53. Further detail is not required.

122. When an enterprise has more than one defined benefit plan, disclosures may be made in total, separately for each plan, or in such groupings as are considered to be the most useful. It may be useful to distinguish groupings by criteria such as the following:

(a) the geographical location of the plans, for example, by distinguishing domestic plans from foreign plans; or

(b) whether plans are subject to materially different risks, for example, by distinguishing flat salary pension plans from final salary pension plans and from post-employment medical plans.

When an enterprise provides disclosures in total for a grouping of plans, such disclosures are provided in the form of weighted averages or of relatively narrow ranges.

123. Paragraph 30 requires additional disclosures about multi-employer defined benefit plans that are treated as if they were defined contribution plans.

124. Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about:

(a) related party transactions with post-employment benefit plans; and

(b) post-employment benefits for key management personnel.

125. Where required by AS 29 *Provisions, Contingent Liabilities and Contingent Assets* an enterprise discloses information about contingent liabilities arising from post-employment benefit obligations.

Illustrative Disclosures

126. Illustration II attached to the Standard contains illustrative disclosures.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities, may not apply the disclosure requirements laid down in paragraphs 119 to 123 of the Standard in respect of accounting for defined benefit plans. However, such company/ enterprise, except a Small and Medium-sized Enterprise (Levels II and III non-corporate entities) whose average number of persons employed during the year are less than 50, should disclose actuarial assumptions as per paragraph 120(1) of the Standard.

Other Long-term Employee Benefits

127. Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related service; and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

128. In case of other long-term employee benefits, the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. For this reason, this Standard requires a simplified method of accounting for other long-term employee benefits. This method differs

from the accounting required for post-employment benefits insofar as that all past service cost is recognised immediately.

Recognition and Measurement

129. The amount recognised as a liability for other long-term employee benefits should be the net total of the following amounts:

- ***(a) the present value of the defined benefit obligation at the balance sheet date (see paragraph 65);***
- ***(b) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102).***

In measuring the liability, an enterprise should apply paragraphs 49-91, excluding paragraphs 55 and 61. An enterprise should apply paragraph 103 in recognising and measuring any reimbursement right.

130. For other long-term employee benefits, an enterprise should recognise the net total of the following amounts as expense or (subject to paragraph 59) income, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

- ***(a) current service cost (see paragraphs 64-91); (b) interest cost (see paragraph 82);***
- ***(c) the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement right recognised as an asset (see paragraph 103);***
- ***(d) actuarial gains and losses, which should all be recognised immediately;***
- ***(e) past service cost, which should all be recognised immediately; and***
- ***(f) the effect of any curtailments or settlements (see paragraphs 110 and 111).***

131. One form of other long-term employee benefit is long- term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), whose average number of persons employed during the year is 50 or more, may not apply the recognition and measurement principles laid down in paragraphs 129 to 131 in respect of accounting for other long-term employee benefits. However, such companies/ enterprises should actuarially determine and provide for accrued liability in respect of other long-term employee benefits as follows:

- ***The method used for actuarial valuation should be the Projected Unit Credit Method; and***
- ***The discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.***

Provided further that a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), whose average number of persons employed during the year is less than 50 may not apply the recognition and measurement principles as laid down in paragraphs 129 to 131 in respect of accounting for other long-term employee benefits. However, such enterprises may calculate and account for the accrued liability under the other long-term employee benefits by

reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

Disclosure

132. Although this Standard does not require specific disclosures about other long-term employee benefits, other Accounting Standards may require disclosures, for example, where the expense resulting from such benefits is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period (see AS 5 *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*). Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about other long-term employee benefits for key management personnel.

Termination Benefits

133. This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination rather than employee service.

Recognition

134. An enterprise should recognise termination benefits as a liability and an expense when, and only when:

- ***(a) the enterprise has a present obligation as a result of a past event;***
- ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
- ***(c) a reliable estimate can be made of the amount of the obligation.***

135. An enterprise may be committed, by legislation, by contractual or other agreements with employees or their representatives or by an obligation based on business practice, custom or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment. Such payments are termination benefits. Termination benefits are typically lump-sum payments, but sometimes also include:

- (a) enhancement of retirement benefits or of other post-employment benefits, either indirectly through an employee benefit plan or directly; and
- (b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the enterprise.

136. Some employee benefits are payable regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain.

Although such benefits may be described as termination indemnities, or termination gratuities, they are post-employment benefits, rather than termination benefits and an enterprise accounts for them as post-employment benefits. Some enterprises provide a lower level of benefit for voluntary termination at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the enterprise. The additional benefit payable on involuntary termination is a termination benefit.

137. Termination benefits are recognised as an expense immediately.

138. Where an enterprise recognises termination benefits, the enterprise may also have to account for a curtailment of retirement benefits or other employee benefits (see paragraph 110).

Measurement

139. Where termination benefits fall due more than 12 months after the balance sheet date, they should be discounted using the discount rate specified in paragraph 78.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), may not discount amounts that fall due more than 12 months after the balance sheet date.

Disclosure

140. Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists. As required by AS 29, *Provisions, Contingent Liabilities and Contingent Assets* an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

141. As required by AS 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies* an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period. Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

142. Where required by AS 18, *Related Party Disclosures* an enterprise discloses information about termination benefits for key management personnel.

Transitional Provisions

142. An enterprise may disclose the amounts required by paragraph 120(n) as the amounts are determined for each accounting period prospectively from the date the enterprise first adopts this Standard.

Employee Benefits other than Defined Benefit Plans and Termination Benefits

143. Where an enterprise first adopts this Standard for employee benefits, the difference (as adjusted by any related tax expense) between the liability in respect of employee benefits other than defined benefit plans and termination benefits, as per this Standard, existing on the date of adopting this Standard and the liability that would have been recognised at the same date, as per the pre-revised AS 15, should be adjusted against opening balance of revenue reserves and surplus.

Defined Benefit Plans

144. On first adopting this Standard, an enterprise should determine its transitional liability for defined benefit plans at that date as:

- ***(a) the present value of the obligation (see paragraph 65) at the date of adoption;***
- ***(b) minus the fair value, at the date of adoption, of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102);***
- ***(c) minus any past service cost that, under paragraph 94, should be recognised in later periods.***

145. If the transitional liability is more than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should make an irrevocable choice to recognise that increase as part of its defined benefit liability under paragraph 55:

- ***(a) immediately as an adjustment against the opening balance of revenue reserves and surplus (as adjusted by any related tax expense), or***

(b) as an expense on a straight-line basis over up to five years from the date of adoption.

If an enterprise chooses (b), the enterprise should:

(i) apply the limit describe in paragraph 59(b) in measuring any asset recognised in the balance sheet;

(ii) disclose at each balance sheet date (1) the amount of the increase that remains unrecognised; and (2) the amount recognised in the current period;

(iii) limit the recognition of subsequent actuarial gains (but not negative past service cost) only to the extent that the net cumulative unrecognised actuarial gains (before recognition of that actuarial gain) exceed the unrecognised part of the transitional liability; and

(iv) include the related part of the unrecognised transitional liability in determining any subsequent gain or loss on settlement or curtailment.

If the transitional liability is less than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should recognise that decrease immediately as an adjustment against the opening balance of revenue reserves and surplus.

Example Illustrating Paragraphs 144 and 145

At 31 March 20X7, an enterprise's balance sheet includes a pension liability of ₹ 100, recognised as per the pre-revised AS 15. The enterprise adopts the Standard as of 1 April 20X7, when the present value of the obligation under the Standard is ₹ 1,300 and the fair value of plan assets is ₹ 1,000. On 1 April 20X1, the enterprise had improved pensions (cost for non-vested benefits: ₹ 160; and average remaining period at that date until vesting: 10 years).

The transitional effect is as follows:

	(Amount in ₹)
Present value of the obligation	*1,300*
Fair value of plan assets	*(1,000)*
Less: past service cost to be recognised	
in later periods (160 x 4/10)	*(64)*
Transitional liability	*236*
Liability already recognised	*100*
Increase in liability	*136*

An enterprise may choose to recognise the increase in liability (as adjusted by any related tax expense) *either immediately as an adjustment against the opening balance of revenue reserves and surplus as on 1 April 20X7 or as an expense on straight line basis over up to five years from that date. The choice is irrevocable.*

At 31 March 20X8, the present value of the obligation under the Standard is ₹ 1,400 and the fair value of plan assets is ₹ 1,050. Net cumulative unrecognised actuarial gains since the date of adopting the Standard are ₹ 120. The enterprise is required, as per paragraph 92, to recognise all actuarial gains and losses immediately.

The effect of the limit in paragraph 145 (b) (iii) is as follows:

	(Amount in ₹)
Net unrecognised actuarial gain	120
Unrecognised part of the transitional liability (136 × 4/5)	109
(If the enterprise adopts the policy of recognising it over 5 years)	____
Maximum gain to be recognised	11

Termination Benefits

146. This Standard requires immediate expensing of expenditure on termination benefits (including expenditure incurred on voluntary retirement scheme (VRS)). However, where an enterprise incurs expenditure on termination benefits on or before 31st March, 2009, the enterprise may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1st April, 2010.

Illustration I

This illustration is illustrative only and does not form part of the Standard. The purpose of this illustration is to illustrate the application of the Standard to assist in clarifying its meaning. Extracts from statements of profit and loss and balance sheets are provided to show the effects of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Accounting Standards.

Background Information

The following information is given about a funded defined benefit plan. To keep interest computations simple, all transactions are assumed to occur at the year end. The present value of the obligation and the fair value of the plan assets were both ₹ 1,000 at 1 April, 20X4.

(Amount in ₹)

	20X4-X5	*20X5-X6*	*20X6-X7*
Discount rate at start of year	10.0%	9.0%	8.0%
Expected rate of return on plan assets at start of year	12.0%	11.1%	10.3%
Current service cost	130	140	150
Benefits paid	150	180	190
Contributions paid	90	100	110
Present value of obligation at 31 March	1,141	1,197	1,295
Fair value of plan assets at 31 March	1,092	1,109	1,093
Expected average remaining working lives of employees (years)	10	10	10

In 20X5-X6, the plan was amended to provide additional benefits with effect from 1 April 20X5. The present value as at 1 April 20X5 of additional benefits for employee service before 1 April 20X5 was ₹ 50 for vested benefits and ₹ 30 for non-vested benefits. As at 1 April 20X5, the enterprise estimated that the average period until the non-vested benefits would become vested was three years; the past service cost arising from additional non-vested benefits is therefore recognised on a straight-line basis over three years. The past service cost arising from additional vested benefits is recognised immediately (paragraph 94 of the Standard).

Changes in the Present Value of the Obligation and in the Fair Value of the Plan Assets

The first step is to summarise the changes in the present value of the obligation and in the fair value of the plan assets and use this to determine the amount of the actuarial gains or losses for the period. These are as follows:

	(Amount in ₹)		
	20X4-X5	*20X5-X6*	*20X6-X7*
Present value of obligation, 1 April	1,000	1,141	1,197
Interest cost	100	103	96
Current service cost	130	140	150
Past service cost – (non vested benefits)	-	30	-
Past service cost – (vested benefits)	-	50	-
Benefits paid	(150)	(180)	(190)
Actuarial (gain) loss on obligation (balancing figure)	61	(87)	42
Present value of obligation, 31 March	1,141	1,197	1,295
Fair value of plan assets, 1 April	1,000	1,092	1,109
Expected return on plan assets	120	121	114
Contributions	90	100	110
Benefits paid	(150)	(180)	(190)
Actuarial gain (loss) on plan assets (balancing figure)	32	(24)	(50)
Fair value of plan assets, 31 March	1,092	1,109	1,093
Total actuarial gain (loss) to be recognised immediately as per the Standard	(29)	63	(92)

Amounts Recognised in the Balance Sheet and Statements of Profit and Loss, and Related Analyses

The final step is to determine the amounts to be recognised in the balance sheet and statement of profit and loss, and the related analyses to be disclosed in accordance with paragraphs 120 (f), (g) and (j) of the Standard (the analyses required to be disclosed in accordance with paragraph 120(c) and (e) are given in the section of this illustration 'Changes in the Present Value of the Obligation and in the Fair Value of the Plan Assets'). These are as follows:

(Amount in ₹)

	20X4-X5	*20X5-X6*	*20X6-X7*
Present value of the obligation	1,141	1,197	1,295
Fair value of plan assets	(1,092)	(1,109)	(1,093)
	49	88	202

Unrecognised past service cost – non vested benefits	-	(20)	(10)
Liability recognised in balance sheet	**49**	**68**	**192**
Current service cost	130	140	150
Interest cost	100	103	96
Expected return on plan assets	(120)	(121)	(114)
Net actuarial (gain) loss recognised in year	29	(63)	92
Past service cost - non-vested benefits	-	10	10
Past service cost - vested benefits	-	50	-
Expense recognised in the statement of profit and loss	**139**	**119**	**234**
Actual return on plan assets:			
Expected return on plan assets	120	121	114
Actuarial gain (loss) on plan assets	32	(24)	(50)
Actual return on plan assets	152	97	64

Note: see example illustrating paragraphs 103-105 for presentation of reimbursements.

Illustration II

Illustrative Disclosures

This illustration is illustrative only and does not form part of the Standard. The purpose of this illustration is to illustrate the application of the Standard to assist in clarifying its meaning. Extracts from notes to the financial statements show how the required disclosures may be aggregated in the case of a large multi-national group that provides a variety of employee benefits. These extracts do not necessarily provide all the information required under the disclosure and presentation requirements of AS 15 (2005) and other Accounting Standards. In particular, they do not illustrate the disclosure of:

- *(a) accounting policies for employee benefits (see AS 1 Disclosure of Accounting Policies). Paragraph 120(a) of the Standard requires this disclosure to include the enterprise's accounting policy for recognising actuarial gains and losses.*
- *(b) a general description of the type of plan (paragraph 120(b)).*
- *(c) a narrative description of the basis used to determine the overall expected rate of return on assets (paragraph 120(j)).*
- *(d) employee benefits granted to directors and key management personnel (see AS 18 Related Party Disclosures).*

Employee Benefit Obligations

The amounts (in ₹) recognised in the balance sheet are as follows:

	Defined benefit pension plans		*Post-employment medical benefits*	
	20X5-X6	*20X4-X5*	*20X5-X6*	*20X4-X5*
Present value of funded obligations	20,300	17,400	-	-
Fair value of plan assets	18,420	17,280	-	-

	1,880	120	-	-
Present value of unfunded obligations	2,000	1,000	7,337	6,405
Unrecognised past service cost	(450)	(650)	-	-
Net liability	3,430	470	7,337	6,405
Amounts in the balance sheet:				
Liabilities	3,430	560	7,337	6,405
Assets	-	(90)	-	-
Net liability	3,430	470	7,337	6,405

The pension plan assets include equity shares issued by [name of reporting enterprise] with a fair value of ₹ 317 (20X4-X5: ₹ 281). Plan assets also include property occupied by [name of reporting enterprise] with a fair value of ₹ 200 (20X4-X5: ₹ 185).

The amounts (in ₹) recognised in the statement of profit and loss are as follows:

	Defined benefit pension plans		*Post-employment medical benefits*	
	20X5-X6	*20X4-X5*	*20X5-X6*	*20X4-X5*
Current service cost	850	750	479	411
Interest on obligation	950	1,000	803	705
Expected return on plan assets	(900)	(650)		
Net actuarial losses (gains) recognised in year	2,650	(650)	250	400
Past service cost	200	200	-	-
Losses (gains) on curtailments and settlements	175	(390)	-	-
Total, included in 'employee benefit expense'	3,925	260	1,532	1,516
Actual return on plan assets	600	2,250	-	-

Changes in the present value of the defined benefit obligation representing reconciliation of opening and closing balances thereof are as follows:

	Defined benefit pension plans		*Post-employment medical benefits*	
	20X5-X6	*20X4-X5*	*20X5-X6*	*20X4-X5*
Opening defined benefit obligation	18,400	11,600	6,405	5,439
Service cost	850	750	479	411
Interest cost	950	1,000	803	705
Actuarial losses (gains)	2,350	950	250	400
Losses (gains) on curtailments	(500)			
Liabilities extinguished on settlements	-	(350)		
Liabilities assumed in an amalgamation in the nature of purchase	-	5,000		
Exchange differences on foreign plans	900	(150)		
Benefits paid	(650)	(400)	(600)	(550)
Closing defined benefit obligation	22,300	18,400	7,337	6,405

Changes in the fair value of plan assets representing reconciliation of the opening and closing balances thereof are as follows:

	Defined benefit pension plans	
	20X5-X6	*20X4-X5*
Opening fair value of plan assets	17,280	9,200
Expected return	900	650
Actuarial gains and (losses)	(300)	1,600
Assets distributed on settlements	(400)	-
Contributions by employer	700	350
Assets acquired in an amalgamation in the nature of purchase	-	6,000
Exchange differences on foreign plans	890	(120)
Benefits paid	(650)	(400)
	18,420	17,280

The Group expects to contribute ₹ 900 to its defined benefit pension plans in 20X6-X7.

The major categories of plan assets as a percentage of total plan assets are as follows:

	Defined benefit pension plans		*Post-employment medical benefits*	
	20X5-X6	*20X4-X5*	*20X5-X6*	*20X4-X5*
Government of India Securities	80%	82%	78%	81%
High quality corporate bonds	11%	10%	12%	12%
Equity shares of listed companies	4%	3%	10%	7%
Property	5%	5%	-	-

Principal actuarial assumptions at the balance sheet date (expressed as weighted averages):

	20X5-X6	*20X4-X5*
Discount rate at 31 March	5.0%	6.5%
Expected return on plan assets at 31 March	5.4%	7.0%
Proportion of employees opting for early retirement	30%	30%
Annual increase in healthcare costs	8%	8%
Future changes in maximum state health care benefits	3%	2%

The estimates of future salary increases, considered in actuarial valuation, take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

Assumed healthcare cost trend rates have a significant effect on the amounts recognised in the statement of profit and loss. At present, healthcare costs, as indicated in the principal actuarial assumption given above, are expected to increase at 8% p.a. A one percentage point change in assumed healthcare cost trend rates would have the following effects on the aggregate of the service cost and interest cost and defined benefit obligation:

	One percentage point increase	*One percentage point decrease*
Effect on the aggregate of the service cost and interest cost	190	(150)
Effect on defined benefit obligation	1,000	(900)

Amounts for the current and previous four periods are as follows:

Defined benefit pension plans

	20X5-X6	*20X4-X5*	*20X3-X4*	*20X2-X3*	*20X1-X2*
Defined benefit obligation	(22,300)	(18,400)	(11,600)	(10,582)	(9,144)
Plan assets	18,420	17,280	9,200	8,502	10,000
Surplus/(deficit)	(3,880)	(1,120)	(2,400)	(2,080)	856
Experience adjustments on plan liabilities	(1,111)	(768)	(69)	543	(642)
Experience adjustments on plan assets	(300)	1,600	(1,078)	(2,890)	2,777

Post-employment medical benefits

	20X5-X6	*20X4-X5*	*20X3-X4*	*20X2-X3*	*20X1-X2*
Defined benefit obligation	7,337	6,405	5,439	4,923	4,221
Experience adjustments on plan liabilities	(232)	829	490	(174)	(103)

The group also participates in an industry-wide defined benefit plan which provides pensions linked to final salaries and is funded in a manner such that contributions are set at a level that is expected to be sufficient to pay the benefits falling due in the same period. It is not practicable to determine the present value of the group's obligation or the related current service cost as the plan computes its obligations on a basis that differs materially from the basis used in [name of reporting enterprise]'s financial statements. [describe basis] On that basis, the plan's financial statements to 30

September 20X3 show an unfunded liability of ₹ 27,525. The unfunded liability will result in future payments by participating employers. The plan has approximately 75,000 members, of whom approximately 5,000 are current or former employees of [name of reporting enterprise] or their dependants. The expense recognised in the statement of profit and loss, which is equal to contributions due for the year, and is not included in the above amounts, was ₹ 230 (20X4-X5: ₹ 215). The group's future contributions may be increased substantially if other enterprises withdraw from the plan.

AS 16* : Borrowing Costs

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should*

* Issued in 2000.

be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]

Objective

The objective of this Standard is to prescribe the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1 Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

3.2 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Explanation:

What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

4. Borrowing costs may include:

(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Explanation:

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, The Effect of Changes in Foreign Exchange Rates. For this purpose, the

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[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

The application of this explanation is illustrated in the Illustration attached to the Standard.

5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

7. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

9. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when a range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required.

10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

12. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined

by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

13. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

Commencement of Capitalisation

14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- ***(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***
- ***(b) borrowing costs are being incurred; and***
- ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.***

15. Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government Grants). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of Capitalisation

17. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not

normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Disclosure

23. The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of paragraph 4(e) of the Standard.

Facts:

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was ₹ 45 per USD. The exchange rate, as at March 31, 20X4, is ₹ 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = USD 10,000 × 5% × ₹ 48/USD = ₹ 24,000.

(ii) Increase in the liability towards the principal amount = USD 10,000 × (48–45) = ₹ 30,000.

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 × 45 × 11% = ₹ 49,500.

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 49,500 – ₹ 24,000 = ₹ 25,500.

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings [covered by paragraph 4(a) of AS 16] plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500. Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e. ₹ 34,500 (₹ 58,500 – ₹ 24,000)] is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates.

AS 17: Segment Reporting

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

This Accounting Standard is not mandatory for Small and Medium Sized Companies and Small and Medium Sized non-corporate entities falling in Level II and Level III 'Applicability of Accounting Standards to Various Entities'. Such Entities are however encouraged to comply with this Standard.

Objective

The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

(a) better understand the performance of the enterprise;

(b) better assess the risks and returns of the enterprise; and

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(c) make more informed judgements about the enterprise as a whole. Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas - often called segment information - is relevant to assessing the risks and returns of a diversified or multi-locational enterprise but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

Scope

1. This Standard should be applied in presenting general purpose financial statements.

2. The requirements of this Standard are also applicable in case of consolidated financial statements.

3. An enterprise should comply with the requirements of this Standard fully and not selectively.

4. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Standard to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.

Definitions

5. The following terms are used in this Standard with the meanings specified:

5.1 A <u>business segment</u> is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services; (b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

5.2 A <u>geographical segment</u> is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

5.3 A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard.

5.4 Enterprise revenue is revenue from sales to external customers as reported in the statement of profit and loss.

5.5 Segment revenue is the aggregate of

(i) the portion of enterprise revenue that is directly attributable to a segment,

(ii) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

(iii) revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

5.6 Segment expense is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

Explanation:

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment are not included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories. In case interest is included as a part of the cost of inventories where it is so required as per AS 16, Borrowing Costs, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest is considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest is disclosed by way of a note to the segment result.

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

5.7 Segment result is segment revenue less segment expense.

5.8 Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include income tax assets.

Segment assets are determined after deducting related allowances/ provisions that are reported as direct offsets in the balance sheet of the enterprise.

5.9 Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Segment liabilities do not include income tax liabilities.

5.10 Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting.

6. The factors in paragraph 5 for identifying business segments and geographical segments are not listed in any particular order.

7. A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

8. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

9. The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:

(a) the location of production or service facilities and other assets of an enterprise; or

(b) the location of its customers.

10. The organisational and internal reporting structure of an enterprise will normally provide evidence of whether its dominant source of geographical risks results from the location of its assets (the origin of

its sales) or the location of its customers (the destination of its sales). Accordingly, an enterprise looks to this structure to determine whether its geographical segments should be based on the location of its assets or on the location of its customers.

11. Determining the composition of a business or geographical segment involves a certain amount of judgement. In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in this Standard and the qualitative characteristics of financial statements as identified in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. The qualitative characteristics include the relevance, reliability, and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise as a whole.

12. The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

13. The definitions of segment revenue, segment expense, segment assets and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis. An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

14. In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Such an allocation would not constitute a reasonable basis under the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Statement. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Standard.

15. Examples of segment assets include current assets that are used in the operating activities of the segment and tangible and intangible fixed assets. If a particular item of depreciation or amortisation is included in segment expense, the related asset is also included in segment assets. Segment assets do not include assets used for general enterprise or head-office purposes. Segment assets include operating assets shared by two or more segments if a reasonable basis for allocation exists. Segment assets include goodwill that is directly attributable to a segment or that can be allocated to a segment on a reasonable basis, and segment expense includes related amortisation of goodwill. If segment assets have been revalued subsequent to acquisition, then the measurement of segment assets reflects those revaluations.

16. Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services. Segment liabilities do not include borrowings and other liabilities that are incurred for financing rather than operating purposes. The liabilities of segments whose operations are not primarily of a financial nature do not include borrowings and similar liabilities because segment result represents

an operating, rather than a net-of-financing, profit or loss. Further, because debt is often issued at the head-office level on an enterprise-wide basis, it is often not possible to directly attribute, or reasonably allocate, the interest- bearing liabilities to segments.

17. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment.

18. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

Identifying Reportable Segments

Primary and Secondary Segment Reporting Formats

19. The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

20. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided in sub-paragraphs (a) and (b) below:

- ***(a) if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach' to managing the company and to reporting internally to the board of directors and the chief executive officer, then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and***
- ***(b) if internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas, the directors and management of the enterprise should determine whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and should, accordingly, choose business segments or geographical segments as the primary segment reporting format of the enterprise, with the other as its secondary reporting format.***

21. For most enterprises, the predominant source of risks and returns determines how the enterprise is organised and managed. Organisational and management structure of an enterprise and its internal financial reporting system normally provide the best evidence of the predominant source of risks and returns of the enterprise for the purpose of its segment reporting. Therefore, except in rare circumstances, an enterprise will report segment information in its financial statements on the same basis as it reports internally to top management. Its predominant source of risks and returns becomes its primary segment reporting format. Its secondary source of risks and returns becomes its secondary segment reporting format.

22. A 'matrix presentation' — both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis -- will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Standard does not require, but does not prohibit, a 'matrix presentation'.

23. In some cases, organisation and internal reporting of an enterprise may have developed along lines unrelated to both the types of products and services it produces, and the geographical areas in which it operates. In such cases, the internally reported segment data will not meet the objective of this Standard. Accordingly, paragraph 20(b) requires the directors and management of the enterprise to determine whether the risks and returns of the enterprise are more product/service driven or geographically driven and to accordingly choose business segments or geographical segments as the primary basis of segment reporting. The objective is to achieve a reasonable degree of comparability with other enterprises, enhance understandability of the resulting information, and meet the needs of investors, creditors, and others for information about product/service-related and geographically-related risks and returns.

Business and Geographical Segments

24. Business and geographical segments of an enterprise for external reporting purposes should be those organisational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the unit's performance and for making decisions about future allocations of resources, except as provided in paragraph 25.

25. If internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas, paragraph 20(b) requires that the directors and management of the enterprise should choose either business segments or geographical segments as the primary segment reporting format of the enterprise based on their assessment of which reflects the primary source of the risks and returns of the enterprise, with the other as its secondary reporting format. In that case, the directors and management of the enterprise should determine its business segments and geographical segments for external reporting purposes based on the factors in the definitions in paragraph 5 of this Standard, rather than on the basis of its system of internal financial reporting to the board of directors and chief executive officer, consistent with the following:

(a) if one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions in paragraph 5 but others are not, sub-paragraph (b) below should be applied only to those internal segments that do not meet the definitions in paragraph 5 (that is, an

internally reported segment that meets the definition should not be further segmented);

(b) ***for those segments reported internally to the directors and management that do not satisfy the definitions in paragraph 5, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions in paragraph 5; and***

(c) ***if such an internally reported lower-level segment meets the definition of business segment or geographical segment based on the factors in paragraph 5, the criteria in paragraph 27 for identifying reportable segments should be applied to that segment.***

26. Under this Standard, most enterprises will identify their business and geographical segments as the organisational units for which information is reported to the board of the directors (particularly the non-executive directors, if any) and to the chief executive officer (the senior operating decision maker, which in some cases may be a group of several people) for the purpose of evaluating each unit's performance and for making decisions about future allocations of resources. Even if an enterprise must apply paragraph 25 because its internal segments are not along product/service or geographical lines, it will consider the next lower level of internal segmentation that reports information along product and service lines or geographical lines rather than construct segments solely for external reporting purposes. This approach of looking to organisational and management structure of an enterprise and its internal financial reporting system to identify the business and geographical segments of the enterprise for external reporting purposes is sometimes called the 'management approach', and the organisational components for which information is reported internally are sometimes called 'operating segments'.

Reportable Segments

27. A business segment or geographical segment should be identified as a reportable segment if:

(a) ***its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or***

(b) ***its segment result, whether profit or loss, is 10 per cent or more of -***

(i) ***the combined result of all segments in profit, or***

(ii) ***the combined result of all segments in loss, whichever is greater in absolute amount; or***

(c) ***its segment assets are 10 per cent or more of the total assets of all segments.***

28. A business segment or a geographical segment which is not a reportable segment as per paragraph 27, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

29. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds in paragraph 27, until at least 75 per cent of total enterprise revenue is included in reportable segments.

30. The 10 per cent thresholds in this Standard are not intended to be a guide for determining materiality for any aspect of financial reporting other than identifying reportable business and geographical segments.

Illustration II attached to this Standard presents an illustration of the determination of reportable segments as per paragraphs 27-29.

31. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 per cent thresholds.

32. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

Segment Accounting Policies

33. Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.

34. There is a presumption that the accounting policies that the directors and management of an enterprise have chosen to use in preparing the financial statements of the enterprise as a whole are those that the directors and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements better understand and make more informed judgements about the enterprise as a whole, this Standard requires the use, in preparing segment information, of the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. That does not mean, however, that the enterprise accounting policies are to be applied to reportable segments as if the segments were separate stand-alone reporting entities. A detailed calculation done in applying a particular accounting policy at the enterprise-wide level may be allocated to segments if there is a reasonable basis for doing so. Pension calculations, for example, often are done for an enterprise as a whole, but the enterprise-wide figures may be allocated to segments based on salary and demographic data for the segments.

35. This Standard does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described.

36. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

37. The way in which asset, liability, revenue, and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all enterprises; nor is it appropriate to force allocation of enterprise asset, liability, revenue, and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary. At the same time, the definitions of segment revenue, segment expense, segment assets, and segment liabilities are interrelated, and the resulting allocations should

be consistent. Therefore, jointly used assets and liabilities are allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. For example, an asset is included in segment assets if, and only if, the related depreciation or amortisation is included in segment expense.

Disclosure

38. Paragraphs 39-46 specify the disclosures required for reportable segments for primary segment reporting format of an enterprise. Paragraphs 47-51 identify the disclosures required for secondary reporting format of an enterprise. Enterprises are encouraged to make all of the primary-segment disclosures identified in paragraphs 39-46 for each reportable secondary segment although paragraphs 47-51 require considerably less disclosure on the secondary basis. Paragraphs 53-59 address several other segment disclosure matters. Illustration III attached to this Standard illustrates the application of these disclosure standards.

Explanation:

In case, by applying the definitions of 'business segment' and 'geographical segment', it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information as per this Standard is not required to be disclosed. However, the fact that there is only one 'business segment' and 'geographical segment' is disclosed by way of a note.

Primary Reporting Format

39. The disclosure requirements in paragraphs 40-46 should be applied to each reportable segment based on primary reporting format of an enterprise.

40. An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

41. Paragraph 40 (b) requires an enterprise to report segment result. If an enterprise can compute segment net profit or loss or some other measure of segment profitability other than segment result, without arbitrary allocations, reporting of such amount(s) in addition to segment result is encouraged. If that measure is prepared on a basis other than the accounting policies adopted for the financial statements of the enterprise, the enterprise will include in its financial statements a clear description of the basis of measurement.

42. An example of a measure of segment performance above segment result in the statement of profit and loss is gross margin on sales. Examples of measures of segment performance below segment result in the statement of profit and loss are profit or loss from ordinary activities (either before or after income taxes) and net profit or loss.

43. Accounting Standard 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' requires 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". Examples of such items include write- downs of inventories, provisions for restructuring, disposals of fixed assets and long-term investments, legislative changes having retrospective application, litigation settlements, and reversal of provisions. An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

44. An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortisation expense and non-cash expenses of such segment pursuant to sub-paragraphs (f) and (g) of paragraph 40.

45. AS 3, Cash Flow Statements, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses pursuant to sub-paragraphs (f) and (g) of paragraph 40.

46. An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

Secondary Segment Information

47. Paragraphs 39-46 identify the disclosure requirements to be applied to each reportable segment based on primary reporting format of an enterprise. Paragraphs 48-51 identify the disclosure requirements to be applied to each reportable segment based on secondary reporting format of an enterprise, as follows:

(a) if primary format of an enterprise is business segments, the required secondary-format disclosures are identified in paragraph 48;

(b) if primary format of an enterprise is geographical segments based on location of assets (where the products of the enterprise are produced or where its service rendering operations are based), the required secondary-format disclosures are identified in paragraphs 49 and 50;

(c) if primary format of an enterprise is geographical segments based on the location of its customers (where its products are sold or services are rendered), the required secondary-format disclosures are identified in paragraphs 49 and 51.

48. If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

- ***(a) segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;***
- ***(b) the total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and***
- ***(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.***

49. If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

- ***(a) segment revenue from external customers;***
- ***(b) the total carrying amount of segment assets; and***
- ***(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).***

50. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

51. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

- ***(a) the total carrying amount of segment assets by geographical location of the assets; and***
- ***(b) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.***

Illustrative Segment Disclosures

52. Illustration III attached to this Standard Illustrates the disclosures for primary and secondary formats that are required by this Standard.

Other Disclosures

53. In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

54. Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

55. AS 5 requires that changes in accounting policies adopted by the enterprise should be made only if required by statute, or for compliance with an accounting standard, or if it is considered that the change would result in a more appropriate presentation of events or transactions in the financial statements of the enterprise.

56. Changes in accounting policies adopted at the enterprise level that affect segment information are dealt with in accordance with AS 5. AS 5 requires that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

57. Some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effect of the change, if reasonably determinable.

58. An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

59. To assess the impact of such matters as shifts in demand, changes in the prices of inputs or other factors of production, and the development of alternative products and processes on a business segment, it is necessary to know the activities encompassed by that segment. Similarly, to assess the impact of changes in the economic and political environment on the risks and returns of a geographical segment, it is important to know the composition of that geographical segment.

Illustration I

Segment Definition Decision Tree

The purpose of this illustration is to illustrate the application of paragraphs 24-32 of the Accounting Standard.

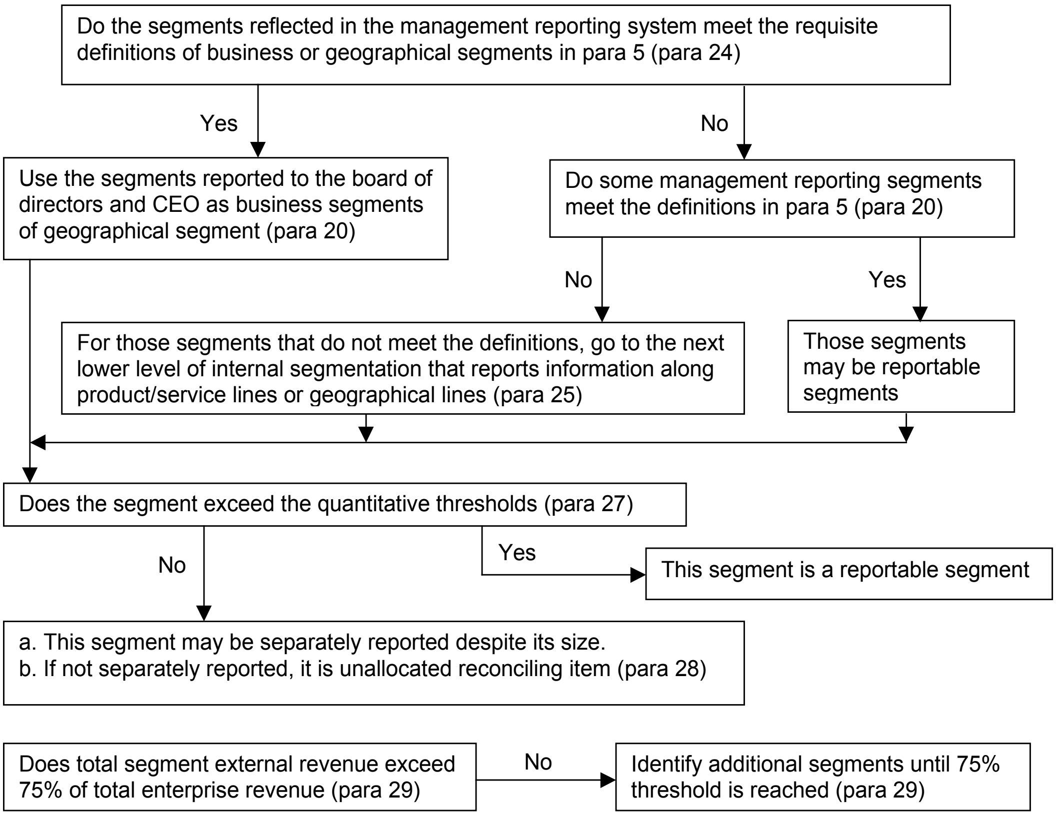

Illustration II

Illustration on Determination of Reportable Segments [Paragraphs 27-29]

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of paragraphs 27-29 of the Accounting Standard.

An enterprise operates through eight segments, namely, A, B, C, D, E, F, G and H. The relevant information about these segments is given in the following table (amounts in ₹ '000):

	A	*B*	*C*	*D*	*E*	*F*	*G*	*H*	*Total (Segments)*	*Total (Enterprise)*
1. SEGMENT REVENUE										
(a) External Sales	-	255	15	10	15	50	20	35	400	
(b) Inter-segment Sales	100	60	30	5	-	-	5	-	200	
(c) Total Revenue	100	315	45	15	15	50	25	35	600	400
2. Total Revenue of each segment as a percentage of total revenue of all segments	16.7	52.5	7.5	2.5	2.5	8.3	4.2	5.8		

3.SEGMENT RESULT [Profit/(Loss)]	5	(90)	15	(5)	8	(5)	5	7		
4. Combined Result of all Segments in profits	5		15		8		5	7	40	
5. Combined Result of all Segments in loss		(90)		(5)		(5)			(100)	
6. Segment Result as a percentage of the greater of the totals arrived at 4 and 5 above in absolute amount (i.e., 100)	5	90	15	5	8	5	5	7		
7.SEGMENT ASSETS	15	47	5	11	3	5	5	9	100	
8. Segment assets as a percentage of total assets of all segments	15	47	5	11	3	5	5	9		

The reportable segments of the enterprise will be identified as below:

(a) In accordance with paragraph 27(a), segments whose total revenue from external sales and inter-segment sales is 10% or more of the total revenue of all segments, external and internal, should be identified as reportable segments. Therefore, Segments A and B are reportable segments.

(b) As per the requirements of paragraph 27(b), it is to be first identified whether the combined result of all segments in profit or the combined result of all segments in loss is greater in absolute amount. From the table, it is evident that combined result in loss (i.e., ₹ 100,000) is greater. Therefore, the individual segment result as a percentage of ₹ 100,000 needs to be examined. In accordance with paragraph 27(b), Segments B and C are reportable segments as their segment result is more than the threshold limit of 10%.

(c) Segments A, B and D are reportable segments as per paragraph 27(c), as their segment assets are more than 10% of the total segment assets. Thus, Segments A, B, C and D are reportable segments in terms of the criteria laid down in paragraph 27.

Paragraph 28 of the Standard gives an option to the management of the enterprise to designate any segment as a reportable segment. In the given case, it is presumed that the management decides to designate Segment E as a reportable segment.

Paragraph 29 requires that if total external revenue attributable to reportable segments identified as aforesaid constitutes less than 75% of the total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds in paragraph 27, until at least 75% of total enterprise revenue is included in reportable segments.

The total external revenue of Segments A, B, C, D and E, identified above as reportable segments, is ₹ 295,000. This is less than 75% of total enterprise revenue of ₹ 400,000. The management of the enterprise is required to designate any one or more of the remaining segments as reportable segment(s) so that the external revenue of reportable segments is at least 75% of the total enterprise revenue. Suppose, the management designates Segment H for this purpose. Now the external revenue of reportable segments is more than 75% of the total enterprise revenue.

Segments A, B, C, D, E and H are reportable segments. Segments F and G will be shown as reconciling items.

Illustration III

Illustrative Segment Disclosures

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of paragraphs 38-59 of the Accounting Standard.

This illustration illustrates the segment disclosures that this Standard would require for a diversified multi-locational business enterprise. This example is intentionally complex to illustrate most of the provisions of this Standard.

INFORMATION ABOUT BUSINESS SEGMENTS (NOTE XX)

(ALL AMOUNTS IN ₹ LAKHS)

	Paper Products		Office Products		Publishing		Other Operations		Eliminations		Consolidated Total	
	Current Year	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*
REVENUE												
External sales	55	50	20	17	19	16	7	7				
Inter-segment sales	15	10	10	14	2	4	2	2	(29)	(30)		
Total Revenue	70	60	30	31	21	20	9	9	(29)	(30)	101	90
RESULT												
Segment result	20	17	9	7	2	1	0	0	(1)	(1)	30	24
Unallocated corporate expenses											(7)	(9)
Operating profit											23	15
Interest expense											(4)	(4)
Interest income											2	3
Income taxes											(7)	(4)
Profit from ordinary activities											14	10
Extraordinary loss: uninsured earthquake damage to factory		(3)										(3)

Net profit									14	7
OTHER INFORMATION										
Segment assets	54	50	34	30	10	10	10	9	108	99
Unallocated Corporate assets									35	30
Total assets									143	129
Segment liabilities	25	15	8	11	8	8	1	1	42	35
Unallocated liabilities									40	55
Total liabilities									82	90
Capital expenditure	12	10	3	5	5		4	3		
Depreciation	9	7	9	7	5	3	3	4		
Non-cash expenses other than	8	2	7	3	2	2	2	1		

Note xx-Business and Geographical Segments (amounts in ₹ lakhs)

Business segments: For management purposes, the Company is organised on a worldwide basis into three major operating divisions-paper products, office products and publishing — each headed by a senior vice president. The divisions are the basis on which the company reports its primary segment information. The paper products segment produces a broad range of writing and publishing papers and newsprint. The office products segment manufactures labels, binders, pens, and markers and also distributes office products made by others. The publishing segment develops and sells books in the fields of taxation, law and accounting. Other operations include development of computer software for standard and specialised business applications. Financial information about business segments is presented in the above table (from page 314 to page 317).

Geographical segments: Although the Company's major operating divisions are managed on a worldwide basis, they operate in four principal geographical areas of the world. In India, its home country, the Company produces and sells a broad range of papers and office products. Additionally, all of the Company's publishing and computer software development operations are conducted in India. In the European Union, the Company operates paper and office products manufacturing facilities and sales offices in the following countries: France, Belgium, Germany and the U.K. Operations in Canada and the United States are essentially similar and consist of manufacturing papers and newsprint that are sold entirely within those two countries. Operations in Indonesia include the production of paper pulp and the manufacture of writing and publishing papers and office products, almost all of which is sold outside Indonesia, both to other segments of the company and to external customers.

Sales by market: The following table shows the distribution of the Company's consolidated sales by geographical market, regardless of where the goods were produced:

	Sales Revenue by *Geographical Market*	
	Current Year	*Previous Year*
India	19	22
European Union	30	31
Canada and the United States	28	21
Mexico and South America	6	2
Southeast Asia (principally Japan and Taiwan)	18	14
	101	90

Assets and additions to tangible and intangible fixed assets by geographical area: The following table shows the carrying amount of segment assets and additions to tangible and intangible fixed assets by geographical area in which the assets are located:

	Carrying Amount of Segment Assets		**Additions to Fixed Assets and Intangible Assets**	
	Current Year	**Previous Year**	**Current Year**	**Previous Year**
India	72	78	8	5
European Union	47	37	5	4
Canada and the United States	34	20	4	3
Indonesia	22	20	7	6
	175	155	24	18

Segment revenue and expense: In India, paper and office products are manufactured in combined facilities and are sold by a combined sales force. Joint revenues and expenses are allocated to the two business segments on a reasonable basis. All other segment revenue and expense are directly attributable to the segments.

Segment assets and liabilities: Segment assets include all operating assets used by a segment and consist principally of operating cash, debtors, inventories and fixed assets, net of allowances and provisions which are reported as direct offsets in the balance sheet. While most such assets can be directly attributed to individual segments, the carrying amount of certain assets used jointly by two or more segments is allocated to the segments on a reasonable basis. Segment liabilities include all operating liabilities and consist principally of creditors and accrued liabilities. Segment assets and liabilities do not include deferred income taxes.

Inter-segment transfers: Segment revenue, segment expenses and segment result include transfers between business segments and between geographical segments. Such transfers are accounted for at competitive market prices charged to unaffiliated customers for similar goods. Those transfers are eliminated in consolidation.

Unusual item: Sales of office products to external customers in the current year were adversely affected by a lengthy strike of transportation workers in India, which interrupted product shipments for approximately four months. The Company estimates that sales of office products during the four-month period were approximately half of what they would otherwise have been.

Extraordinary loss: As more fully discussed in Note x, the Company incurred an uninsured loss of ₹ 3,00,000 caused by earthquake damage to a paper mill in India during the previous year.

Illustration IV

Summary of Required Disclosure

This illustration does not form part of the Accounting Standard. Its purpose is to summarise the disclosures required by paragraphs 38-59 for each of the three possible primary segment reporting formats.

Figures in parentheses refer to paragraph numbers of the relevant paragraphs in the text.

PRIMARY FORMAT IS BUSINESS SEGMENTS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF ASSETS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF CUSTOMERS
Required Primary Disclosures	***Required Primary Disclosures***	***Required Primary Disclosures***
Revenue from external customers by business segment [40(a)]	Revenue from external customers by location of assets [40(a)]	Revenue from external customers by location of customers [40(a)]
Revenue from transactions with other segments by business segment [40(a)]	Revenue from transactions with other segments by location of assets [40(a)]	Revenue from transactions with other segments by location of customers [40(a)]
Segment result by business segment [40(b)]	Segment result by location of assets [40(b)]	Segment result by location of customers [40(b)]
Carrying amount of segment assets by business segment [40(c)]	Carrying amount of segment assets by location of assets [40(c)]	Carrying amount of segment assets by location of customers [40(c)]
Segment liabilities by business segment [40(d)]	Segment liabilities by location of assets [40(d)]	Segment liabilities by location of customers [40(d)]
Cost to acquire tangible and intangible fixed assets by business segment [40(e)]	Cost to acquire tangible and intangible fixed assets by location of assets [40(e)]	Cost to acquire tangible and intangible fixed assets by location of customers [40(e)]
Required Primary Disclosures	***Required Primary Disclosures***	***Required Primary Disclosures***
Depreciation and amortisation expense by business segment [40(f)]	Depreciation and amortisation expense by location of assets[40(f)]	Depreciation and amortisation expense by location of customers[40(f)]
Non-cash expenses other than depreciation and amortisation by business segment [40(g)]	Non-cash expenses other than depreciation and amortisation by location of assets [40(g)]	Non-cash expenses other than depreciation and amortisation by location of customers [40(g)]
Reconciliation of revenue, result, assets, and liabilities by business segment [46]	Reconciliation of revenue, result, assets, and liabilities [46]	Reconciliation of revenue, result, assets, and liabilities [46]

Required Secondary Disclosures	***Required Secondary Disclosures***	***Required Secondary Disclosures***
Revenue from external customers by location of customers [48]	Revenue from external customers by business segment [49]	Revenue from external customers by business segment [49]
Carrying amount of segment assets by location of assets [48]	Carrying amount of segment assets by business segment [49]	Carrying amount of segment assets by business segment [49]
Cost to acquire tangible and intangible fixed assets by location of assets [48]	Cost to acquire tangible and intangible fixed assets by business segment [49]	Cost to acquire tangible and intangible fixed assets by business segment [49]
	Revenue from external customers by geographical customers if different from location of assets [50]	
PRIMARY FORMAT IS BUSINESS SEGMENTS	**PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF ASSETS**	**PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF CUSTOMERS**
Required Secondary Disclosures	***Required Secondary Disclosures***	***Required Secondary Disclosures***
		Carrying amount of segment assets by location of assets if different from location of customers [51]
		Cost to acquire tangible and intangible fixed assets by location of assets if different from location of customers [51]
Other Required Disclosures	***Other Required Disclosures***	***Other Required Disclosures***
Basis of pricing inter- segment transfers and any change therein [53]	Basis of pricing inter- segment transfers and any change therein [53]	Basis of pricing inter- segment transfers and any change therein [53]
Changes in segment accounting policies [54]	Changes in segment accounting policies [54]	Changes in segment accounting policies [54]
Types of products and services in each business segment [58]	Types of products and services in each business segment [58]	Types of products and services in each business segment [58]
Composition of each geographical segment [58]	Composition of each geographical segment [58]	Composition of each geographical segment [58]

AS 18* (issued 2000) - Related Party Disclosures

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

This Accounting Standard is not Mandatory for non-corporate entities falling in Level III.

Objective

The objective of this Standard is to establish requirements for disclosure of:

(a) related party relationships; and

(b) transactions between a reporting enterprise and its related parties.

Scope

1. This Standard should be applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The requirements of this Standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

2. This Standard applies only to related party relationships described in paragraph 3.

3. This Standard deals only with related party relationships described in (a) to (e) below:

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

4. In the context of this Standard, the following are deemed not to be related parties:

(a) two companies simply because they have a director in common, notwithstanding paragraph 3(d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings);

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* A limited revision to this Standard was made in 2003, pursuant to which paragraph 26 of this Standard was revised and paragraph 27 was added to this Standard.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

5. Related party disclosure requirements as laid down in this Standard do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

6. In case a statute or a regulator or a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

7. No disclosure is required in consolidated financial statements in respect of intra-group transactions.

8. Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise.

9. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Definitions

10. For the purpose of this Standard, the following terms are used with the meanings specified:

10.1 Related party - parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

10.2 Related party transaction - a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

10.3 Control –

(a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

10.4 Significant influence - participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

10.5 An Associate - an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

10.6 A Joint venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

10.7 Joint control - the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

10.8 Key management personnel - those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

10.9 Relative – in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

10.10 Holding company - a company having one or more subsidiaries.

10.11 Subsidiary - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

10.12 Fellow subsidiary - a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

10.13 State-controlled enterprise - an enterprise which is under the control of the Central Government and/or any State Government(s).

11. For the purpose of this Standard, an enterprise is considered to control the composition of

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

12. An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.

13. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel, or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investing party holds, directly or indirectly through intermediaries, less than 20 per cent of the voting power of the enterprise, it is presumed that the investing party does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

Explanation

An intermediary means a subsidiary as defined in AS 21, Consolidated Financial Statements.

14. Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. For example, in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

Explanation

A non-executive director of a company is not considered as a key management person under this Standard by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. The requirements of this Standard are not applied in respect of a non-executive director even enterprise, unless he falls in any of the categories in paragraph 3 of this Standard.

The Related Party Issue

15. Related party relationships are a normal feature of commerce and business. For example, enterprises frequently carry on separate parts of their activities through subsidiaries or associates and acquire interests in other enterprises - for investment purposes or for trading reasons - that are of sufficient proportions for the investing enterprise to be able to control or exercise significant influence on the financial and/or operating decisions of its investee.

16. Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's- length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. Sometimes, no price is charged in related party transactions, for example, free provision of management services and the extension of free credit on a debt. In view of the aforesaid, the resulting

accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

17. The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another - for example, a subsidiary may be instructed by its holding company not to engage in research and development.

18. Because there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required by this Standard.

19. Sometimes, transactions would not have taken place if the related party relationship had not existed. For example, a company that sold a large proportion of its production to its holding company at cost might not have found an alternative customer if the holding company had not purchased the goods.

Disclosure

20. The statutes governing an enterprise often require disclosure in financial statements of transactions with certain categories of related parties. In particular, attention is focussed on transactions with the directors or similar key management personnel of an enterprise, especially their remuneration and borrowings, because of the fiduciary nature of their relationship with the enterprise.

21. Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

22. Where the reporting enterprise controls, or is controlled by, another party, this information is relevant to the users of financial statements irrespective of whether or not transactions have taken place with that party. This is because the existence of control relationship may prevent the reporting enterprise from being independent in making its financial and/or operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an enterprise's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the enterprise's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.

23. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

- ***(i) the name of the transacting related party;***
- ***(ii) a description of the relationship between the parties;***
- ***(iii) a description of the nature of transactions;***
- ***(iv) volume of the transactions either as an amount or as an appropriate proportion;***
- ***(v) any other elements of the related party transactions necessary for an understanding of the financial statements;***

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

24. The following are examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of fixed assets;

(c) rendering or receiving of services;

(d) agency arrangements;

(e) leasing or hire purchase arrangements;

(f) transfer of research and development;

(g) license agreements;

(h) finance (including loans and equity contributions in cash or in kind);

(i) guarantees and collaterals; and

(j) management contracts including for deputation of employees.

25. Paragraph 23 (v) requires disclosure of 'any other elements of the related party transactions necessary for an understanding of the financial statements'. An example of such a disclosure would be an indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.

26. Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Explanation:

Type of related party means each related party relationship described in paragraph 3 above.

27. Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions. Hence, purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

Explanation:

(a) Materiality primarily depends on the facts and circumstances of each case. In deciding whether an item or an aggregate of items is material, the nature and the size of the item(s) are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor. As regards size, for the purpose of applying the test of materiality as per this paragraph, ordinarily a related party transaction, the amount of which is in excess of 10% of the total related party transactions of the same type (such as purchase of goods), is considered material, unless on the basis of facts and circumstances of the case it can be concluded that even a transaction of less than 10% is material. As regards nature, ordinarily the related party transactions which are not entered into in the normal course of the business of the reporting enterprise are considered material subject to the facts and circumstances of the case.

(b) The manner of disclosure required by paragraph 23, read with paragraph 26, is illustrated in the Illustration attached to the Standard.

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the Accounting Standard.

The manner or disclosures required by paragraphs 23 and 26 of AS 18 is illustrated as below. It may be noted that the format given below is merely illustrative in nature and is not exhaustive.

	Holding Company	*Subsidi aries*	*Fellow Subsidi aries*	*Associ ates*	*Key Management Personnel*	*Relatives Total of Key Management Personnel*
Purchases of goods Sale of goods Purchase of fixed assets Sale of fixed assets Rendering of services Receiving of services Agency arrangements Leasing or hire purchase arrangements Transfer of research and development License agreements Finance (including loans and equity contributions in cash or in kind) Guarantees and collaterals Management contracts including for deputation of employees						

Note:

Name of related parties and description of relationship:

1	Holding Company	A Ltd.
2	Subsidiaries	B Ltd. and C (P) Ltd.
3	Fellow Subsidiaries	D Ltd. and Q Ltd.
4	Associates	X Ltd., Y Ltd. and Z (P) Ltd.
5	Key Management Personnel	Mr. Y and Mr. Z
6	Relatives of Key Management Personnel	Mrs. Y (wife of Mr. Y), Mr. F (father of Mr. Z)

AS 19[1]: Leases

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Scope

1. This Standard should be applied in accounting for all leases other than:

(a) lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and

(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

(c) lease agreements to use lands.

2. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1 A <u>lease</u> is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

3.2 A <u>finance lease</u> is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

3.3 An <u>operating lease</u> is a lease other than a finance lease.

3.4 A <u>non-cancellable lease</u> is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

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[1] Issued in 2001

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

3.5 The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

3.6 The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

3.7 Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- *(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or*
- *(b) in the case of the lessor, any residual value guaranteed to the lessor:*
  - *(i) by or on behalf of the lessee; or*
  - *(ii) by an independent third party financially capable of meeting this guarantee.*

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

3.8 Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

3.9 Economic life is either:

- *(a) the period over which an asset is expected to be economically usable by one or more users; or*
- *(b) the number of production or similar units expected to be obtained from the asset by one or more users.*

3.10 Useful life of a leased asset is either:

- *(a) the period over which the leased asset is expected to be used by the lessee; or*
- *(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.*

3.11 Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

3.12 Guaranteed residual value is:

- *(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and*
- *(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.*

3.13 Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

3.14 <u>Gross investment in the lease</u> is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

3.15 <u>Unearned finance income</u> is the difference between:

- ***(a) the gross investment in the lease; and***
- ***(b) the present value of***
  - ***(i) the minimum lease payments under a finance lease from the standpoint of the lessor; and***
  - ***(ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.***

3.16 <u>Net investment in the lease</u> is the gross investment in the lease less unearned finance income.

3.17 The <u>interest rate implicit in the lease</u> is the discount rate that, at the inception of the lease, causes the aggregate present value of

- ***(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and***
- ***(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.***

3.18 The <u>lessee's incremental borrowing rate of interest</u> is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

3.19 <u>Contingent rent</u> is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

4. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

Classification of Leases

5. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

7. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

10. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 5 to 9 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Leases in the Financial Statements of Lessees

Finance Leases

11. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the

discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example

(a) An enterprise (the lessee) acquires a machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery, i.e., 3 years. The fair value of the machinery on January 1, 20X0 is ₹ .2,35,500. The lease agreement requires the lessee to pay an amount of ₹ .1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of ₹ .17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only ₹ .3,500 on December 31, 20X2.

The interest rate implicit in the lease is 16 per cent (approx.). This is calculated using the following formula:

$$\text{Fair value} = \frac{ALR}{(1+r)^1} + \frac{ALR}{(1+r)^2} + \ldots \quad \frac{ALR}{(1+r)^n} + \frac{RV}{(1+r)^n}$$

where ALR is annual lease rental,

RV is residual value (both guaranteed and unguaranteed),

n is the lease term,

r is interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is ₹ 2,35,500.

The lessee would record the machinery as an asset at ₹ 2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of ₹ 17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of ₹ 5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at 16% (approx.). The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be ₹ .2,27,805. As this amount is lower than the fair value of the leased asset (₹ .2,35,500), the lessee would recognise the asset and the liability arising from the lease at ₹ 2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be computed using the lessee's incremental borrowing rate.

12. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

13. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is

therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

14. It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

15. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

16. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example

In the example (a) illustrating paragraph 11, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows:

	Year	*Finance charge (₹)*	*Payment (₹)*	*Reduction in outstanding liability (₹)*	*Outstanding liability (₹)*
Year 1	(January 1)				2,35,500
	(December 31)	37,680	1,00,000	62,320	1,73,180
Year 2	(December 31)	27,709	1,00,000	72,291	1,00,889
Year 3	(December 31)	16,142	1,00,000	83,858	17,031*

17. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

18. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

19. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

20. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply

* The difference between this figure and guaranteed residual value (₹ 17,000) is due to approximation in computing the interest rate implicit in the lease.

to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

21. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[4], that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

- ***(a) assets acquired under finance lease as segregated from the assets owned;***
- ***(b) for each class of assets, the net carrying amount at the balance sheet date;***
- ***(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:***
    - ***(i) not later than one year;***
    - ***(ii) later than one year and not later than five years; (iii) later than five years;***
- ***(d) contingent rents recognised as expense in the statement of profit and loss for the period;***
- ***(e) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and***
- ***(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:***
    - ***(i) the basis on which contingent rent payments are determined;***
    - ***(ii) the existence and terms of renewal or purchase options and escalation clauses; and***
    - ***(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.***

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), may not comply with sub- paragraphs (c), (e) and (f).

Operating Leases

23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis

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[4] Accounting Standard (AS) 28, 'Impairment of Assets',' specifies the requirements relating to impairment of assets.

unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

25. The lessee should make the following disclosures for operating leases:

- ***(a) the total of future minimum lease payments under non- cancellable operating leases for each of the following periods:***
  - ***(i) not later than one year;***
  - ***(ii) later than one year and not later than five years;***
  - ***(iii) later than five years;***
- ***(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;***
- ***(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;***
- ***(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;***
- ***(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:***
  - ***(i) the basis on which contingent rent payments are determined;***
  - ***(ii) the existence and terms of renewal or purchase options and escalation clauses; and***
  - ***(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.***

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), may not comply with sub- paragraphs (a), (b) and (e).

Leases in the Financial Statements of Lessors

Finance Leases

26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

27. Under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services.

28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

29. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.

30. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

31. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

32. The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

33. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

34. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) ***unearned finance income;***

(c) ***the unguaranteed residual values accruing to the benefit of the lessor;***

(d) ***the accumulated provision for uncollectible minimum lease payments receivable;***

(e) ***contingent rents recognised in the statement of profit and loss for the period;***

(f) ***a general description of the significant leasing arrangements of the lessor; and***

(g) ***accounting policy adopted in respect of initial direct costs.***

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level IIImay not comply with sub- paragraphs (a) and (f). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, may not comply with sub-paragraph (g) also.

38. As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

Operating Leases

39. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

40. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

42. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

43. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

44. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[5] that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

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[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

45. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, and the governing statute, make the following disclosures for operating leases:

- ***(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and***
  - ***(i) the depreciation recognised in the statement of profit and loss for the period;***
  - ***(ii) impairment losses recognised in the statement of profit and loss for the period;***
  - ***(iii) impairment losses reversed in the statement of profit and loss for the period;***
- ***(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:***
  - ***(i) not later than one year;***
  - ***(ii) later than one year and not later than five years;***
  - ***(iii) later than five years;***
- ***(c) total contingent rents recognised as income in the statement of profit and loss for the period;***
- ***(d) a general description of the lessor 's significant leasing arrangements; and***
- ***(e) accounting policy adopted in respect of initial direct costs.***

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level III, may not comply with sub- paragraphs (b) and (d). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, may not comply with sub-paragraph (e) also.

Sale and Leaseback Transactions

47. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

49. If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset

is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

51. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

53. For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Illustration

Sale and Leaseback Transactions that Result in Operating Leases

The illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The following table shows the requirements of the accounting standard in various circumstances.

Sale price established at fair value (paragraph 50)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	No profit	Recognise profit immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately
Sale price below fair value (paragraph 50)			
Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)

Sale price above fair value (paragraph 50)			
Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

Note 1 These parts of the table represent circumstances that would have been dealt with under paragraph 52 of the Standard. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

AS 20* - Earnings Per Share

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Standard is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

Scope

1. This Standard should be applied by all the entities. However, a Small and Medium Sized Company and a Small and Medium Sized non-corporate entity falling in Level II or Level III 'Applicability of Accounting Standards to Various Entities', may not disclose diluted earnings per share (both including and excluding extraordinary items). Further, a non-corporate Small and Medium Sized Entity falling in level III, may not disclose the information required by paragraph 48(ii) of the standard.

2. In consolidated financial statements, the information required by this Standard should be presented on the basis of consolidated information. [2]

3. In the case of a parent (holding enterprise), users of financial statements are usually concerned with, and need to be informed about, the results of operations of both the enterprise itself as well as of the group as a whole. Accordingly, in the case of such enterprises, this Standard requires the

* Issued in 2001. A limited revision to this Standard was made in 2004, pursuant to which paragraphs 48 and 51 of this Standard were revised.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] Accounting Standard (AS) 21, 'Consolidated Financial Statements', specifies the requirements relating to consolidated financial statements.

presentation of earnings per share information on the basis of consolidated financial statements as well as individual financial statements of the parent. In consolidated financial statements, such information is presented on the basis of consolidated information.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

4.1 An equity share is a share other than a preference share.

4.2 A preference share is a share carrying preferential rights to dividends and repayment of capital.

4.3 A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

4.4 A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

4.5 Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

4.6 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

5. Equity shares participate in the net profit for the period only after preference shares. An enterprise may have more than one class of equity shares. Equity shares of the same class have the same rights to receive dividends.

6. A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise. For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

7. Examples of potential equity shares are:

(a) debt instruments or preference shares, that are convertible into equity shares;

(b) share warrants;

(c) options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

(d) shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Presentation

8. An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

9. This Standard requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Measurement

Basic Earnings Per Share

10. Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

Earnings - Basic

11. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

12. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise *(see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).* The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

13. The amount of preference dividends for the period that is deducted from the net profit for the period is:

(a) the amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

(b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

14. If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per Share - Basic

15. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

16. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which

the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration I attached to the Standard illustrates the computation of weighted average number of shares.

17. In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

(a) equity shares issued in exchange for cash are included when cash is receivable;

(b) equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

(c) equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

(e) equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

18. Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

19. Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Illustration II attached to the Standard illustrates the computations in respect of partly paid equity shares.

20. Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

21. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

22. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

23. Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a bonus issue;

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

(c) a share split; and

(d) a reverse share split (consolidation of shares).

24. In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Illustration III attached to the Standard illustrates the computation of weighted average number of equity shares in case of a bonus issue during the period.

25. The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Illustration IV attached to the Standard illustrates the computation of weighted average number of equity shares in case of a rights issue during the period.

Diluted Earnings Per Share

26. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

27. In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

(a) the net profit for the period attributable to equity shares is:

(i) increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

(ii) increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

(iii) adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

(b) the weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

28. For the purpose of this Standard, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Earnings - Diluted

29. For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 11, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

30. After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in accordance with paragraph 11 is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Illustration V attached to the standard illustrates the computation of diluted earnings in case of convertible debentures.

31. The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the purpose of calculating diluted earnings per

share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

Per Share - Diluted

32. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated in accordance with paragraphs 15 and 22, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

33. The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

34. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

35. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

36. Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six months weekly closing prices are usually adequate for use in computing the average price.

37. Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

(a) a contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti- dilutive. They are ignored in the computation of diluted earnings per share; and

(b) a contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Illustration VI attached to the Standard illustrates the effects of share options on diluted earnings per share.

38. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

Dilutive Potential Equity Shares

39. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

40. An enterprise uses net profit from continuing ordinary activities as "the control figure" that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations[3].

41. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

42. In considering whether potential equity shares are dilutive or anti- dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration VII attached to the Standard illustrates the manner of determining the order in which dilutive securities should be included in the computation of weighted average number of shares.

43. Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

Restatement

44. If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on

[3] Accounting Standard (AS) 24, 'Discontinuing Operations', specifies the requirements in respect of discontinued operations.

which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

45. An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

46. An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

47. Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

Disclosure

48. In addition to disclosures as required by paragraphs 8, 9 and 44 of this Standard, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

(ii) (a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(b) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(c) the nominal value of shares along with the earnings per share figures.

Provided that a non-corporate Small and Medium Sized Entity Falling in Level III, 'Applicability of Accounting Standards to Various Entities', may not comply with sub-paragraph (ii).

49. Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine

whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Standard.

50. If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Standard. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

51. An enterprise may wish to disclose more information than this Standard requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of per share amounts for various components of net profit. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in accordance with this Standard in order to ensure the comparability of the per share amounts disclosed.

Illustrations

Note: These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Accounting Standard.

Illustration I

Example - Weighted Average Number of Shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares Issued	*No. of Shares Bought Back*	*No. of Shares Outstanding*
1st Jan., 20X1	Balance at beginning of year	1,800	-	1,800
31st May, 20X1	Issue of shares for cash	600	-	2,400
1st Nov., 20X1	Buy Back of shares	-	300	2,100
31st Dec., 20X1	Balance at end of year	2,400	300	2,100

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

Example – Partly paid shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of shares issued	*Nominal value of shares*	*Amount paid*
1st January, 20X1	Balance at beginning of year	1,800	₹ 10	₹ 10
31st October, 20X1	Issue of Shares	600	₹ 10	₹ 5

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share. Computation of weighted average would be as follows: (1,800x12/12) + (300x2/12) = 1,850 shares.

Illustration III

Example - Bonus Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X0	₹ 18,00,000
Net profit for the year 20X1	₹ 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 1st October 20X1	2 equity shares for each equity share outstanding at 30th September, 20X1 20,00,000 x 2 = 40,00,000
Earnings per share for the year 20X1	$\frac{60,00,000}{(20,00,000+40,00,000)}$ = ₹ 1.00
Adjusted earnings per share for the year 20X0	$\frac{18,00,000}{(20,00,000+40,00,000)}$ ₹ 0.30
Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X0, the earliest period reported.	

Example - Rights Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit	Year 20X0 : ₹ 11,00,000 Year 20X1 : ₹ 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares
lights issue	One new share for each five outstanding (i.e. 1,00,000 new shares) Rights issue price : ₹ 15.00 Last date to exercise rights: 1st March 20X1
Fair value of one equity share immediately prior to exercise of rights on 1st March 20X1	₹ 21.00

Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights+total amount rec}}{\text{Number of shares outstanding prior to exercise + number of shares issued in the}}$$

$$\frac{(₹\ 21.00 \times 5,00,000 \text{ shares}) + (₹\ 15.00 \times 1,00,000 \text{ shares})}{5,00,000 \text{ shares} + 1,00,000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{₹\ (21.00)}{₹\ (20.00)} = 1.05$$

Computation of earnings per share

	Year 20X0	**Year 20X1**
EPS for the year 20X0 as originally reported: ₹ .11,00,000/5,00,000 shares	₹ 2.20	
EPS for the year 20X0 restated for rights issue: ₹ .11,00,000/ (5,00,000 shares x 1.05)	₹ 2.10	
EPS for the year 20X1 including effects of rights issue $\frac{\text{Rs. } 15,00,000}{(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12)}$		₹ 2.55

Example - Convertible Debentures

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the current year	₹ 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	₹ 2.00
No. of 12% convertible debentures of ₹ 100 each Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	₹ 12,00,000
Tax relating to interest expense (30%)	₹ 3,60,000
Adjusted net profit for the current year	₹ (1,00,00,000 + 12,00,000 -3,60,000) = ₹ 1,08,40,000
No. of equity shares resulting from conversion of debentures	10,00,000

No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 =60,00,000
Diluted earnings per share	1,08,40,000/60,00,000 = Re. 1.81

Illustration VI

Example - Effects of Share Options on Diluted Earnings Per Share

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X1	₹ 12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	₹ 20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	₹ 15.00

Computation of earnings per share

	Earnings	***Shares***	***Earnings per share***
Net profit for the year 20X1	₹ 12,00,000		
Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			₹ 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 x 15.00)/20.00	*	(75,000)	
Diluted earnings per share	₹ 12,00,000	5,25,000	₹ 2.29
**The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration {see para 37(b)}*			

Illustration VII

Example - Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares (Accounting year 01-01-20XX to 31-12-20XX)

Earnings, i.e., Net profit attributable to equity shareholders	₹ 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	₹ 75.00

Potential Equity Shares	
Options	1,00,000 with exercise price of ₹ 60
Convertible Preference Shares Attributable tax, e.g., corporate dividend tax	8,00,000 shares entitled to a cumulative dividend of ₹ 8 per share. Each preference share is convertible into 2 equity shares. 10%
12% Convertible Debentures of ₹ 100 each	Nominal amount ₹ 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	*Increase in no. of Equity Shares*	*Earnings per Incremental Share*
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration {1,00,000 x (75 - 60) / 75}		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(₹ .8 x 8,00,000)+ 10% (8 x 8,00,000)]	₹ 70,40,000		
No. of incremental shares {2 x 8,00,000}		16,00,000	₹ 4.40
12% Convertible Debentures			
Increase in net profit {₹ 10,00,00,000 x 0.12 x (1-0.30)}	₹ 84,00,000		
No. of incremental shares {10,00,000 x 4}		40,00,000	₹ .2.10

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (see para 42).

Conversion of Diluted Earnings Per Shares

	Net Profit Attributable (₹)	*No. of Equity Shares*	*Net profit attributable Per Share (₹)*	
As reported	1,00,00,000	20,00,000	5.00	
Options		20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti- Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 3.06 to ₹ 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is ₹ 3.06.

AS 21 (issued 2001) – Consolidated Financial Statements[1]

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

Scope

1. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

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[1] It is clarified that AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21.

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2. This Standard should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate financial statements.

4. This Standard does not deal with:

(a) methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, Accounting for Amalgamations);

(b) accounting for investments in associates (at present governed by AS 13, Accounting for Investments[3] and

(c) accounting for investments in joint ventures (at present governed by AS 13, Accounting for Investments[4]).

Definitions

5. For the purpose of this Standard, the following terms are used with the meanings specified:

5.1 Control:

(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

5.2 A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

5.3 A parent is an enterprise that has one or more subsidiaries.

5.4 A group is a parent and all its subsidiaries.

5.5 Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

5.6 Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

5.7 Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

6. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow

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[3] Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

[4] Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', specifies the requirements relating to accounting for investments in joint ventures.

statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

Explanation:

All the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statement. For preparing consolidated financial statements, the following principles may be observed in respect of notes and other explanatory material that form an integral part thereof:

(a) Notes which are necessary for presenting a true and fair view of the consolidated financial statements are included in the consolidated financial statements as an integral part thereof.

(b) Only the notes involving items which are material need to be disclosed. Materiality for this purpose is assessed in relation to the information contained in consolidated financial statements. In view of this, it is possible that certain notes which are disclosed in separate financial statements of a parent or a subsidiary would not be required to be disclosed in the consolidated financial statements when the test of materiality is applied in the context of consolidated financial statements.

(c) Additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having no bearing on the true and fair view of the consolidated financial statements need not be disclosed in the consolidated financial statements. An illustration of such information in the case of companies is attached to the Standard.

Presentation of Consolidated Financial Statements

7. A parent which presents consolidated financial statements should present these statements in addition to its separate financial statements.

8. Users of the financial statements of a parent are usually concerned with, and need to be informed about, the financial position and results of operations of not only the enterprise itself but also of the group as a whole. This need is served by providing the users -

(a) separate financial statements of the parent; and

(b) consolidated financial statements, which present financial information about the group as that of a single enterprise without regard to the legal boundaries of the separate legal entities.

Scope of Consolidated Financial Statements

9. A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign, other than those referred to in paragraph 11. Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

10. The consolidated financial statements are prepared on the basis of financial statements of parent and all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 11. Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic

benefits from its activities. An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust etc. Since the objective of control over such entities is not to obtain economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements. For the purpose of this Standard, an enterprise is considered to control the composition of:

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:

  (a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

  (b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

  (c) the director is nominated by that enterprise or a subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:

  (a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

  (b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

  (c) the member of the governing body is nominated by that other enterprise.

Explanation:

It is possible that an enterprise is controlled by two enterprises — one controls by virtue of ownership of majority of the voting power of that enterprise and other controls, by virtue of an agreement or otherwise, the composition of the board of directors so as to obtain economic benefit from its activities. In such a rare situation, when an enterprise is controlled by two enterprises as per the definition of 'control', the first mentioned enterprise will be considered as subsidiary of both the controlling enterprises within the meaning of this Standard and, therefore, both the enterprises need to consolidate the financial statements of that enterprise as per the requirements of this Standard.

11. A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

Explanation:

(a) ***Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise is considered to be temporary within the meaning of paragraph 11(a).***

(b) ***The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an in- vestment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.***

12. Exclusion of a subsidiary from consolidation on the ground that its business activities are dissimilar from those of the other enterprises within the group is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by Accounting Standard (AS) 17, Segment Reporting, help to explain the significance of different business activities within the group.

Consolidation Procedures

13. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

(a) ***the cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;***

(b) ***any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements;***

(c) ***when the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;***

(d) minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and

(e) minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:

(i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(ii) the minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.

Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

Explanation:

(a) The tax expense (comprising current tax and deferred tax) to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

(b) The parent's share in the post-acquisition reserves of a subsidiary, forming part of the corresponding reserves in the consolidated balance sheet, is not required to be disclosed separately in the consolidated balance sheet keeping in view the objective of consolidated financial statements to present financial information of the group as a whole. In view of this, the consolidated reserves disclosed in the consolidated balance sheet are inclusive of the parent's share in the post-acquisition reserves of a subsidiary.

14. The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment. However, if the financial statements of a subsidiary, as on the date of investment, are not available and if it is impracticable to draw the financial statements of the subsidiary as on that date, financial statements of the subsidiary for the immediately preceding period are used as a basis for consolidation. Adjustments are made to these financial statements for the effects of significant transactions or other events that occur between the date of such financial statements and the date of investment in the subsidiary.

15. If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment, for the purposes of paragraph 13 above, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.

16. Intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

17. Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealised losses

resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered.

18. The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.

19. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements are usually drawn up to the same date. When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. The consistency principle requires that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.

20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

21. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements.

22. The results of operations of a subsidiary are included in the consolidated financial statements as from the date on which parent-subsidiary relationship came in existence. The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship. The difference between the proceeds from the disposal of investment in a subsidiary and the carrying amount of its assets less liabilities as of the date of disposal is recognised in the consolidated statement of profit and loss as the profit or loss on the disposal of the investment in the subsidiary. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments, from the date that the enterprise ceases to be a subsidiary and does not become an associate[5].

24. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

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[5] Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', defines the term 'associate' and specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

25. Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

26. The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

27. If a subsidiary has outstanding cumulative preference shares which are held outside the group, the parent computes its share of profits or losses after adjusting for the subsidiary's preference dividends, whether or not dividends have been declared.

Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

28. In a parent's separate financial statements, investments in subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

Disclosure

29. In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

- ***(a) in consolidated financial statements a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;***
- ***(b) in consolidated financial statements, where applicable:***
  - ***(i) the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;***
  - ***(ii) the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and***
  - ***(iii) the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.***

Transitional Provisions

30. On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the Accounting Standard.

In the case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements:

(i) Source from which bonus shares are issued, e.g., capitalisation of profits or Reserves or from Share Premium Account.

(ii) Disclosure of all unutilised monies out of the issue indicating the form in which such unutilised funds have been invested.

(iii) The name(s) of small scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than thirty days.

(iv) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.

(v) Quantitative information in respect of sales, raw materials consumed, opening and closing stocks of goods produced/traded and purchases made, wherever applicable.

(vi) A statement showing the computation of net profits in accordance with section 198 of the Companies Act, 2013, with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors) or manager (if any).

(vii) In the case of manufacturing companies, quantitative information in regard to the licensed capacity (where licence is in force); the installed capacity; and the actual production.

(viii) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of:

(a) raw materials;

(b) components and spare parts;

(c) capital goods.

(ix) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional, consultation fees, interest, and other matters.

(x) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.

(xi) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.

(xii) Earnings in foreign exchange classified under the following heads, namely:

(a) export of goods calculated on F.O.B. basis;

(b) royalty, know-how, professional and consultation fees; (c) interest and dividend;

(d) other income, indicating the nature thereof.

AS 22 (issued 2001) – Accounting for Taxes on Income

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to prescribe accounting treatment for taxes on income. Taxes on income is one of the significant items in the statement of profit and loss of an enterprise. In accordance with the matching concept, taxes on income are accrued in the same period as the revenue and expenses to which they relate. Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons. Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income.

Scope

1. This Standard should be applied in accounting for taxes on income. This includes the determination of the amount of the expense or saving related to taxes on income in respect of an accounting period and the disclosure of such an amount in the financial statements.

2. For the purposes of this Standard, taxes on income include all domestic and foreign taxes which are based on taxable income.

3. This Standard does not specify when, or how, an enterprise should account for taxes that are payable on distribution of dividends and other distributions made by the enterprise.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

4.1 <u>Accounting income</u> (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.

4.2 <u>Taxable income</u> (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.

4.3 <u>Tax expense</u> (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

4.4 <u>Current tax</u> is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

4.5 <u>Deferred tax</u> is the tax effect of timing differences.

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[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material

4.6 Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

4.7 Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

5. Taxable income is calculated in accordance with tax laws. In some circumstances, the requirements of these laws to compute taxable income differ from the accounting policies applied to determine accounting income. The effect of this difference is that the taxable income and accounting income may not be the same.

6. The differences between taxable income and accounting income can be classified into permanent differences and timing differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.

7. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. Another example of timing difference is a situation where, for the purpose of computing taxable income, tax laws allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. Some other examples of timing differences arising under the Indian tax laws are given in Illustration 1.

8. Unabsorbed depreciation and carry forward of losses which can be set- off against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence (see paragraphs 15-18).

Recognition

9. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

10. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets (subject to the consideration of prudence as set out in paragraphs 15-18) or as deferred tax liabilities, in the balance sheet.

11. An example of tax effect of a timing difference that results in a deferred tax asset is an expense provided in the statement of profit and loss but not allowed as a deduction under Section 43B of the Income-tax Act, 1961. This timing difference will reverse when the deduction of that expense is allowed under Section 43B in subsequent year(s). An example of tax effect of a timing difference resulting in a deferred tax liability is the higher charge of depreciation allowable under the Income-tax Act, 1961, compared to the depreciation provided in the statement of profit and loss. In subsequent years, the differential will reverse when comparatively lower depreciation will be allowed for tax purposes.

12. Permanent differences do not result in deferred tax assets or deferred tax liabilities.

13. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18.

Explanation:

(a) ***The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of sections 80-IA/80IB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'). In case of sections 10A/10B of the Act (covered under Chapter III of the Act dealing with incomes which do not form part of total income), the deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of the said sections.***

(b) ***Deferred tax in respect of timing differences which reverse after the tax holiday period is recognised in the year in which the timing differences originate. However, recognition of deferred tax assets is subject to the consideration of prudence as laid down in paragraphs 15 to 18.***

(c) ***For the above purposes, the timing differences which originate first are considered to reverse first.***

The application of the above explaination is illustrated in the Illustration attached to the Standard.

14. This Standard requires recognition of deferred tax for all the timing differences. This is based on the principle that the financial statements for a period should recognise the tax effect, whether current or deferred, of all the transactions occurring in that period.

15. Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

16. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.

17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Explanation:

1. ***Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of***

perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc. submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

2 (a) As per the relevant provisions of the Income-tax Act, 1961 (here in after referred to as the 'Act'), the 'loss' arising under the head 'Capital gains' can be carried forward and set-off in future years, only against the income arising under that head as per the requirements of the Act.

(b) Where an enterprise's statement of profit and loss includes an item of 'loss' which can be set-off in future for taxation purposes, only against the income arising under the head 'Capital gains' as per the requirements of the Act, that item is a timing difference to the extent it is not set-off in the current year and is allowed to be set-off against the income arising under the head 'Capital gains' in subsequent years subject to the provisions of the Act. In respect of such 'loss', deferred tax asset is recognised and carried forward subject to the consideration of prudence. Accordingly, in respect of such 'loss', deferred tax asset is recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act. Whether the test of virtual certainty is fulfilled or not would depend on the facts and circumstances of each case. The examples of situations in which the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head 'Capital gains' is normally fulfilled, are sale of an asset giving rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act) after the balance sheet date but before the financial statements are approved, and binding sale agreement which will give rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act).

(c) In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long- term capital assets, the deferred tax asset is recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act.

18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed.

Re-assessment of Unrecognised Deferred Tax Assets

19. At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become

reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which such deferred tax assets can be realised. For example, an improvement in trading conditions may make it reasonably certain that the enterprise will be able to generate sufficient taxable income in the future.

Measurement

20. Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

21. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Explanation:

- ***(a) The payment of tax under section 115JB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act') is a current tax for the period.***
- ***(b) In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under this Standard, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.***
- ***(c) In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.***

22. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

23. When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using average rates.

24. Deferred tax assets and liabilities should not be discounted to their present value.

25. The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each timing difference. In a number of cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between enterprises. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

Review of Deferred Tax Assets

26. The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available.

Presentation and Disclosure

27. An enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends to settle the asset and the liability on a net basis.

28. An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

29. An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

30. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

Explanation:

Deferred tax assets (net of the deferred tax liabilities, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Investments' and deferred tax liabilities (net of the deferred tax assets, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Unsecured Loans.'

31. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

32. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Transitional Provisions

33. On the first occasion that the taxes on income are accounted for in accordance with this Standard the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Standard 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 (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Standard had been in effect from the beginning.

34. For the purpose of determining accumulated deferred tax in the period in which this Standard 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. For example, in the year in which an enterprise adopts this Standard, the opening balance of a fixed asset is ₹ 100 for accounting purposes and ₹ 60 for tax purposes. The difference is because the enterprise applies written down value method of depreciation for calculating taxable income whereas for accounting purposes straight line method is used. This difference will reverse in future when depreciation for tax purposes will be lower as compared to the depreciation for accounting

purposes. In the above case, assuming that enacted tax rate for the year is 40% and that there are no other timing differences, deferred tax liability of ₹ 16 [(₹ 100 - ₹ 60) x 40%] would be recognised. Another example is an expenditure that has already been written off for accounting purposes in the year of its incurrence but is allowable for tax purposes over a period of time. In this case, the asset representing that expenditure would have a balance only for tax purposes but not for accounting purposes. The difference between balance of the asset for tax purposes and the balance (which is nil) for accounting purposes would be a timing difference which will reverse in future when this expenditure would be allowed for tax purposes. Therefore, a deferred tax asset would be recognised in respect of this difference subject to the consideration of prudence (see paragraphs 15 - 18).

Illustration I

Examples of Timing Differences

Note: This illustration does not form part of the Accounting Standard. The purpose of this illustration is to assist in clarifying the meaning of the Accounting Standard. The sections mentioned hereunder are references to sections in the Income-tax Act, 1961, as amended by the Finance Act, 2001.

1. Expenses debited in the statement of profit and loss for accounting purposes but allowed for tax purposes in subsequent years, e.g.

   (a) Expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis but allowed for tax purposes in subsequent years on payment basis.

   (b) Payments to non-residents accrued in the statement of profit and loss on mercantile basis, but disallowed for tax purposes under section 40(a)(i) and allowed for tax purposes in subsequent years when relevant tax is deducted or paid.

   (c) Provisions made in the statement of profit and loss in anticipation of liabilities where the relevant liabilities are allowed in subsequent years when they crystallize.

2. Expenses amortized in the books over a period of years but are allowed for tax purposes wholly in the first year (e.g. substantial advertisement expenses to introduce a product, etc. treated as deferred revenue expenditure in the books) or if amortization for tax purposes is over a longer or shorter period (e.g. preliminary expenses under section 35D, expenses incurred for amalgamation under section 35DD, prospecting expenses under section 35E).

3. Where book and tax depreciation differ. This could arise due to:

   (a) Differences in depreciation rates.

   (b) Differences in method of depreciation e.g. SLM or WDV.

   (c) Differences in method of calculation e.g. calculation of depreciation with reference to individual assets in the books but on block basis for tax purposes and calculation with reference to time in the books but on the basis of full or half depreciation under the block basis for tax purposes.

   (d) Differences in composition of actual cost of assets.

4. Where a deduction is allowed in one year for tax purposes on the basis of a deposit made under a permitted deposit scheme (e.g. tea development account scheme under section 33AB or site restoration fund scheme under section 33ABA) and expenditure out of withdrawal from such deposit is debited in the statement of profit and loss in subsequent years.

5. Income credited to the statement of profit and loss but taxed only in subsequent years e.g. conversion of capital assets into stock in trade.

6. If for any reason the recognition of income is spread over a number of years in the accounts but the income is fully taxed in the year of receipt.

Illustration II

Note: This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard. Extracts from statement of profit and loss are provided to show the effects of the transactions described below.

Illustration 1

A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20x1, it purchases a machine at a cost of ₹ 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of ₹ 2,00,000 each year and the corporate tax rate is 40 per cent each year.

The purchase of machine at a cost of ₹ 1,50,000 in 20x1 gives rise to a tax saving of ₹ 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

Statement of Profit and Loss

(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	*20x2*	*20x3*
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Less: Tax expense			
Current tax			
0.40 (200 – 150)	20		
0.40 (200)		80	80
Deferred tax			
Tax effect of timing differences originating during the year			
0.40 (150 – 50)	40		
Tax effect of timing differences reversing during the year			
0.40 (0 – 50)		(20)	(20)
Tax expense	60	60	60
Profit after tax	90	90	90
Net timing differences	100	50	0
Deferred tax liability	40	20	0

In 20x1, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purposes by ₹ 1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of ₹ 40,000. In 20x2 and 20x3, accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by ₹ 50,000 each year. Accordingly, deferred tax liability is reduced by ₹ 20,000 each in both the years. As may be seen, tax expense is based on the accounting income of each period.

In 20x1, the profit and loss account is debited and deferred tax liability account is credited with the amount of tax on the originating timing difference of ₹ 1,00,000 while in each of the following two years, deferred tax liability account is debited and profit and loss account is credited with the amount of tax on the reversing timing difference of ₹ 50,000.

The following Journal entries will be passed:

Year 20x1

Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000
(Being the amount of taxes payable for the year 20x1 provided for)			
Profit and Loss A/c	Dr.	40,000	
To Deferred tax A/c			40,000
(Being the deferred tax liability created for originating timing difference of ₹ 1,00,000)			

Year 20x2

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x2 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of ₹ 50,000)			

Year 20x3

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x3 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of ₹ 50,000)			

In year 20x1, the balance of deferred tax account i.e., ₹ 40,000 would be shown separately from the current tax payable for the year in terms of paragraph 30 of the Statement. In Year 20x2, the balance of deferred tax account would be ₹ 20,000 and be shown separately from the current tax payable for the year as in year 20x1. In Year 20x3, the balance of deferred tax liability account would be nil.

Illustration 2

In the above illustration, the corporate tax rate has been assumed to be same in each of the three years. If the rate of tax changes, it would be necessary for the enterprise to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year (see paragraphs 21 and 22). For example, if in Illustration 1, the substantively enacted tax rates for 20x1, 20x2 and 20x3 are 40%, 35% and 38% respectively, the amount of deferred tax liability would be computed as follows:

The deferred tax liability carried forward each year would appear in the balance sheet as under:

31st March, 20x1 = 0.40 (1,00,000)= ₹ 40,000

31st March, 20x2 = 0.35 (50,000) = ₹ 17,500

31st March, 20x3 = 0.38 (Zero) = ₹ Zero

Accordingly, the amount debited/(credited) to the profit and loss account (with corresponding credit or debit to deferred tax liability) for each year would be as under:

31st March, 20x1 Debit = ₹ 40,000

31st March, 20x2 (Credit) = ₹ (22,500)

31st March, 20x3 (Credit) = ₹ (17,500)

Illustration 3

A company, ABC Ltd., prepares its accounts annually on 31st March. The company has incurred a loss of ₹ 1,00,000 in the year 20x1 and made profits of ₹ 50,000 and 60,000 in year 20x2 and year 20x3 respectively. It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 20x1, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. It is also assumed that there is no difference between taxable income and accounting income except that set- off of loss is allowed in years 20x2 and 20x3 for tax purposes.

Statement of Profit and Loss

(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	*20x2*	*20x3*
Profit (loss)	(100)	50	60
Less: Current tax	—	—	(4)
Deferred tax:			
Tax effect of timing differences originating during the year	40		
Tax effect of timing differences reversing during the year		(20)	(20)
Profit (loss) after tax effect	(60)	30	36

Illustration 4

Note: The purpose of this illustration is to assist in clarifying the meaning of the explanation to paragraph 13 of the Standard.

Facts:

1. The income before depreciation and tax of an enterprise for 15 years is ₹ 1000 lakhs per year, both as per the books of account and for in- come-tax purposes.

2. The enterprise is subject to 100 percent tax-holiday for the first 10 years under section 80-IA. Tax rate is assumed to be 30 percent.
3. At the beginning of year 1, the enterprise has purchased one machine for ₹ 1500 lakhs. Residual value is assumed to be nil.
4. For accounting purposes, the enterprise follows an accounting policy to provide depreciation on the machine over 15 years on straight-line basis.
5. For tax purposes, the depreciation rate relevant to the machine is 25% on written down value basis.

The following computations will be made, ignoring the provisions of section 115JB (MAT), in this regard:

Table 1

Computation of depreciation on the machine for accounting purposes and tax purposes

(Amounts in ₹ lakhs)

Year	*Depreciation for accounting purposes*	*Depreciation for tax purposes*
1	100	375
2	100	281
3	100	211
4	100	158
5	100	119
6	100	89
7	100	67
8	100	50
9	100	38
10	100	28
11	100	21
12	100	16
13	100	12
14	100	9
15	100	7

At the end of the 15th year, the carrying amount of the machinery for ac- counting purposes would be nil whereas for tax purposes, the carrying amount is ₹ 19 lakhs which is eligible to be allowed in subsequent years.

Table 2

Computation of Timing differences

(Amounts in ₹ lakhs)

1	2	3	4	5	6	7	8	9
Year	Income before depreciation and tax (both for accounting purposes and tax purposes	Accounting Income after depreciation	Gross Total Income after deducting depreciation under tax laws)	Deduction under section 80-IA	Taxable Income (4-5)	Total Difference between accounting income and taxable income (3-6)	Permanent Difference (deduction pursuant to section 80-IA)	Timing Difference (due to different amounts of depreciation for accounting purposes and tax purposes) (O= originating and R= Reversing)
1	1000	900	625	625	Nil	900	625	275 (O)
2	1000	900	719	719	Nil	900	719	181 (O)
3	1000	900	789	789	Nil	900	789	111 (O)
4	1000	900	842	842	Nil	900	842	58 (O)
5	1000	900	881	881	Nil	900	881	19(0)
6	1000	900	911	911	Nil	900	911	11 (R)
7	1000	900	933	933	Nil	900	933	33 (R)
8	1000	900	950	950	Nil	900	950	50 (R)
9	1000	900	962	962	Nil	900	962	62 (R)
10	1000	900	972	972	Nil	900	972	72 (R)
11	1000	900	979	Nil	979	-79	Nil	79 (R)
12	1000	900	984	Nil	984	-84	Nil	84 (R)
13	1000	900	988	Nil	988	-88	Nil	88 (R)
14	1000	900	991	Nil	991	-91	Nil	91 (R)
15	1000	900	993	Nil	993	-93	Nil	74 (R)
								19 (O)

Notes:

1. Timing differences originating during the tax holiday period are ₹ 644 lakhs, out of which ₹ 228 lakhs are reversing during the tax holiday period and ₹ 416 lakhs are reversing after the tax holiday period. Timing difference of ₹ 19 lakhs is originating in the 15th year which would re- verse in subsequent years when for accounting purposes depreciation would be nil but for tax purposes the written down value of the machinery of ₹ 19 lakhs would be eligible to be allowed as depreciation.

2. As per the Standard, deferred tax on timing differences which reverse during the tax holiday period should not be recognised. For this purpose, timing differences which originate first are considered to reverse first. There- fore, the reversal of timing difference of ₹ 228 lakhs during the tax holiday period, would be considered to be out of the timing difference which originated in year 1. The rest of the timing difference originating in year 1 and timing differences originating in years 2 to 5 would be considered to be reversing after the tax holiday period. Therefore, in year 1, deferred tax would be recognised on the timing difference of ₹ 47 lakhs (₹ 275 lakhs - ₹ 228 lakhs) which would reverse after the tax holiday period. Similar computations would be made for the subsequent years. The deferred tax assets/liabilities to be recognised during different years would be computed as per the following Table.

Table 3

Computation of current tax and deferred tax

(Amounts in ₹ lakhs)

Year	*Current tax (Taxable Income x 30%)*	*Deferred tax (Timing difference x 30%)*	*Accumulated Deferred tax (L= Liability and A = Asset)*	*Tax expense*
1	Nil	47 × 30%= 14 (see note 2 above)	14 (L)	14
2	Nil	118 × 130%=54	68 (L)	54
3	Nil	111× 30%=33	101 (L)	33
4	Nil	58 × 30%= 17	118 (L)	17
5	Nil	19 × 30%=6	124 (L)	6
6	Nil	Nil[1]	124 (L)	Nil
7	Nil	Nil[1]	124 (L)	Nil
8	Nil	Nil[1]	124 (L)	Nil
9	Nil	Nil[1]	124 (L)	Nil
10	Nil	Nil[1]	124 (L)	Nil
11	294	–79 × 30%=-24	100 (L)	270
12	295	–84 × 30%=-25	75 (L)	270
13	296	–88 × 30%=-26	49 (L)	270
14	297	–91 × 30%=-27	22 (L)	270
15	298	–74 × 30%=-22 –19 × 30%=-6	Nil 6(A)[2]	270

[1] No deferred tax is recognised since in respect of timing differences reversing during the tax holiday period, no deferred tax was recognised at their origination.

[2] Deferred tax asset of ₹ 6 lakhs would be recognised at the end of year 15 subject to consideration of prudence as per As 22. If it is so recognised, the said deferred tax asset would be realized in subsequent periods when for tax purposes depreciation would be allowed but for accounting purposes no depreciation would be recognised.

AS 23 (issued 2001) - Accounting for Investments in Associates in Consolidated Financial Statements[1]

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to set out principles and procedures for recognising, in the consolidated financial statements, the effects of the investments in associates on the financial position and operating results of a group.

Scope

1. This Standard should be applied in accounting for investments in associates in the preparation and presentation of consolidated financial statements by an investor.

2. This Standard does not deal with accounting for investments in associates in the preparation and presentation of separate financial statements by an investor.[3]

Definitions

3. For the purpose of this Standard, the following terms are used with the meanings specified:

3.1 An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture[4] of the investor.

3.2 Significant influence is the power to participate in the financial and/ or operating policy decisions of the investee but not control over those policies.

3.3 Control:

- ***(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or***
- ***(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.***

3.4 A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

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[1] It is clarified that AS 23 is mandatory if an enterprise presents consolidated financial statements. In other words, if an enterprise presents consolidated financial statements, it should account for investments in associates in the consolidated financial statements in accordance with AS 23 from the date of its coming into effect, i.e., 1-4-2002 (see 'The Chartered Accountant', July 2001, page 95).

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[3] Accounting Standard (AS) 13, 'Accounting for Investments', is applicable for accounting for investments in associates in the separate financial statements of an investor.

[4] Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', defines the term 'joint venture' and specifies the requirements relating to accounting for investments in joint ventures.

3.5 A parent is an enterprise that has one or more subsidiaries.

3.6 A group is a parent and all its subsidiaries.

3.7 Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

3.8 The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

3.9 Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

4. For the purpose of this Standard significant influence does not extend to power to govern the financial and/or operating policies of an enterprise. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary(ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Explanation :

In considering the share ownership, the potential equity shares of the investees held by the investor are not taken into account for determining the voting power of the investor.

5. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(a) Representation on the board of directors or corresponding governing body of the investee;

(b) participation in policy making processes;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.

6. Under the equity method, the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition and the carrying amount is increased or decreased to recognise the investor's share of the profits or losses of the investee after the date of acquisition. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for alterations in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been included in the statement of profit and loss. Such changes include those arising from the revaluation of fixed assets and investments, from foreign exchange translation differences and from the adjustment of differences arising on amalgamations.

Explanations:

(a) Adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/ credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

(b) In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking in to consideration the proposed dividend.

Accounting for Investments – Equity Method

7. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:

(a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

Investments in such associates should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

Explanation:

The period of time, which is considered as near future for the purposes of this Standard, primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investment, such an investment is not excluded from application of the equity method, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, however, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from application of the equity method, provided there is no change in the intention.

8. Recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of results of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, application of the equity method in consolidated financial statements provides more informative reporting of the net assets and net income of the investor.

9. An investor should discontinue the use of the equity method from the date that:

(a) it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or

(b) the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

Application of the Equity Method

10. Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in Accounting Standard (AS) 21, Consolidated Financial Statements. Furthermore, the broad concepts underlying the consolidation procedures used in the acquisition of a subsidiary are adopted on the acquisition of an investment in an associate.

11. An investment in an associate is accounted for under the equity method from the date on which it falls within the definition of an associate. On acquisition of the investment any difference between the cost of acquisition and the investor's share of the equity of the associate is described as goodwill or capital reserve, as the case may be.

12. Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately.

13. In using equity method for accounting for investment in an associate, unrealised profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor's interest in the associate. Unrealised losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.

14. The most recent available financial statements of the associate are used by the investor in applying the equity method; they are usually drawn up to the same date as the financial statements of the investor. When the reporting dates of the investor and the associate are different, the associate often prepares, for the use of the investor, statements as at the same date as the financial statements of the investor. When it is impracticable to do this, financial statements drawn up to a different reporting date may be used. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

15. When financial statements with a different reporting date are used, adjustments are made for the effects of any significant events or transactions between the investor (or its consolidated subsidiaries) and the associate that occur between the date of the associate's financial statements and the date of the investor's consolidated financial statements.

16. The investor usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the associate's financial statements when they are used by the investor in applying the equity method. If it is not practicable to

do so, that fact is disclosed along with a brief description of the differences between the accounting policies.

17. If an associate has outstanding cumulative preference shares held outside the group, the investor computes its share of profits or losses after adjusting for the preference dividends whether or not the dividends have been declared.

18. If, under the equity method, an investor's share of losses of an associate equals or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognising its share of further losses and the investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or to which the investor is otherwise committed. If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the share of net losses that have not been recognised.

19. Where an associate presents consolidated financial statements, the results and net assets to be taken into account are those reported in that associate's consolidated financial statements.

20. The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

Contingencies

21. In accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[5], the investor discloses in the consolidated financial statements:

(a) its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

(b) those contingencies that arise because the investor is severally liable for the liabilities of the associate.

Disclosure

22. In addition to the disclosures required by paragraphs 7 and 12, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.

23. Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.

24. The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.

25. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the

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[5] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

fact should be disclosed along with a brief description of the differences in the accounting policies.

Transitional Provisions

26. On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Standard the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Standard since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

AS 24 (issued 2002) - Discontinuing Operations

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities]*

This Accounting Standard is not mandatory for non-corporate entities falling in Level III.

Objective

The objective of this Standard is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

Scope

1. This Standard applies to all discontinuing operations of an enterprise.

2. The requirements related to cash flow statement contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement.

Definitions

Discontinuing Operation

3. A discontinuing operation is a component of an enterprise:

- ***(a) that the enterprise, pursuant to a single plan, is:***
  - ***(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or***
  - ***(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or***
  - ***(iii) terminating through abandonment; and***
- ***(b) that represents a separate major line of business or geographical area of operations; and***
- ***(c) that can be distinguished operationally and for financial reporting purposes.***

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[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

4. Under criterion (a) of the definition (paragraph 3 (a)), a discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.

5. If an enterprise sells a component substantially in its entirety, the result can be a net gain or net loss. For such a discontinuance, a binding sale agreement is entered into on a specific date, although the actual transfer of possession and control of the discontinuing operation may occur at a later date. Also, payments to the seller may occur at the time of the agreement, at the time of the transfer, or over an extended future period.

6. Instead of disposing of a component substantially in its entirety, an enterprise may discontinue and dispose of the component by selling its assets and settling its liabilities piecemeal (individually or in small groups). For piecemeal disposals, while the overall result may be a net gain or a net loss, the sale of an individual asset or settlement of an individual liability may have the opposite effect. Moreover, there is no specific date at which an overall binding sale agreement is entered into. Rather, the sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single co- ordinated plan.

7. An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not an abandonment because that operation, although changed, is continuing.

8. Business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations as that term is defined in paragraph 3 of this Standard they can occur in connection with a discontinuing operation.

9. Examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

(a) gradual or evolutionary phasing out of a product line or class of service;

(b) discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(c) shifting of some production or marketing activities for a particular line of business from one location to another; and

(d) closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

10. A reportable business segment or geographical segment as defined in Accounting Standard (AS) 17, Segment Reporting, would normally satisfy criterion (b) of the definition of a discontinuing operation (paragraph 3), that is, it would represent a separate major line of business or geographical area of operations. A part of such a segment may also satisfy criterion (b) of the definition. For an enterprise that operates in a single business or geographical segment and therefore does not report segment information, a major product or service line may also satisfy the criteria of the definition.

11. A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation (paragraph 3) - if all the following conditions are met:

(a) the operating assets and liabilities of the component can be directly attributed to it;

(b) its revenue can be directly attributed to it;

(c) at least a majority of its operating expenses can be directly attributed to it.

12. Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

13. Discontinuing operations, as defined in this Standard are expected to occur relatively infrequently. All infrequently occurring events do not necessarily qualify as discontinuing operations. Infrequently occurring events that do not qualify as discontinuing operations may result in items of income or expense that require separate disclosure pursuant to Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, because their size, nature, or incidence make them relevant to explain the performance of the enterprise for the period.

14. The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under this Standard does not, in itself, bring into question the enterprise's ability to continue as a going concern.

Initial Disclosure Event

15. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(a) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(b) the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

16. A detailed, formal plan for the discontinuance normally includes:

(a) identification of the major assets to be disposed of;

(b) the expected method of disposal;

(c) the period expected to be required for completion of the disposal;

(d) the principal locations affected;

(e) the location, function, and approximate number of employees who will be compensated for terminating their services; and

(f) the estimated proceeds or salvage to be realised by disposal.

17. An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, creditors, trade unions, etc., in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

Recognition and Measurement

18. An enterprise should apply the principles of recognition and measurement that are set out in other Accounting Standards for the purpose of deciding as to when and how to recognise and measure the changes in assets and liabilities and the revenue, expenses, gains, losses and cash flows relating to a discontinuing operation.

19. This Standard does not establish any recognition and measurement principles. Rather, it requires that an enterprise follow recognition and measurement principles established in other Accounting Standards, e.g., Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[2] and Accounting Standard on Impairment of Assets[3].

Presentation and Disclosure

Initial Disclosure

20. An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

- ***(a) a description of the discontinuing operation(s);***
- ***(b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;***
- ***(c) the date and nature of the initial disclosure event;***
- ***(d) the date or period in which the discontinuance is expected to be completed if known or determinable;***
- ***(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;***
- ***(f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;***
- **(g) the amount of pre-tax profit or loss from ordinary activities *attributable to the discontinuing operation during the current financial reporting period, and the income tax expense[4] related thereto; and***
- **(h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.**

21. For the purpose of presentation and disclosures required by this Standard, the items of assets, liabilities, revenues, expenses, gains, losses, and cash flows can be attributed to a discontinuing operation only if they will be disposed of, settled, reduced, or eliminated when the discontinuance is completed. To the extent that such items continue after completion of the discontinuance, they are not allocated to the discontinuing operation. For example, salary of the continuing staff of a discontinuing operation.

22. If an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise, disclosures as required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

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[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extend they deal with impairment of assets not covered by other Accounting Standards.

[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

[4] As defined in Accounting Standard (AS) 22, Accounting for Taxes on Income.

Other Disclosures

23. When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

(a) for any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss; and

(b) the net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

24. The asset disposals, liability settlements, and binding sale agreements referred to in the preceding paragraph may occur concurrently with the initial disclosure event, or in the period in which the initial disclosure event occurs, or in a later period.

25. If some of the assets attributable to a discontinuing operation have actually been sold or are the subject of one or more binding sale agreements entered into between the balance sheet date and the date on which the financial statements are approved by the board of directors in case of a company or by the corresponding approving authority in the case of any other enterprise, the disclosures required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

Updating the Disclosures

26. In addition to the disclosures in paragraphs 20 and 23, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

27. Examples of events and activities that would be disclosed include the nature and terms of binding sale agreements for the assets, a demerger or spin-off by issuing equity shares of the new company to the enterprise's shareholders, and legal or regulatory approvals.

28. The disclosures required by paragraphs 20, 23 and 26 should continue in financial statements for periods up to and including the period in which the discontinuance is completed. A discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

29. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefor and its effect should be disclosed.

30. For the purpose of applying paragraph 29, disclosure of the effect includes reversal of any prior impairment loss[5] or provision that was recognised with respect to the discontinuing operation.

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[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to reversal of impairment loss.

Separate Disclosure for Each Discontinuing Operation

31. Any disclosures required by this Standard should be presented separately for each discontinuing operation.

Presentation of the Required Disclosures

32. The disclosures required by paragraphs 20, 23, 26, 28, 29 and 31 should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

- ***(a) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto (paragraph 20 (g)); and***
- ***(b) the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation (paragraph 23 (a)).***

Illustrative Presentation and Disclosures

33. Illustration 1 attached to the standard illustrates the presentation and disclosures required by this Standard.

Restatement of Prior Periods

34. Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that required by paragraphs 20, 23, 26, 28, 29, 31 and 32.

35. Illustration 2 attached to this Standard illustrates application of paragraph 34.

Disclosure in Interim Financial Reports

36. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, Interim Financial Reporting, including:

- ***(a) any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation; and***
- ***(b) any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.***

Illustration 1

Illustrative Disclosures

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Facts

- Delta Company has three segments, Food Division, Beverage Division and Clothing Division.
- Clothing Division, is deemed inconsistent with the long-term strategy of the Company. Management has decided, therefore, to dispose of the Clothing Division.
- On 15 November 20X1, the Board of Directors of Delta Company approved a detailed, formal plan for disposal of Clothing Division, and an announcement was made. On that date the Clothing Division's net assets was ₹ 90 lakhs (assets of ₹ 105 lakhs minus liabilities of ₹ 15 lakhs).

- The recoverable amount of the assets carried at ₹ 105 lakhs was estimated to be ₹ 85 lakhs and the Company had concluded that a pre-tax impairment loss of ₹ 20 lakhs should be recognised.
- At 31 December 20XI, the carrying amount of the Clothing Division's net assets was ₹ 70 lakhs (assets of ₹ 85 lakhs minus liabilities of ₹ 15 lakhs). There was no further impairment of assets between 15 November 20X1 and 31 December 20X1 when the financial statements were prepared.
- On 30 September 20X2, the carrying amount of the net assets of the Clothing Division continued to be ₹ 70 lakhs. On that day, Delta Company signed a legally binding contract to sell the Clothing Division.
- The sale is expected to be completed by 31 January 20X3. The recover- able amount of the net assets is ₹ 60 lakhs. Based on that amount, an additional impairment loss of ₹ 10 lakhs is recognised.
- In addition, prior to 31 January 20X3, the sale contract obliges Delta Company to terminate employment of certain employees of the Clothing Division, which would result in termination cost of ₹ 30 lakhs, to be paid by 30 June 20X3. A liability and related expense in this regard is also recognised.
- The Company continued to operate the Clothing Division throughout 20X2.
- At 31 December 20X2, the carrying amount of the Clothing Division's net assets is ₹ 45 lakhs, consisting of assets of ₹ 80 lakhs minus liabilities of ₹ 35 lakhs (including provision for expected termination cost of ₹ 30 lakhs).
- Delta Company prepares its financial statements annually as of 31 December. It does not prepare a cash flow statement.
- Other figures in the following financial statements are assumed to illustrate the presentation and disclosures required by the Standard.

I. Financial Statements for 20X1

1.1 Statement of Profit and Loss for 20X1

The Statement of Profit and Loss of Delta Company for the year 20X1 can be presented as follows:

(Amount in ₹ lakhs)

		20X1		***20X0***
Turnover		140		150
Operating expenses		(92)		(105)
Impairment loss		<u>(20)</u>		<u>(---)</u>
Pre-tax profit from operating activities		28		45
Interest expense		(15)		(20)
Profit before tax		13		25
Profit from continuing operations before tax (see Note 5)	15		12	
Income tax expense	(7)		(6)	
Profit from continuing operations after tax		8		6
Profit (loss) from				

discontinuing operations before tax (see Note 5)	(2)		13	
Income tax expense	1		(7)	
Profit (loss) from discontinuing operations after tax		(1)		6
Profit from operating activities after tax		**7**		**12**

1.2 Note to Financial Statements for 20X1

The following is Note 5 to Delta Company's financial statements:

On 15 November 20XI, the Board of Directors announced a plan to dispose of Company's Clothing Division, which is also a separate segment as per AS 17, Segment Reporting. The disposal is consistent with the Company's long-term strategy to focus its activities in the areas of food and beverage manufacture and distribution, and to divest unrelated activities. The Company is actively seeking a buyer for the Clothing Division and hopes to complete the sale by the end of 20X2. At 31 December 20XI, the carrying amount of the assets of the Clothing Division was ₹ 85 lakhs (previous year ₹ 120 lakhs) and its liabilities were ₹ 15 lakhs (previous year ₹ 20 lakhs). The following statement shows the revenue and expenses of continuing and discontinuing operations:

(Amount in ₹ lakhs)

	Continuing Operations (Food and Beverage Divisions)		***Discontinuing Operation (Clothing Division)***		***Total***	
	20X1	***20X0***	***20X1***	***20X0***	***20X1***	***20X0***
Turnover	90	80	50	70	140	150
Operating Expenses	(65)	(60)	(27)	(45)	(92)	(105)
Impairment Loss	----	----	(20)	(---)	(20)	(---)
Pre-tax profit from operating activities	25	20	3	25	28	45
Interest expense	(10)	(8)	(5)	(12)	(15)	(20)
Profit (loss) before tax	15	12	(2)	13	13	25
Income tax expense	(7)	(6)	1	(7)	(6)	(13)
Profit (loss) from operating activities after tax	8	6	(1)	6	7	12

II. Financial Statements for 20X2

2.1 Statement of Profit and Loss for 20X2

The Statement of Profit and Loss of Delta Company for the year 20X2 can be presented as follows:

(Amount in ₹ lakhs)

	20X2	***20X1***
Turnover	140	140
Operating expenses	(90)	(92)

	20X2	20X1
Impairment loss	(10)	(20)
Provision for employee termination benefits	(30)	--
Pre-tax profit from operating activities	10	28
Interest expense	(25)	(15)
Profit (loss) before tax	(15)	13
Profit from continuing operations before tax (see Note 5)	20	15
Income tax expense	(6)	(7)
Profit from continuing operations after tax	14	8
Loss from discontinuing operations before tax (see Note 5)	(35)	(2)
Income tax expense	10	1
Loss from discontinuing operations after tax	(25)	(1)
Profit (loss) from operating activities after tax	**(11)**	**7**

2.2 Note to Financial Statements for 20X2

The following is Note 5 to Delta Company's financial statements:

On 15 November 20XI, the Board of Directors had announced a plan to dispose of Company's Clothing Division, which is also a separate segment as per AS 17, Segment Reporting. The disposal is consistent with the Company's long-term strategy to focus its activities in the areas of food and beverage manufacture and distribution, and to divest unrelated activities. On 30 September 20X2, the Company signed a contract to sell the Clothing Division to Z Corporation for ₹ 60 lakhs.

Clothing Division's assets are written down by ₹ 10 lakhs (previous year ₹ 20 lakhs) before income tax saving of ₹ 3 lakhs (previous year ₹ 6 lakhs) to their recoverable amount.

The Company has recognised provision for termination benefits of ₹ 30 lakhs (previous year ₹ nil) before income tax saving of ₹ 9 lakhs (previous year ₹ nil) to be paid by 30 June 20X3 to certain employees of the Clothing Division whose jobs will be terminated as a result of the sale.

At 31 December 20X2, the carrying amount of assets of the Clothing Division was ₹ 80 lakhs (previous year ₹ 85 lakhs) and its liabilities were ₹ 35 lakhs (previous year ₹ 15 lakhs), including the provision for expected termination cost of ₹ 30 lakhs (previous year ₹ nil). The process of selling the Clothing Division is likely to be completed by 31 January 20X3.

The following statement shows the revenue and expenses of continuing and discontinuing operations:

(Amount in ₹ lakhs)

	Continuing Operations (Food and Beverage Divisions)		***Discontinuing Operation (Clothing Division)***		***Total***	
	20X2	***20X1***	***20X2***	***20X1***	***20X2***	***20X1***
Turnover	100	90	40	50	140	140
Operating Expenses	(60)	(65)	(30)	(27)	(90)	(92)
Impairment Loss	----	----	(10)	(20)	(10)	(20)

Provision for employee termination	----	----	(30)	----	(30)	---
Pre-tax profit (loss) from operating activities	40	25	(30)	3	10	28
Interest expense	(20)	(10)	(5)	(5)	(25)	(15)
Profit (loss) before tax	20	15	(35)	(2)	(15)	13
Income tax expense	(6)	(7)	10	1	4	(6)
Profit (loss) from operating activities after tax	14	8	(25)	(1)	(11)	7

III. Financial Statements for 20X3

The financial statements for 20X3, would disclose information related to discontinued operations in a manner similar to that for 20X2 including the fact of completion of discontinuance.

Illustration 2

Classification of Prior Period Operations

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Facts

I. Paragraph 34 requires that comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that required by paragraphs 20, 23, 26, 28, 29, 31 and 32.

2. Consider following facts:

   (a) Operations A, B, C, and D were all continuing in years 1 and 2;

   (b) Operation D is approved and announced for disposal in year 3 but actually disposed of in year 4;

   (c) Operation B is discontinued in year 4 (approved and announced for disposal and actually disposed of) and operation E is acquired; and

   (d) Operation F is acquired in year 5.

3. The following table illustrates the classification of continuing and discontinuing operations in years 3 to 5:

FINANCIAL STATEMENTS FOR YEAR 3 (Approved and Published early in Year 4)			
Year 2 Comparatives		**Year 3**	
Continuing	Discontinuing	Continuing	Discontinuing
A B C	D	A B C	D

FINANCIAL STATEMENTS FOR YEAR 4 (Approved and Published early in Year 5)			
Year 3 Comparatives		**Year 4**	
Continuing	Discontinuing	Continuing	Discontinuing
A		A	

	B		B
C		C	
	D		D
		E	

FINANCIAL STATEMENTS FOR YEAR 5 (Approved and Published early in Year 6)			
Year 4 Comparatives		Year 5	
Continuing	Discontinuing	Continuing	Discontinuing
A		A	
	B		
C		C	
	D		
E		E	
		F	

4. If, for whatever reason, five-year comparative financial statements were prepared in year 5, the classification of continuing and discontinuing operations would be as follows:

FINANCIAL STATEMENTS FOR YEAR 5									
Year 1 Comparatives		Year 2 Comparatives		Year 3 Comparatives		Year 4 Comparatives		Year 5	
Cont.	Disc.	Cont.	Disc.	Cont.	Disc.	Cont.	Disc.	Cont.	Disc.
A		A		A		A		A	
	B		B		B		B		
C		C		C		C		C	
	D		D		D		D		
						E		E	
								F	

AS 25 (issued 2002) - Interim Financial Reporting

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards*[1] *and the 'Applicability of Accounting Standards to Various]*

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of

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[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

investors, creditors, and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

Scope

1. This Standard does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

3. The requirements related to cash flow statement, complete or condensed, contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.

Definitions

4. The following terms are used in this Standard with the meanings specified:

4.1 Interim period is a financial reporting period shorter than a full financial year.

4.2 Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Standard) for an interim period.

5. During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

Content of an Interim Financial Report

6. A complete set of financial statements normally includes:

(a) balance sheet;

(b) statement of profit and loss;

(c) cash flow statement; and

(d) notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

7. In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an enterprise may be required to or may elect to present less information at interim dates as compared with its annual financial statements. The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Standard requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. The interim financial report containing condensed financial statements is intended to provide an update on the latest annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.

8. This Standard does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. This Standard also does not prohibit or discourage an enterprise from including, in condensed interim financial statements, more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement principles set out in this Standard apply also to complete

financial statements for an interim period, and such statements would include all disclosures required by this Standard (particularly the selected disclosures in paragraph 16) as well as those required by other Accounting Standards.

Minimum Components of an Interim Financial Report

9. An interim financial report should include, at a minimum, the following components:

- ***(a) condensed balance sheet;***
- ***(b) condensed statement of profit and loss; (c) condensed cash flow statement; and***
- ***(d) selected explanatory notes.***

Form and Content of Interim Financial Statements

10. If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

11. If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

12. If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with Accounting Standard (AS) 20, Earnings Per Share, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim period.

13. If an enterprise's annual financial report included the consolidated financial statements in addition to the parent's separate financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

14. Illustration I attached to the Standard provides illustrative format of condensed financial statements.

Selected Explanatory Notes

15. A user of an enterprise's interim financial report will ordinarily have access to the most recent annual financial report of that enterprise. It is, therefore, not necessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual financial report. At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date is more useful.

16. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

- ***(a) a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;***
- ***(b) explanatory comments about the seasonality of interim operations;***

(c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence (see paragraphs 12 to 14 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies);

(d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

(e) issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;

(f) dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;

(g) segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements);

(h) material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;

(i) the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and

(j) material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year- to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

17. Other Accounting Standards specify disclosures that should be made in financial statements. In that context, financial statements mean complete set of financial statements normally included in an annual financial report and sometimes included in other reports. The disclosures required by those other Accounting Standards are not required if an enterprise's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements.

Periods for which Interim Financial Statements are required to be presented

18. Interim reports should include interim financial statements (condensed or complete) for periods as follows:

(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;

(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;

(c) ***cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year- to-date period of the immediately preceding financial year.***

19. For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful. Accordingly, enterprises whose business is highly seasonal are encouraged to consider reporting such information in addition to the information called for in the preceding paragraph.

20. Illustration 2 attached to the Standard illustrates the periods required to be presented by an enterprise that reports half-yearly and an enterprise that reports quarterly.

Materiality

21. In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

22. The Preface to the Statements of Accounting Standards states that “The Accounting Standards are intended to apply only to items which are material”. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, states that “information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information”.

23. Judgement is always required in assessing materiality for financial reporting purposes. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data. The overriding objective is to ensure that an interim financial report includes all information that is relevant to understanding an enterprise's financial position and performance during the interim period.

Disclosure in Annual Financial Statements

24. An enterprise may not prepare and present a separate financial report for the final interim period because the annual financial statements are presented. In such a case, paragraph 25 requires certain disclosures to be made in the annual financial statements for that financial year.

25. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

26. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Paragraph 16(d) of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with AS 5 requirements and is intended to be restricted in scope so as to relate only to the change in estimates. An enterprise is not required to include additional interim period financial information in its annual financial statements.

Recognition and Measurement

Same Accounting Policies as Annual

27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.

29. To illustrate:

(a) the principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

(b) a cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

(c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.

30. Under the Framework for the Preparation and Presentation of Financial Statements, recognition is the "process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition". The definitions of assets, liabilities, income, and expenses are fundamental to recognition, both at annual and interim financial reporting dates.

31. For assets, the same tests of future economic benefits apply at interim dates as they apply at the end of an enterprise's financial year. Costs that, by their nature, would not qualify as assets at financial year end would not qualify at interim dates as well. Similarly, a liability at an interim reporting date must represent an existing obligation at that date, just as it must at an annual reporting date.

32. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured

reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

33. In measuring assets, liabilities, income, expenses, and cash flows reported in its financial statements, an enterprise that reports only annually is able to take into account information that becomes available throughout the financial year. Its measurements are, in effect, on a year-to-date basis.

34. An enterprise that reports half-yearly, uses information available by mid-year or shortly thereafter in making the measurements in its financial statements for the first six-month period and information available by year- end or shortly thereafter for the twelve-month period. The twelve-month measurements will reflect any changes in estimates of amounts reported for the first six-month period. The amounts reported in the interim financial report for the first six-month period are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

35. An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

Revenues Received Seasonally or Occasionally

36. Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

37. Examples include dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.

Costs Incurred Unevenly During the Financial Year

38. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

Applying the Recognition and Measurement principles

39. Illustration 3 attached to the Standard illustrates application of the general recognition and measurement principles set out in paragraphs 27 to 38.

Use of Estimates

40. The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

41. Illustration 4 attached to the Standard illustrates the use of estimates in interim periods.

Restatement of Previously Reported Interim

Periods

42. A change in accounting policy, other than one for which the transition is specified by an Accounting Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year.

43. One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle in paragraph 42 is to require that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

Transitional Provision

44. On the first occasion that an interim financial report is presented in accordance with this Standard, the following need not be presented in respect of all the interim periods of the current financial year:

(a) comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

(b) comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

Illustration 1

Illustrative Format of Condensed Financial Statements

This illustration which does not form part of the Accounting Standard, provides illustrative format of condensed financial statements. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Paragraph 11 of the Accounting Standard provides that if an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by the Standard. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

The purpose of the following illustrative format is primarily to illustrate the requirements of paragraph 11 of the Standard. It may be noted that these illustrative formats are subject to the requirements laid down in the Standard including those of paragraph 11.

Illustrative Format of Condensed Financial Statements for an enterprise other than a bank

(A) Condensed Balance Sheet

	Figures at the end of the current interim period	**Figures at the end of the previous accounting year**
I. Sources of Funds		
1. Capital		
2. Reserve and surplus		
3. Minority interests (in case of consolidated financial statements)		

4. Loan funds: (a) Secured loans (b) Unsecured loans		
Total		
II. Application of Funds		
1. Fixed assets (a) Tangible fixed assets (b) Intangible fixed assets		
2. Investments		
3. Current assets, loans and advances (a) Inventories (b) Sundry debtors (c) Cash and bank balances (d) Loans and advances (e) Others		
Less: Current liabilities and provisions (a) Liabilities (b) Provisions		
Net Current assets		
4. Miscellaneous expenditure to the extent not written off or adjusted		
5. Profit and loss account		
Total		

(B) Condensed Statement of Profit and Loss

	Three months ended	**Corresponding three months of the previous accounting year**	**Year-to-date figures for current period**	**Year-to-date figures for the previous year**
1. Turnover				
2. Other Income				
Total				
3. Changes in inventories of finished goods and work in progress				
4. Cost of raw materials and consumables used				
5. Salaries, wages and other staff costs				
6. Other expenses				
7. Interest				
8. Depreciation and amortisations				

Total				
9. Profit or loss from ordinary activities before tax				
10. Extraordinary items				
11. Profit or loss before tax				
12. Tax expense				
13. Profit or loss after tax				
14. Minority Interests (in case of consolidated financial statements)				
15. Net profit or loss for the period				
Earnings Per Share 1. Basic Earnings Per Share 2. Diluted Earnings Per Share				

(C) Condensed Cash Flow Statement

	Year-to-date figures for the current period	**Year-to-date figures for the previous year**
1. Cash flows from operating activities		
2. Cash flows from investing activities		
3. Cash flows from financing activities		
4.Net increase/(decrease) in cash and cash equivalents		
5. Cash and cash equivalents at beginning of period		
6. Cash and cash equivalents at end of period		

(D) Selected Explanatory Notes

This part should contain selected explanatory notes as required by para- graph 16 of this Standard.

Illustrative Format of Condensed Financial Statements for a Bank

(A) Condensed Balance Sheet

	Figures at the end of the current interim period	Figures at the end of the previous accounting year
I. Capital and Liabilities		
1. Capital		
2. Reserve and surplus		

3. Minority interests (in case of consolidated financial statements)		
4. Deposits		
5. Borrowings		
6. Other liabilities and provisions		
Total		
II. Assets		
1. Cash and balances with Reserve Bank of India		
2. Balances with banks and money at call and short notice		
3. Investments		
4. Advances		
5. Fixed assets (a) Tangible fixed assets (b) Intangible fixed assets		
6. Other Assets		
Total		

(B) Condensed Statement of Profit and Loss

	Three months ended	**Corresponding three months of the previous accounting year**	**Year-to-date figures for current period**	**Year-to-date figures for the previous year**
	1	**2**	**3**	**4**
1. Interest earned (a) Interest/discount on advances/bills (b) Interest on Investments (c) Interest on balances with Reserve Bank of India and other inter banks funds (d) Others				
2. Other Income				
Total Income				
1. Interest expended				
2. Operating expenses (a) Payments to and provisions for employees (b) Other operating expenses				
3. Total expenses (excluding provisions and contingencies)				

4. Operating profit (profit before provisions and contingencies)				
5. Provisions and contingencies				
6. Profit or loss from ordinary activities before tax				
7. Extraordinary items				
8. Profit or loss before tax				
9. Tax expense				

(B) Condensed Statement of Profit and Loss *(Contd.)*

	Three months ended	**Corresponding three months of the previous accounting year**	**Year-to-date figures for current period**	**Year-to-date figures for the previous year**
10. Profit or loss				
11. Minority Interests (in case of				
12. Net profit or loss for the				
Earnings Per Share 1. Basic Earnings Per Share 2. Diluted				

(C) Condensed Cash Flow Statement

	Year-to-date figures for the current period	**Year-to-date figures for the previous year**
1. Cash flows from operating activities		
2. Cash flows from investing activities		
3. Cash flows from financing activities		
4. Net increase/(decrease) in cash and cash equivalents		
5. Cash and cash equivalents at beginning of period		
6. Cash and cash equivalents at end of period		

(D) Selected Explanatory Notes

This part should contain selected explanatory notes as required by paragraph 16 of this Standard.

Illustration 2

Illustration of Periods Required to Be Presented

This illustration which does not form part of the Accounting Standard, Illustrates application of the principles in paragraphs 18 and 19. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Enterprise Preparing and Presenting Interim Financial Reports Half- Yearly

1. An enterprise whose financial year ends on 31 March, presents financial statements (condensed or complete) for following periods in its half-yearly interim financial report as of 30 September 2001:

Balance Sheet:		
As at	30 September 2001	31 March 2001
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
Cash Flow Statement[2]:		
6 months ending	30 September 2001	30 September 2000

Enterprise Preparing and Presenting Interim Financial Reports

Quarterly

2. An enterprise whose financial year ends on 31 March, presents financial statements (condensed or complete) for following periods in its interim financial report for the second quarter ending 30 September 2001:

Balance Sheet:		
As at	30 September 2001	31 March 2001
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
3 months ending	30 September 2001	30 September 2000
Cash Flow Statement:		
6 months ending	30 September 2001	30 September 2000

Enterprise whose business is highly seasonal Preparing and Presenting

Interim Financial Reports Quarterly

3. An enterprise whose financial year ends on 31 March, may present financial statements (condensed or complete) for the following periods in its interim financial report for the second quarter ending 30 September 2001:

[2] It is assumed that the enterprise prepares a cash flow statement for the purpose of its Annual Report.

Balance Sheet:

As at	30 September 2001	31 March 2001
		30 September 2000
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
3 months ending	30 September 2001	30 September 2000
12 months ending	30 September 2001	30 September 2000
Cash Flow Statement:		
6 months ending	30 September 2001	30 September 2000
12 months ending	30 September 2001	30 September 2000

Illustration 3

Illustration of Applying the Recognition and Measurement Principles

This illustration, which does not form part of the Accounting Standard, illustrates application of the general recognition and measurement principles set out in paragraphs 27-38 of this Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Gratuity and Other Defined Benefit Schemes

1. Provisions in respect of gratuity and other defined benefit schemes for an interim period are calculated on a year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements, or other significant one-time events.

Major Planned Periodic Maintenance or Overhaul

2. The cost of a major planned periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the enterprise to have a present obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

Provisions

3. This Standard requires that an enterprise apply the same criteria for recognising and measuring a provision at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer economic benefits is not a function of the length of the reporting period. It is a question of fact subsisting on the reporting date.

Year-End Bonuses

4. The nature of year-end bonuses varies widely. Some are earned simply by continued employment during a time period. Some bonuses are earned based on monthly, quarterly, or annual measure of operating result. They may be purely discretionary, contractual, or based on years of historical precedent.

5. A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation or an obligation arising from past practice for which the enterprise has no realistic alternative but to make the payments, and (b) a reliable estimate of the obligation can be made.

Intangible Assets

6. An enterprise will apply the definition and recognition criteria for an intangible asset in the same way in an interim period as in an annual period. Costs incurred before the recognition criteria for an intangible asset are met are recognised as an expense. Costs incurred after the specific point in time at which the criteria are met are recognised as part of the cost of an intangible asset. "Deferring" costs as assets in an interim balance sheet in the hope that the recognition criteria will be met later in the financial year is not justified.

Other Planned but Irregularly Occurring Costs

7. An enterprise's budget may include certain costs expected to be incurred irregularly during the financial year, such as employee training costs. These costs generally are discretionary even though they are planned and tend to recur from year to year. Recognising an obligation at an interim financial reporting date for such costs that have not yet been incurred generally is not consistent with the definition of a liability.

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Standard. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns ₹ 150 lakhs pre- tax profit in the first quarter but expects to incur losses of ₹ 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in ₹ lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns ₹ 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in ₹ lakhs)

	Quarter Ending 31 Dec. Year 1	Quarter Ending 31 Mar. Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep. Year 2	Year Ending 30 Sep. Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carry forwards

15. A deferred tax asset should be recognised in respect of carryforward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of ₹ 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns ₹ 100 lakhs in the first quarter of the current year and expects to earn ₹ 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on ₹ 400 lakhs of earnings for the current year would be ₹ 120 lakhs {(₹ 400 lakhs - ₹ 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(₹ 120 lakhs/₹ 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in ₹ lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00

Contractual or Anticipated Purchase Price Changes

17. Volume rebates or discounts and other contractual changes in the prices of goods and services are anticipated in interim periods, if it is probable that they will take effect. Thus, contractual rebates and discounts are anticipated but discretionary rebates and discounts are not anticipated because the resulting liability would not satisfy the conditions of recognition, viz., that a liability must be a present obligation whose settlement is expected to result in an outflow of resources.

Depreciation and Amortisation

18. Depreciation and amortisation for an interim period is based only on assets owned during that interim period. It does not take into account asset acquisitions or disposals planned for later in the financial year.

Inventories

19. Inventories are measured for interim financial reporting by the same principles as at financial year end. AS 2 on Valuation of Inventories, establishes standards for recognising and measuring inventories. Inventories pose particular problems at any financial reporting date because of the need to determine inventory quantities, costs, and net realisable values. Nonetheless, the same measurement principles are applied for interim inventories. To save cost and time, enterprises often use estimates to measure inventories at interim dates to a greater extent than at annual reporting dates. Paragraph 20 below provides an example of how to apply the net realisable value test at an interim date.

Net Realisable Value of Inventories

20. The net realisable value of inventories is determined by reference to selling prices and related costs to complete and sell the inventories. An enterprise will reverse a write-down to net realisable value in a subsequent interim period as it would at the end of its financial year.

Foreign Currency Translation Gains and Losses

21. Foreign currency translation gains and losses are measured for interim financial reporting by the same principles as at financial year end in accordance with the principles as stipulated in AS 11 on Accounting for the Effects of Changes in Foreign Exchange Rates.

Impairment of Assets

22. Accounting Standard on Impairment of Assets[3] requires that an impairment loss be recognised if the recoverable amount has declined below carrying amount.

23. An enterprise applies the same impairment tests, recognition, and reversal criteria at an interim date as it would at the end of its financial year. That does not mean, however, that an enterprise must necessarily make a detailed impairment calculation at the end of each interim period. Rather, an enterprise will assess the indications of significant impairment since the end of the most recent financial year to determine whether such a calculation is needed.

Illustration 4

Examples of the Use of Estimates

This illustration which does not form part of the Accounting Standard, illustrates application of the principles in this Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

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[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

1. **Provisions:** Determination of the appropriate amount of a provision (such as a provision for warranties, restructuring costs, gratuity, etc.) may be complex and often costly and time-consuming. Enterprises sometimes engage outside experts to assist in annual calculations. Making similar estimates at interim dates often involves updating the provision made in the preceding annual financial statements rather than engaging outside experts to do a new calculation.

2. **Contingencies:** Measurement of contingencies may involve obtaining opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not be needed at interim dates.

3. **Specialised industries:** Because of complexity, costliness, and time involvement, interim period measurements in specialised industries might be less precise than at financial year end. An example is calculation of insurance reserves by insurance companies.

AS 26* : Intangible Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. This Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

Scope

1. This Standard should be applied by all enterprises in accounting for intangible assets, except:

- ***(a) intangible assets that are covered by another Accounting Standard;***
- ***(b) financial assets[2];***
- ***(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and***
- ***(d) intangible assets arising in insurance enterprises from contracts with policyholders.***

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* Issued in 2002.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

This Standard should not be applied to expenditure in respect of termination benefits[3] also.

2. If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Standard. For example, this Standard does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS 2, Valuation of Inventories, and AS 7, Construction Contracts);

(b) deferred tax assets (see AS 22, Accounting for Taxes on Income);

(c) leases that fall within the scope of AS 19, Leases; and

(d) goodwill arising on an amalgamation (see AS 14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS 21, Consolidated Financial Statements).

3. This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This Standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

4. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee deals with an intangible asset held under a finance lease under this Standard.

5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Standard does not apply to expenditure on such activities. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Accordingly, this Standard does not apply to such items also.

Definitions

6. The following terms are used in this Standard with the meanings specified:

6.1 An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

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[3] Termination benefits are employee benefits payable as a result of either:

6.3 Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

6.4 Non-monetary assets are assets other than monetary assets.

6.5 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

6.6 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

6.7 Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

6.8 Depreciable amount is the cost of an asset less its residual value.

6.9 Useful life is either:

- ***(a) the period of time over which an asset is expected to be used by the enterprise; or***
- ***(b) the number of production or similar units expected to be obtained from the asset by the enterprise.***

6.10. Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

6.11. Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

6.12. An active market is a market where all the following conditions exist:

- ***(a) the items traded within the market are homogeneous;***
- ***(b) willing buyers and sellers can normally be found at any time; and***
- ***(c) prices are available to the public.***

6.13. An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount[4].

6.14. Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

7. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

[4] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

8. Not all the items described in paragraph 7 will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation (see paragraph 55).

9. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a

necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset (see paragraphs 6-18); and

(b) recognition criteria set out in this Standard (see paragraphs 20-54).

20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost.

Separate Acquisition

24. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as Part of an Amalgamation

27. An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation, paragraphs 28 to 32 of this Standard need to be considered.

28. Judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

29. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

30. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value as defined in this Standard and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

31. In accordance with this Standard:

(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor; and

(b) if the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill (see paragraph 55).

32. Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

33. In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also requires that in case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of Assets

34. An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

Internally Generated Goodwill

35. Internally generated goodwill should not be recognised as an asset.

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

37. Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

38. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to- day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an enterprise applies the requirements and guidance in paragraphs 39-54 below to all internally generated intangible assets.

39. To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

40. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

41. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

42. This Standard takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Therefore, this expenditure is recognised as an expense when it is incurred.

43. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

45. In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

46. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

47. To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets[5]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash- generating units as set out in Accounting Standard on Impairment of Assets.

48. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

49. An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

50. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

51. This Standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Cost of an Internally Generated Intangible Asset

52. The cost of an internally generated intangible asset for the purpose of paragraph 23 is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria in paragraphs 20-21 and

44. Paragraph 58 prohibits reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports.

53. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

(a) expenditure on materials and services used or consumed in generating the intangible asset;

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[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

54. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Example Illustrating Paragraph 52

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was ₹ 10 lakhs, of which ₹ 9 lakhs was incurred before 1 December 20X1 and 1 lakh was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 5 lakhs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of ₹ 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The ₹ 9 lakhs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is ₹ 20 lakhs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 19 lakhs.

At the end of the year 20X2, the cost of the production process is ₹ 21 lakhs (₹ 1 lakh expenditure recognised at the end of 20X1 plus ₹ 20 lakhs expenditure recognised in 20X2). The enterprise recognises an impairment loss of ₹ 2 lakhs to adjust the carrying amount of the process before impairment loss (₹ 21 lakhs) to its recoverable amount (₹ 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets[6], are met.

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[6] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Recognition of an Expense

55. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- ***(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 19-54); or***
- ***(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, Accounting for Amalgamations).***

56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

- (a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);
- (b) expenditure on training activities;
- (c) expenditure on advertising and promotional activities; and
- (d) expenditure on relocating or re-organising part or all of an enterprise.

57. Paragraph 55 does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be Recognised as an Asset

58. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure

59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

- ***(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and***
- ***(b) the expenditure can be measured and attributed to the asset reliably.***

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a

particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

61. Consistent with paragraph 50, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

62. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation

Amortisation Period

63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

65. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Standard adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

Examples

A. An enterprise has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro- electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

The enterprise amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

The enterprise amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

69. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

71. The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;

(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and

(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

74. Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see AS 2, Valuation of Inventories).

Residual Value

75. The residual value of an intangible asset should be assumed to be zero unless:

- ***(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or***
- ***(b) there is an active market for the asset and:***
  - ***(i) residual value can be determined by reference to that market; and***
  - ***(ii) it is probable that such a market will exist at the end of the asset's useful life.***

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value.

Review of Amortisation Period and Amortisation Method

78. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

79. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves

the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

80. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount — Impairment Losses

81. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[7]. That Standard explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

82. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

83. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

84. The ability of an intangible asset to generate sufficient future economic benefits to recover its cost is usually subject to great uncertainty until the asset is available for use. Therefore, this Standard requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

85. It is sometimes difficult to identify whether an intangible asset may be impaired because, among other things, there is not necessarily any obvious evidence of obsolescence. This difficulty arises particularly if the asset has a long useful life. As a consequence, this Standard requires, as a minimum, an annual calculation of the recoverable amount of an intangible asset if its useful life exceeds ten years from the date when it becomes available for use.

86. The requirement for an annual impairment test of an intangible asset applies whenever the current total estimated useful life of the asset exceeds ten years from when it became available for use. Therefore, if the useful life of an intangible asset was estimated to be less than ten years at initial

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[7] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the impairment test required under paragraph 83(b) and also makes the disclosure required under paragraph 94(a).

Retirements and Disposals

87. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

88. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

89. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets[8], and recognises any impairment loss accordingly.

Disclosure

General

90. The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- ***(a) the useful lives or the amortisation rates used;***
- ***(b) the amortisation methods used;***
- ***(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;***
- ***(d) a reconciliation of the carrying amount at the beginning and end of the period showing:***
  - ***(i) additions, indicating separately those from internal development and through amalgamation;***
  - ***(ii) retirements and disposals;***
  - ***(iii) impairment losses recognised in the statement of profit and loss during the period (if any);***
  - ***(iv) impairment losses reversed in the statement of profit and loss during the period (if any);***
  - ***(v) amortisation recognised during the period; and***
  - ***(vi) other changes in the carrying amount during the period.***

91. A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

- (a) brand names;
- (b) mastheads and publishing titles;

[8] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(c) computer software;

(d) licences and franchises;

(e) copyrights, and patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

92. An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets[9] in addition to the information required by paragraph 90(d)(iii) and (iv).

93. An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;

(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and

(d) the amount of commitments for the acquisition of intangible assets.

95. When an enterprise describes the factor(s) that played a significant role in determining the useful life of an intangible asset that is amortised over more than ten years, the enterprise considers the list of factors in paragraph 64.

Research and Development Expenditure

96. The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

97. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities (see paragraphs 53-54 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 96).

[9] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Other Information

98. An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

99. Where, on the date of this Standard coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Standard and the period determined under paragraph 63 has expired on the date of this Standard coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Standard coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

(b) if the remaining period as per the accounting policy followed by the enterprise:

(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

(ii) is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

100. Illustration B attached to the Standard illustrates the application of paragraph 99.

Illustration A

This illustration which does not form part of the Accounting Standard, provides illustrative application of the principles laid down in the Standard to internal use software and web-site costs. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

I. Illustrative Application of the Accounting Standard to Internal Use Computer Software

Computer software for internal use can be internally generated or acquired.

Internally Generated Computer Software

1. Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

2. The stages of development of internally generated software may be categorised into the following two phases:

- Preliminary project stage, i.e., the research phase
- Development stage

Preliminary project stage

3. At the preliminary project stage the internally generated software should not be recognised as an asset. Expenditure incurred in the preliminary project stage should be recognised as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise cannot demonstrate that an asset exists from which future economic benefits are probable.

4. When a computer software project is in the preliminary project stage, enterprises are likely to:

(a) Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system.

(b) Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

(c) Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software. Should the software run on a mainframe or a client server system.

(d) Determine that the technology needed to achieve performance requirements exists.

(e) Select a consultant to assist in the development and/or installation of the software.

Development Stage

5. An internally generated software arising at the development stage should be recognised as an asset if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the internally generated software so that it will be available for internal use;

(b) the intention of the enterprise to complete the internally generated software and use it to perform the functions intended. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;

(c) the ability of the enterprise to use the software;

(d) how the software will generate probable future economic benefits. Among other things, the enterprise should demonstrate the usefulness of the software;

(e) the availability of adequate technical, financial and other resources to complete the development and to use the software; and

(f) the ability of the enterprise to measure the expenditure attributable to the software during its development reliably.

6. Examples of development activities in respect of internally generated software include:

(a) Design including detailed program design - which is the process of detail design of computer software that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

(b) Coding which includes generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

At the end of these stages of the development activity, the enterprise has a working model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

(c) Testing which is the process of performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

At the end of the testing process, the enterprise has a master version of the internal use software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

7. The cost of an internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of this Standard and paragraph 5 above. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

8. The cost of an internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost include:

(a) expenditure on materials and services used or consumed in developing the software;

(b) the salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) any expenditure that is directly attributable to generating software; and

(d) overheads that are necessary to generate the software and that can be allocated on a reasonable and consistent basis to the software (For example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads are made on basis similar to those used in allocating the overhead to inventories.

9. The following are not components of the cost of an internally generated software:

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

(b) clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

(c) expenditure on training the staff to use the internally generated software.

Software Acquired for Internal Use

10. The cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this Standard.

11. The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use.

Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Standard need to be considered, as appropriate.

Subsequent expenditure

12. Enterprises may incur considerable cost in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) the expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognised as an expense when, and only when, the restoration or maintenance work is carried out.

Amortisation period

13. The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortisation should commence when the software is available for use.

14. As per this Standard, there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.

Amortisation method

15. The amortisation method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of a software used in a production process is included in the carrying amount of inventories.

II. Illustrative Application of the Accounting Standard to Web-Site Costs

1. An enterprise may incur internal expenditures when developing, enhancing and maintaining its own web site. The web site may be used for various purposes such as promoting and advertising products and services, providing electronic services, and selling products and services.

2. The stages of a web site's development can be described as follows:

(a) Planning - includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences;

(b) Application and Infrastructure Development - includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing; and

(c) Graphical Design and Content Development - includes designing the appearance of web pages and creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed and the web site is available for use, the web site commences an operating stage. During this stage, an enterprise maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. The expenditures for purchasing, developing, maintaining and enhancing hardware (e.g., web servers, staging servers, production servers and Internet connections) related to a web site are not accounted for under this Standard but are accounted for under AS 10, Accounting for Fixed Assets. Additionally, when an enterprise incurs an expenditure for having an Internet service provider host the enterprise's web site on its own servers connected to the Internet, the expenditure is recognised as an expense.

5. An intangible asset is defined in paragraph 6 of this Standard as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Paragraph 7 of this Standard provides computer software as a common example of an intangible asset. By analogy, a web site is another example of an intangible asset. Accordingly, a web site developed by an enterprise for its own use is an internally generated intangible asset that is subject to the requirements of this Standard.

6. An enterprise should apply the requirements of this Standard to an internal expenditure for developing, enhancing and maintaining its own web site. Paragraph 55 of this Standard provides expenditure on an intangible item to be recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 19-54 of the Standard. Paragraph 56 of the Standard requires expenditure on start-up activities to be recognised as an expense when incurred. Developing a web site by an enterprise for its own use is not a start-up activity to the extent that an internally generated intangible asset is created. An enterprise applies the requirements and guidance in paragraphs 39-54 of this Standard to an expenditure incurred for developing its own web site in addition to the general requirements for recognition and initial measurement of an intangible asset. The cost of a web site, as described in paragraphs 52-54 of this Standard, comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

The enterprise should evaluate the nature of each activity for which an expenditure is incurred (e.g., training employees and maintaining the web site) and the web site's stage of development or post-development:

(a) Paragraph 41 of this Standard requires an expenditure on research (or on the research phase of an internal project) to be recognised as an expense when incurred. The examples provided in paragraph 43 of this Standard are similar to the activities undertaken in the Planning stage of a web site's development. Consequently, expenditures incurred in the Planning stage of a web site's development are recognised as an expense when incurred.

(b) Paragraph 44 of this Standard requires an intangible asset arising from the development phase of an internal project to be recognised if an enterprise can demonstrate fulfillment of the six criteria specified. Application and Infrastructure Development and Graphical Design and Content Development stages are similar in nature to the development phase. Therefore, expenditures incurred in these stages should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements for recognition and initial measurement of an intangible asset, an enterprise can demonstrate those items described in paragraph 44 of this Standard. In addition,

    (i) an enterprise may be able to demonstrate how its web site will generate probable future economic benefits under paragraph 44(d) by using the principles in Accounting

Standard on Impairment of Assets[10]. This includes situations where the web site is developed solely or primarily for promoting and advertising an enterprise's own products and services. Demonstrating how a web site will generate probable future economic benefits under paragraph 44(d) by assessing the economic benefits to be received from the web site and using the principles in Accounting Standard on Impairment of Assets, may be particularly difficult for an enterprise that develops a web site solely or primarily for advertising and promoting its own products and services; information is unlikely to be available for reliably estimating the amount obtainable from the sale of the web site in an arm's length transaction, or the future cash inflows and outflows to be derived from its continuing use and ultimate disposal. In this circumstance, an enterprise determines the future economic benefits of the cash-generating unit to which the web site belongs, if it does not belong to one. If the web site is considered a corporate asset (one that does not generate cash inflows independently from other assets and their carrying amount cannot be fully attributed to a cash- generating unit), then an enterprise applies the 'bottom-up' test and/or the 'top-down' test under Accounting Standard on Impairment of Assets.

(ii) an enterprise may incur an expenditure to enable use of content, which had been purchased or created for another purpose, on its web site (e.g., acquiring a license to reproduce information) or may purchase or create content specifically for use on its web site prior to the web site becoming available for use. In such circumstances, an enterprise should determine whether a separate asset, is identifiable with respect to such content (e.g., copyrights and licenses), and if a separate asset is not identifiable, then the expenditure should be included in the cost of developing the web site when the expenditure meets the conditions in paragraph 44 of this Standard. As per paragraph 20 of this Standard, an intangible asset is recognised if, and only if, it meets specified criteria, including the definition of an intangible asset. Paragraph 52 indicates that the cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the specified recognition criteria. When an enterprise acquires or creates content, it may be possible to identify an intangible asset (e.g., a license or a copyright) separate from a web site. Consequently, an enterprise determines whether an expenditure to enable use of content, which had been created for another purpose, on its web site becoming available for use results in a separate identifiable asset or the expenditure is included in the cost of developing the web site.

(c) the operating stage commences once the web site is available for use, and therefore an expenditure to maintain or enhance the web site after development has been completed should be recognised as an expense when it is incurred unless it meets the criteria in paragraph 59 of the Standard. Paragraph 60 explains that if the expenditure is required to maintain the asset at its originally assessed standard of performance, then the expenditure is recognised as an expense when incurred.

7. An intangible asset is measured subsequent to initial recognition by applying the requirements in paragraph 62 of this Standard. Additionally, since paragraph 68 of the Standard states that an intangible asset always has a finite useful life, a web site that is recognised as an asset is amortised

[10] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

over the best estimate of its useful life. As indicated in paragraph 65 of the Standard, web sites are susceptible to technological obsolescence, and given the history of rapid changes in technology, their useful life will be short.

8. The following table illustrates examples of expenditures that occur within each of the stages described in paragraphs 2 and 3 above and application of paragraphs 5 and 6 above. It is not intended to be a comprehensive checklist of expenditures that might be incurred.

Nature of Expenditure	Accounting treatment
Planning • undertaking feasibility studies • defining hardware and software specifications • evaluating alternative products and suppliers • selecting preferences	Expense when incurred
Application and Infrastructure Development • purchasing or developing hardware	Apply the requirements of AS 10
• obtaining a domain name • developing operating software (e.g., operating system and server software) • developing code for the application • installing developed applications on the web server • stress testing	Expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Graphical Design and Content Development • designing the appearance (e.g., layout and colour) of web pages • creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading information, either textual or graphical in nature, on the website prior to the web site becoming available for use. Examples of content include information about an enterprise, products or services offered for sale, and topics that subscribers access	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Operating • updating graphics and revising content • adding new functions, features and content • registering the web site with search engines • backing up data • reviewing security access • analysing usage of the web site	Expense when incurred, unless in rare circumstances it meets the criteria in paragraph 59, in which case the expenditure is included in the cost of the web site

Other • selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use • clearly identified inefficiencies • and initial operating losses incurred before the web site achieves planned performance (e.g., false start testing) • training employees to operate the web site	Expense when incurred

Illustration B

This Illustration which does not form part of the Accounting Standard, provides illustrative application of the requirements contained in paragraph 99 of this Accounting Standard in respect of transitional provisions.

Illustration 1 - Intangible Item was not amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 10 lakhs as on 1-4-2003. The item was acquired for ₹ 10 lakhs on April 1, 1990 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1990.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of the intangible item of ₹ 10 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustration 2 - Intangible Item is being amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 8 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 1991 and was available for use from that date. The enterprise has been following a policy of amortising the item over a period of 20 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1991.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of ₹ 8 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustration 3 - Amortisation period determined under paragraph63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is shorter.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 8 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 5 years on straight line basis. Applying paragraph 63, the enterprise determines the amortisation period to be 8 years, being the best estimate of its useful life, from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 2 years as per the accounting policy followed by the enterprise which is shorter as compared to the balance of amortisation period determined by applying paragraph 63, i.e., 5 years. Accordingly, the enterprise would be required to amortise the intangible item over the remaining 2 years as per the accounting policy followed by the enterprise.

Illustration 4 - Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is longer.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 18 lakhs as on 1-4-2003. The item was acquired for ₹ 24 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 12 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 9 years as per the accounting policy followed by the enterprise which is longer as compared to the balance of period stipulated in paragraph 63, i.e., 7 years. Accordingly, the enterprise would be required to restate the carrying amount of intangible item on 1-4-2003 at ₹ 16.8 lakhs (₹ 24 lakhs - 3x₹ 2.4 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of ₹ 1.2 lakhs (₹ 18 lakhs-₹ 16.8 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of ₹ 16.8 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

Illustration 5 - Intangible Item is not amortised and amortisation period determined under paragraph 63 has not expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 20 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the enterprise would be required to restate the carrying amount of intangible item at ₹ 14 lakhs (₹ 20 lakhs - 3x₹ 2 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of ₹ 6 lakhs (₹ 20 lakhs-₹ 14 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of ₹ 14 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

AS 27 (issued 2002) - Financial Reporting of Interests in Joint Ventures

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

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[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

This Standard is mandatory in respect of separate financial statements of an enterprise. In respect of consolidated financial statements of an enterprise, this Standard is mandatory in nature where the enterprise prepares and presents the consolidated financial statements.

Objective

The objective of this Standard is to set out principles and procedures for accounting for interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors.

Scope

1. This Standard should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

2. The requirements relating to accounting for joint ventures in consolidated financial statements, contained in this Standard, are applicable only where consolidated financial statements are prepared and presented by the venturer.

Definitions

3. For the purpose of this Standard, the following terms are used with the meanings specified:

3.1 A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

3.2 Joint control is the contractually agreed sharing of control over an economic activity.

3.3 Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

3.4 A venturer is a party to a joint venture and has joint control over that joint venture.

3.5 An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

3.6 Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Forms of Joint Venture

4. Joint ventures take many different forms and structures. This Standard identifies three broad types - jointly controlled operations, jointly controlled assets and jointly controlled entities - which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

(a) two or more venturers are bound by a contractual arrangement; and

(b) the contractual arrangement establishes joint control.

Contractual Arrangement

5. The existence of a contractual arrangement distinguishes interests which involve joint control from investments in associates in which the investor has significant influence (see Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements). Activities

which have no contractual arrangement to establish joint control are not joint ventures for the purposes of this Standard.

6. In some exceptional cases, an enterprise by a contractual arrangement establishes joint control over an entity which is a subsidiary of that enterprise within the meaning of Accounting Standard (AS) 21, Consolidated Financial Statements. In such cases, the entity is consolidated under AS 21 by the said enterprise, and is not treated as a joint venture as per this Standard. The consolidation of such an entity does not necessarily preclude other venturer(s) treating such an entity as a joint venture.

7. The contractual arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the articles or other by-laws of the joint venture. Whatever its form, the contractual arrangement is normally in writing and deals with such matters as:

(a) the activity, duration and reporting obligations of the joint venture;

(b) the appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;

(c) capital contributions by the venturers; and

(d) the sharing by the venturers of the output, income, expenses or results of the joint venture.

8. The contractual arrangement establishes joint control over the joint venture. Such an arrangement ensures that no single venturer is in a position to unilaterally control the activity. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers.

9. The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies which have been agreed to by the venturers in accordance with the contractual arrangement and delegated to the operator.

Jointly Controlled Operations

10. The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own fixed assets and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture's activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides means by which the revenue from the jointly controlled operations and any expenses incurred in common are shared among the venturers.

11. An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute, jointly, a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

12. In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

13. Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

14. Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Jointly Controlled Assets

15. Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain economic benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

16. These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits through its share in the jointly controlled asset.

17. An example of a jointly controlled asset is an oil pipeline jointly controlled and operated by a number of oil production companies. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two enterprises jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

18. In respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities which it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture.

19. In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognises in its separate financial statements and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment, for example, a share of a jointly controlled oil pipeline is classified as a fixed asset;

(b) any liabilities which it has incurred, for example, those incurred in financing its share of the assets;

(c) its share of any liabilities incurred jointly with other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture, for example, those related to financing the venturer's interest in the assets and selling its share of the output.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

20. The treatment of jointly controlled assets reflects the substance and economic reality and, usually, the legal form of the joint venture. Separate accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers according to their agreed shares. Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Jointly Controlled Entities

21. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

22. A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns income. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the results of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

23. An example of a jointly controlled entity is when two enterprises combine their activities in a particular line of business by transferring the relevant assets and liabilities into a jointly controlled entity. Another example is when an enterprise commences a business in a foreign country in conjunction with the government or other agency in that country, by establishing a separate entity which is jointly controlled by the enterprise and the government or agency.

24. Many jointly controlled entities are similar to those joint ventures referred to as jointly controlled operations or jointly controlled assets. For example, the venturers may transfer a jointly controlled asset, such as an oil pipeline, into a jointly controlled entity. Similarly, the venturers may contribute, into a jointly controlled entity, assets which will be operated jointly. Some jointly controlled operations also involve the establishment of a jointly controlled entity to deal with particular aspects of the activity, for example, the design, marketing, distribution or after-sales service of the product.

25. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity.

Separate Financial Statements of a Venturer

26. In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

27. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

Consolidated Financial Statements of a Venturer

28. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

- ***(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and***
- ***(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.***

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

Explanation:

The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investment, such an investment is not excluded from application of the proportionate consolidation method, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, however, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from application of the proportionate consolidation method, provided there is no change in the intention.

29. When reporting an interest in a jointly controlled entity in consolidated financial statements, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has control over its share of future economic benefits through its share of the assets and liabilities of the venture. This substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, income and expenses of the jointly controlled entity by using proportionate consolidation.

30. The application of proportionate consolidation means that the consolidated balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The consolidated statement of profit and loss of the venturer includes its share of the income and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in Accounting Standard (AS) 21, Consolidated Financial Statements.

31. For the purpose of applying proportionate consolidation, the venturer uses the consolidated financial statements of the jointly controlled entity.

32. Under proportionate consolidation, the venturer includes separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its consolidated financial

statements. For example, it shows its share of the inventory of the jointly controlled entity separately as part of the inventory of the consolidated group; it shows its share of the fixed assets of the jointly controlled entity separately as part of the same items of the consolidated group.

Explanation:

While applying proportionate consolidation method, the venturer's share in the post-acquisition reserves of the jointly controlled entity is shown separately under the relevant reserves in the consolidated financial statements.

33. The financial statements of the jointly controlled entity used in applying proportionate consolidation are usually drawn up to the same date as the financial statements of the venturer. When the reporting dates are different, the jointly controlled entity often prepares, for applying proportionate consolidation, statements as at the same date as that of the venturer. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. In such a case, adjustments are made for the effects of significant transactions or other events that occur between the date of financial statements of the jointly controlled entity and the date of the venturer's financial statements. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

34. The venturer usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case a jointly controlled entity uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the financial statements of the jointly controlled entity when they are used by the venturer in applying proportionate consolidation. If it is not practicable to do so, that fact is disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

35. While giving effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any income or expenses by the deduction of other expenses or income, unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

36. Any excess of the cost to the venturer of its interest in a jointly controlled entity over its share of net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, is recognised as goodwill, and separately disclosed in the consolidated financial statements. When the cost to the venturer of its interest in a jointly controlled entity is less than its share of the net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, the difference is treated as a capital reserve in the consolidated financial statements. Where the carrying amount of the venturer's interest in a jointly controlled entity is different from its cost, the carrying amount is considered for the purpose of above computations.

37. The losses pertaining to one or more investors in a jointly controlled entity may exceed their interests in the equity[2] of the jointly controlled entity. Such excess, and any further losses applicable to such investors, are recognised by the venturers in the proportion of their shares in the venture, except to the extent that the investors have a binding obligation to, and are able to, make good the losses. If

[2] Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

the jointly controlled entity subsequently reports profits, all such profits are allocated to venturers until the investors' share of losses previously absorbed by the venturers has been recovered.

38. A venturer should discontinue the use of proportionate consolidation from the date that:

- ***(a) it ceases to have joint control over a jointly controlled entity but retains, either in whole or in part, its interest in the entity; or***
- ***(b) the use of the proportionate consolidation is no longer appropriate because the jointly controlled entity operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.***

39. From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

- ***(a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and***
- ***(b) in all other cases, as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments, or in accordance with Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate. For this purpose, cost of the investment should be determined as under:***
  - ***(i) the venturer's share in the net assets of the jointly controlled entity as at the date of discontinuance of proportionate consolidation should be ascertained, and***
  - ***(ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve (see paragraph 37) as at the date of discontinuance of proportionate consolidation.***

Transactions between a Venturer and Joint

Venture

40. When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

41. When a venturer purchases assets from a joint venture, the venturer should not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer should recognise its share of the losses resulting from these transactions in the same way as profits except that losses should be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.

42. To assess whether a transaction between a venturer and a joint venture provides evidence of impairment of an asset, the venturer determines the recoverable amount of the asset as per Accounting

Standard on Impairment of Assets[3]. In determining value in use, future cash flows from the asset are estimated based on continuing use of the asset and its ultimate disposal by the joint venture.

43. In case of transactions between a venturer and a joint venture in the form of a jointly controlled entity, the requirements of paragraphs 41 and 42 should be applied only in the preparation and presentation of consolidated financial statements and not in the preparation and presentation of separate financial statements of the venturer.

44. In the separate financial statements of the venturer, the full amount of gain or loss on the transactions taking place between the venturer and the jointly controlled entity is recognised. However, while preparing the consolidated financial statements, the venturer's share of the unrealised gain or loss is eliminated. Unrealised losses are not eliminated, if and to the extent they represent a reduction in the net realisable value of current assets or an impairment loss. The venturer, in effect, recognises, in consolidated financial statements, only that portion of gain or loss which is attributable to the interests of other venturers.

Reporting Interests in Joint Ventures in the financial Statements of an Investor

45. An investor in a joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with Accounting Standard (AS) 13, Accounting for Investments, Accounting Standard (AS) 21, Consolidated Financial Statements or Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate.

46. In the separate financial statements of an investor, the interests in joint ventures should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

Operators of Joint Ventures

47. Operators or managers of a joint venture should account for any fees in accordance with Accounting Standard (AS) 9, Revenue Recognition.

48. One or more venturers may act as the operator or manager of a joint venture. Operators are usually paid a management fee for such duties. The fees are accounted for by the joint venture as an expense.

Disclosure

49. A venturer should disclose the information required by paragraphs 51, 52 and 53 in its separate financial statements as well as in consolidated financial statements.

50. A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

(a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

(c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

51. A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

(a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

(b) its share of the capital commitments of the joint ventures themselves.

52. A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

53. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

AS 28 (issued 2002) - Impairment of Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also specifies when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets.

Scope

1. This Standard should be applied in accounting for the impairment of all assets, other than:

(a) inventories (see AS 2, Valuation of Inventories);

(b) assets arising from construction contracts (see AS 7, Construction Contracts);

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(c) financial assets[2] including investments that are included in the scope of AS 13, Accounting for Investments; and

(d) deferred tax assets (see AS 22, Accounting for Taxes on Income).

2. This Standard does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because existing Accounting Standards applicable to these assets already contain specific requirements for recognising and measuring the impairment related to these assets.

3. This Standard applies to assets that are carried at cost. It also applies to assets that are carried at revalued amounts in accordance with other applicable Accounting Standards. However, identifying whether a revalued asset may be impaired depends on the basis used to determine the fair value of the asset:

(a) if the fair value of the asset is its market value, the only difference between the fair value of the asset and its net selling price is the direct incremental costs to dispose of the asset:

(i) if the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount (fair value). In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated; and

(ii) if the disposal costs are not negligible, net selling price of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount (fair value). In this case, after the revaluation requirements have been applied, an enterprise applies this Standard to determine whether the asset may be impaired; and

(b) if the asset's fair value is determined on a basis other than its market value, its revalued amount (fair value) may be greater or lower than its recoverable amount. Hence, after the revaluation requirements have been applied, an enterprise applies this Standard to determine whether the asset may be impaired.

Definitions

4. The following terms are used in this Standard with the meanings specified:

4.1 Recoverable amount is the higher of an asset's net selling price and its value in use.

4.2 Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Provided that in the context of Small and Medium-sized Companies and Small and Medium-sized Enterprises (SMEs) (Levels II and III non- corporate entities), the definition of the term 'value in use' would read as follows:

"Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life, or a reasonable estimate thereof."

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[2] A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

Explanation:

The definition of the term 'value in use' in the proviso implies that instead of using the present value technique, a reasonable estimate of the 'value in use' can be made. Consequently, if an SMC/SME chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC/SME.

4.3 Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal

4.4 Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

4.5 An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

4.6 Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

4.7 Depreciation (Amortisation) is a systematic allocation of the depreciable amount of an asset over its useful life. [3]

4.8 Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

4.9 Useful life is either:

- ***(a) the period of time over which an asset is expected to be used by the enterprise; or***
- ***(b) the number of production or similar units expected to be obtained from the asset by the enterprise.***

4.10 A cash generating unit is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

4.11 Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units.

4.12 An active market is a market where all the following conditions exist:

- ***(a) the items traded within the market are homogeneous;***
- ***(b) willing buyers and sellers can normally be found at any time; and***
- ***(c) prices are available to the public.***

Identifying an Asset that may be Impaired

5. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. Paragraphs 6 to 13 specify when recoverable amount should be determined. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

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[3] In the case of an intangible asset or goodwill, the term 'amortisation' is generally used instead of 'depreciation'. Both terms have the same meaning.

6. An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset.

7. Paragraphs 8 to 10 describe some indications that an impairment loss may have occurred: if any of those indications is present, an enterprise is required to make a formal estimate of recoverable amount. If no indication of a potential impairment loss is present, this Standard does not require an enterprise to make a formal estimate of recoverable amount.

8. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

- ***(a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;***
- ***(b) significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated;***
- ***(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;***
- ***(d) the carrying amount of the net assets of the reporting enterprise is more than its market capitalisation;***

Internal sources of information

- ***(e) evidence is available of obsolescence or physical damage of an asset;***
- ***(f) significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and***
- ***(g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.***

9. The list of paragraph 8 is not exhaustive. An enterprise may identify other indications that an asset may be impaired and these would also require the enterprise to determine the asset's recoverable amount.

10. Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:

- (a) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;
- (b) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;
- (c) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

(d) operating losses or net cash outflows for the asset, when current period figures are aggregated with budgeted figures for the future.

11. The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated. For example, if previous calculations show that an asset's recoverable amount is significantly greater than its carrying amount, the enterprise need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one (or more) of the indications listed in paragraph 8.

12. As an illustration of paragraph 11, if market interest rates or other market rates of return on investments have increased during the period, an enterprise is not required to make a formal estimate of an asset's recoverable amount in the following cases:

(a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life; or

(b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:

(i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase. For example, in some cases, an enterprise may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates; or

(ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.

13. If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard applicable to the asset, such as Accounting Standard (AS) 6, Depreciation Accounting[4], even if no impairment loss is recognised for the asset.

Measurement of Recoverable Amount

14. This Standard defines recoverable amount as the higher of an asset's net selling price and value in use. Paragraphs 15 to 55 set out the requirements for measuring recoverable amount. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

15. It is not always necessary to determine both an asset's net selling price and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

16. It may be possible to determine net selling price, even if an asset is not traded in an active market. However, sometimes it will not be possible to determine net selling price because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the recoverable amount of the asset may be taken to be its value in use.

17. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for

[4] Amortisation (depreciation) of intangible assets is dealt with in AS 26, Intangible As- sets.

an asset that is held for disposal. This is because the value in use of an asset held for disposal will consist mainly of the net disposal proceeds, since the future cash flows from continuing use of the asset until its disposal are likely to be negligible.

18. Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 63 to 86), unless either:

(a) the asset's net selling price is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

19. In some cases, estimates, averages and simplified computations may provide a reasonable approximation of the detailed computations illustrated in this Standard for determining net selling price or value in use.

Net Selling Price

20. The best evidence of an asset's net selling price is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

21. If there is no binding sale agreement but an asset is traded in an active market, net selling price is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate net selling price, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the estimate is made.

22. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets within the same industry. Net selling price does not reflect a forced sale, unless management is compelled to sell immediately.

23. Costs of disposal, other than those that have already been recognised as liabilities, are deducted in determining net selling price. Examples of such costs are legal costs, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

24. Sometimes, the disposal of an asset would require the buyer to take over a liability and only a single net selling price is available for both the asset and the liability. Paragraph 76 explains how to deal with such cases.

Value in Use

25. Estimating the value in use of an asset involves the following steps:

(a) estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

(b) applying the appropriate discount rate to these future cash flows.

Basis for Estimates of Future Cash Flows

26. In measuring value in use:

(a) cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence;

(b) cash flow projections should be based on the most recent financial budgets/forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified; and

(c) cash flow projections beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

27. Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

28. Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/ forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

29. Where conditions are very favourable, competitors are likely to enter the market and restrict growth. Therefore, enterprises will have difficulty in exceeding the average historical growth rate over the long term (say, twenty years) for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used.

30. In using information from financial budgets/forecasts, an enterprise considers whether the information reflects reasonable and supportable assumptions and represents management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset.

Composition of Estimates of Future Cash Flows

31. Estimates of future cash flows should include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

32. Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases due to general inflation. Therefore, if the discount rate includes the effect of price increases due to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases due to general inflation, future cash flows are estimated in real terms but include future specific price increases or decreases.

33. Projections of cash outflows include future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset.

34. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, the estimate of future cash outflows includes an estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale. For example, this is the case for a building under construction or for a development project that is not yet completed.

35. To avoid double counting, estimates of future cash flows do not include:

(a) cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables); and

(b) cash outflows that relate to obligations that have already been recognised as liabilities (for example, payables, pensions or provisions).

36. Future cash flows should be estimated for the asset in its current condition. Estimates of future cash flows should not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an enterprise is not yet committed; or

(b) future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance.

37. Because future cash flows are estimated for the asset in its current condition, value in use does not reflect:

(a) future cash outflows or related cost savings (for example, reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an enterprise is not yet committed; or

(b) future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance or the related future benefits from this future expenditure.

38. A restructuring is a programme that is planned and controlled by management and that materially changes either the scope of the business undertaken by an enterprise or the manner in which the business is conducted[5].

39. When an enterprise becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the enterprise is committed to the restructuring, in determining value in use, estimates of future cash inflows and cash outflows reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts that have been approved by management).

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[5] See AS 29, *Provisions, Contingent liabilities and Contingent Assets,* for further explanations on 'restructuring'.

Illustration 5 given in the Illustrations attached to the Standard illustrates the effect of a future restructuring on a value in use calculation.

40. Until an enterprise incurs capital expenditure that improves or enhances an asset in excess of its originally assessed standard of performance, estimates of future cash flows do not include the estimated future cash inflows that are expected to arise from this expenditure (see Illustration 6 given in the Illustrations attached to the Standard).

41. Estimates of future cash flows include future capital expenditure necessary to maintain or sustain an asset at its originally assessed standard of performance.

42. Estimates of future cash flows should not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

43. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored. Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities. Similarly, since the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis.

44. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life should be the amount that an enterprise expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

45. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's net selling price, except that, in estimating those net cash flows:

(a) an enterprise uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and that have operated under conditions similar to those in which the asset will be used; and

(b) those prices are adjusted for the effect of both future price increases due to general inflation and specific future price increases (decreases). However, if estimates of future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, this effect is also excluded from the estimate of net cash flows on disposal.

Foreign Currency Future Cash Flows

46. Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An enterprise translates the present value obtained using the exchange rate at the balance sheet date (described in Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates, as the closing rate).

Discount Rate

47. The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

48. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset. This rate is estimated from the rate implicit in current market transactions for

similar assets or from the weighted average cost of capital of a listed enterprise that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review.

49. When an asset-specific rate is not directly available from the market, an enterprise uses other bases to estimate the discount rate. The purpose is to estimate, as far as possible, a market assessment of:

(a) the time value of money for the periods until the end of the asset's useful life; and

(b) the risks that the future cash flows will differ in amount or timing from estimates.

50. As a starting point, the enterprise may take into account the following rates:

(a) the enterprise's weighted average cost of capital determined usingtechniques such as the Capital Asset Pricing Model;

(b) the enterprise's incremental borrowing rate; and

(c) other market borrowing rates.

51. These rates are adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the projected cash flows; and

(b) to exclude risks that are not relevant to the projected cash flows. Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk.

52. To avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted.

53. The discount rate is independent of the enterprise's capital structure and the way the enterprise financed the purchase of the asset because the future cash flows expected to arise from an asset do not depend on the way in which the enterprise financed the purchase of the asset.

54. When the basis for the rate is post-tax, that basis is adjusted to reflect a pre-tax rate.

55. An enterprise normally uses a single discount rate for the estimate of an asset's value in use. However, an enterprise uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

Recognition and Measurement of an Impairment

Loss

56. Paragraphs 57 to 62 set out the requirements for recognising and measuring impairment losses for an individual asset. Recognition and measurement of impairment losses for a cash-generating unit are dealt with in paragraphs 87 to 92.

57. If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss.

58. An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.

59. An impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any

revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

60. When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard.

61. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

62. If an impairment loss is recognised, any related deferred tax assets or liabilities are determined under Accounting Standard (AS) 22, Accounting for Taxes on Income (see Illustration 3 given in the Illustrations attached to the Standard).

Cash-Generating Units

63. Paragraphs 64 to 92 set out the requirements for identifying the cash- generating unit to which an asset belongs and determining the carrying amount of, and recognising impairment losses for, cash-generating units.

Identification of the Cash-Generating Unit to Which an

Asset Belongs

64. If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

65. The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its net selling price (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows from continuing use that are largely independent of those from other assets. In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

Example

A mining enterprise owns a private railway to support its mining activities. The private railway could be sold only for scrap value and the private railway does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine.

It is not possible to estimate the recoverable amount of the private railway because the value in use of the private railway cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the private railway belongs, that is, the mine as a whole.

66. As defined in paragraph 4, an asset's cash-generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use.

Example

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Because the enterprise does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

67. Cash inflows from continuing use are inflows of cash and cash equivalents received from parties outside the reporting enterprise. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an enterprise considers various factors including how management monitors the enterprise's operations (such as by product lines, businesses, individual locations, districts or regional areas or in some other way) or how management makes decisions about continuing or disposing of the enterprise's assets and operations. Illustration 1 in the Illustrations attached to the Standard illustrates identification of a cash-generating unit.

68. If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally. If this is the case, management's best estimate of future market prices for the output should be used:

(a) in determining the value in use of this cash-generating unit, when estimating the future cash inflows that relate to the internal use of the output; and

(b) in determining the value in use of other cash-generating units of the reporting enterprise, when estimating the future cash outflows that relate to the internal use of the output.

69. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise (for example, products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output.

70. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

71. If an enterprise determines that an asset belongs to a different cash- generating unit than in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, paragraph 121 requires certain disclosures about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit and is material to the financial statements of the reporting enterprise as a whole.

Recoverable Amount and Carrying Amount of a Cash- Generating Unit

72. The recoverable amount of a cash-generating unit is the higher of the cash-generating unit's net selling price and value in use. For the purpose of determining the recoverable amount of a cash-

generating unit, any reference in paragraphs 15 to 55 to ‘an asset’ is read as a reference to ‘a cash-generating unit’.

73. The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined.

74. The carrying amount of a cash-generating unit:

(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and that will generate the future cash inflows estimated in determining the cash-generating unit’s value in use; and

(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because net selling price and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have already been recognised in the financial statements, as set out in paragraphs 23 and 35.

75. Where assets are grouped for recoverability assessments, it is important to include in the cash-generating unit all assets that generate the relevant stream of cash inflows from continuing use. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred. In some cases, although certain assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets. Paragraphs 78 to 86 explain how to deal with these assets in testing a cash-generating unit for impairment

76. It may be necessary to consider certain recognised liabilities in order to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit’s value in use and its carrying amount.

Example

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine’s useful life. The carrying amount of the provision for restoration costs is ₹ 50,00,000, which is equal to the present value of the restoration costs.

The enterprise is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The enterprise has received various offers to buy the mine at a price of around ₹ 80,00,000; this price encompasses the fact that the buyer will take over the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,20,00,000 excluding restoration costs. The carrying amount of the mine is ₹ 1,00,00,000.

The net selling price for the cash-generating unit is ₹ 80,00,000. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 70,00,000 (₹ 1,20,00,000 less ₹ 50,00,000). The carrying amount of the cash-generating unit is ₹ 50,00,000, which is the carrying amount of the mine (₹ 1,00,00,000) less the carrying amount of the provision for restoration costs (₹ 50,00,000).

77. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have already been recognised in the financial statements (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

Goodwill

78. In testing a cash-generating unit for impairment, an enterprise should identify whether goodwill that relates to this cash-generating unit is recognised in the financial statements. If this is the case, an enterprise should:

(a) perform a 'bottom-up' test, that is, the enterprise should:

(i) identify whether the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash- generating unit under review; and

(ii) then, compare the recoverable amount of the cash- generating unit under review to its carrying amount (including the carrying amount of allocated goodwill, if any) and recognise any impairment loss in accordance with paragraph 87.

The enterprise should perform the step at (ii) above even if none of the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

(b) if, in performing the 'bottom-up' test, the enterprise could not allocate the carrying amount of goodwill on a reasonable and consistent basis to the cash-generating unit under review, the enterprise should also perform a 'top-down' test, that is, the enterprise should:

(i) identify the smallest cash-generating unit that includes the cash-generating unit under review and to which the carrying amount of goodwill can be allocated on a the reasonable and consistent basis (the 'larger' cash- generating unit); and

(ii) then, compare the recoverable amount of the larger cash- generating unit to its carrying amount (including the carrying amount of allocated goodwill) and recognise any impairment loss in accordance with paragraph 87.

79. Goodwill arising on acquisition represents a payment made by an acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that individually do not qualify for recognition in the financial statements. Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognised in accordance with paragraph 87.

80. Whenever a cash-generating unit is tested for impairment, an enterprise considers any goodwill that is associated with the future cash flows to be generated by the cash-generating unit. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test (see Illustration 7 given in the Illustrations attached to the Standard).

81. The 'bottom-up' test ensures that an enterprise recognises any impairment loss that exists for a cash-generating unit, including for goodwill that can be allocated on a reasonable and consistent basis. Whenever it is impracticable to allocate goodwill on a reasonable and consistent basis in the 'bottom-up' test, the combination of the 'bottom-up' and the 'top-down' test ensures that an enterprise recognises:

(a) first, any impairment loss that exists for the cash-generating unit excluding any consideration of goodwill; and

(b) then, any impairment loss that exists for goodwill. Because an enterprise applies the 'bottom-up' test first to all assets that may be impaired, any impairment loss identified for the larger cash- generating unit in the 'top-down' test relates only to goodwill allocated to the larger unit.

82. If the 'top-down' test is applied, an enterprise formally determines the recoverable amount of the larger cash-generating unit, unless there is persuasive evidence that there is no risk that the larger cash-generating unit is impaired.

Corporate Assets

83. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the enterprise, EDP equipment or a research centre. The structure of an enterprise determines whether an asset meets the definition of corporate assets (see paragraph 4) for a particular cash- generating unit. Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

84. Because corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset. As a consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit to which the corporate asset belongs, compared to the carrying amount of this cash-generating unit and any impairment loss is recognised in accordance with paragraph 87.

85. In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset, an enterprise should then apply paragraph 78, that is:

(a) if the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

(b) if the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom- up' and 'top-down' tests.

86. An Illustrations of how to deal with corporate assets is given as Illustration 8 in the Illustrations attached to the Standard.

Impairment Loss for a Cash-Generating Unit

87. An impairment loss should be recognised for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

- ***(a) first, to goodwill allocated to the cash-generating unit (if any); and***
- ***(b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.***

These reductions in carrying amounts should be treated as impairment losses on individual assets and recognised in accordance with paragraph 58.

88. In allocating an impairment loss under paragraph 87, the carrying amount of an asset should not be reduced below the highest of:

- ***(a) its net selling price (if determinable);***
- ***(b) its value in use (if determinable); and***
- ***(c) zero.***

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

89. The goodwill allocated to a cash-generating unit is reduced before reducing the carrying amount of the other assets of the unit because of its nature.

90. If there is no practical way to estimate the recoverable amount of each individual asset of a cash-generating unit, this Standard requires the allocation of the impairment loss between the assets of that unit other than goodwill on a pro-rata basis, because all assets of a cash-generating unit work together.

91. If the recoverable amount of an individual asset cannot be determined (see paragraph 65):

- (a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its net selling price and the results of the allocation procedures described in paragraphs 87 and 88; and
- (b) no impairment loss is recognised for the asset if the related cash- generating unit is not impaired. This applies even if the asset's net selling price is less than its carrying amount.

Example

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount. The machine does not generate independent cash inflows from continuing use. The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: Budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated since the machine's value in use:

- *(a) may differ from its net selling price; and*
- *(b) can be determined only for the cash-generating unit to which the machine belongs (the production line).*

The production line is not impaired, therefore, no impairment loss is recognised for the machine. Nevertheless, the enterprise may need to reassess the depreciation period or the depreciation method for the machine. Perhaps, a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are consumed by the enterprise.

Assumption 2: Budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its net selling price. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (the production line). Since the machine's net selling price is less than its carrying amount, an impairment loss is recognised for the machine.

92. After the requirements in paragraphs 87 and 88 have been applied, a liability should be recognised for any remaining amount of an impairment loss for a cash-generating unit if that is required by another Accounting Standard.

Reversal of an Impairment Loss

93. Paragraphs 94 to 100 set out the requirements for reversing an impairment loss recognised for an asset or a cash-generating unit in prior accounting periods. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. Additional requirements are set out for an individual asset in paragraphs 101 to 105, for a cash-generating unit in paragraphs 106 to 107 and for goodwill in paragraphs 108 to 111.

94. An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

95. In assessing whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased, an enterprise should consider, as a minimum, the following indications:

External sources of information

- ***(a) the asset's market value has increased significantly during the period;***
- ***(b) significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which the asset is dedicated;***
- ***(c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially;***

Internal sources of information

- ***(d) significant changes with a favourable effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance***

an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs; and

(e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

96. Indications of a potential decrease in an impairment loss in paragraph 95 mainly mirror the indications of a potential impairment loss in paragraph 8. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

97. If there is an indication that an impairment loss recognised for an asset may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

98. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

99. A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or sale, since the date when an enterprise last recognised an impairment loss for that asset. An enterprise is required to identify the change in estimates that causes the increase in estimated service potential. Examples of changes in estimates include:

(a) a change in the basis for recoverable amount (i.e., whether recoverable amount is based on net selling price or value in use);

(b) if recoverable amount was based on value in use: a change in the amount or timing of estimated future cash flows or in the discount rate; or

(c) if recoverable amount was based on net selling price: a change in estimate of the components of net selling price.

100. An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

Reversal of an Impairment Loss for an Individual Asset

101. The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

102. Any increase in the carrying amount of an asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods is a revaluation. In accounting for such a revaluation, an enterprise applies the Accounting Standard applicable to the asset.

103. A reversal of an impairment loss for an asset should be recognised as income immediately in the statement of profit and loss, unless the asset is carried at revalued amount in accordance

with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets) in which case any reversal of an impairment loss on a revalued asset should be treated as a revaluation increase under that Accounting Standard.

104. A reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation surplus. However, to the extent that an impairment loss on the same revalued asset was previously recognised as an expense in the statement of profit and loss, a reversal of that impairment loss is recognised as income in the statement of profit and loss.

105. After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Reversal of an Impairment Loss for a Cash-Generating Unit

106. A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

- ***(a) first, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and***
- ***(b) then, to goodwill allocated to the cash-generating unit (if any), if the requirements in paragraph 108 are met.***

These increases in carrying amounts should be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 103.

107. In allocating a reversal of an impairment loss for a cash-generating unit under paragraph 106, the carrying amount of an asset should not be increased above the lower of:

- ***(a) its recoverable amount (if determinable); and***
- ***(b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.***

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

Reversal of an Impairment Loss for Goodwill

108. As an exception to the requirement in paragraph 98, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

- ***(a) the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and***
- ***(b) subsequent external events have occurred that reverse the effect of that event.***

109. Accounting Standard (AS) 26, Intangible Assets, prohibits the recognition of internally generated goodwill. Any subsequent increase in the recoverable amount of goodwill is likely to be an increase in internally generated goodwill, unless the increase relates clearly to the reversal of the effect of a specific external event of an exceptional nature.

110. This Standard does not permit an impairment loss to be reversed for goodwill because of a change in estimates (for example, a change in the discount rate or in the amount and timing of future cash flows of the cash- generating unit to which goodwill relates).

111. A specific external event is an event that is outside of the control of the enterprise. Examples of external events of an exceptional nature include new regulations that significantly curtail the operating activities, or decrease the profitability, of the business to which the goodwill relates.

Impairment in case of Discontinuing Operations

112. The approval and announcement of a plan for discontinuance[6] is an indication that the assets attributable to the discontinuing operation may be impaired or that an impairment loss previously recognised for those assets should be increased or reversed. Therefore, in accordance with this Standard an enterprise estimates the recoverable amount of each asset of the discontinuing operation and recognises an impairment loss or reversal of a prior impairment loss, if any.

113. In applying this Standard to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

(a) if the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Standard;

(b) if the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

(c) if the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Standard.

114. After announcement of a plan, negotiations with potential purchasers of the discontinuing operation or actual binding sale agreements may indicate that the assets of the discontinuing operation may be further impaired or that impairment losses recognised for these assets in prior periods may have decreased. As a consequence, when such events occur, an enterprise re- estimates the recoverable amount of the assets of the discontinuing operation and recognises resulting impairment losses or reversals of impairment losses in accordance with this Standard.

115. A price in a binding sale agreement is the best evidence of an asset's (cash-generating unit's) net selling price or of the estimated cash inflow from ultimate disposal in determining the asset's (cash-generating unit's) value in use.

116. The carrying amount (recoverable amount) of a discontinuing operation includes the carrying amount (recoverable amount) of any goodwill that can be allocated on a reasonable and consistent basis to that discontinuing operation.

Disclosure

117. For each class of assets, the financial statements should disclose:

(a) the amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

[6] See Accounting Standard (AS) 24 'Discontinuing Operations'

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

(c) the amount of impairment losses recognised directly against revaluation surplus during the period; and

(d) the amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

118. A class of assets is a grouping of assets of similar nature and use in an enterprise's operations.

119. The information required in paragraph 117 may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of fixed assets, at the beginning and end of the period, as required under AS 10, Accounting for Fixed Assets.

120. An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

(a) the amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

121. If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

(a) the events and circumstances that led to the recognition or reversal of the impairment loss;

(b) the amount of the impairment loss recognised or reversed;

(c) for an individual asset:

(i) the nature of the asset; and

(ii) the reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

(d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

(ii) the amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash- generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash- generating unit is identified;

(e) whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

(f) if recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use. Provided that if a Small and Medium-sized Company (SMC) or a Small and Medium-sized Enterprise (SME) (Level II or Level III non-corporate entity), chooses to measure the 'value in use' as per the proviso to paragraph 4.2 of the Standard, such an SMC/ SME need not disclose the information required by paragraph 121(g) of the Standard.

122. If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

(a) the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed under paragraph 121; and

(b) the main events and circumstances that led to the recognition (reversal) of these impairment losses for which no information is disclosed under paragraph 121.

123. An enterprise is encouraged to disclose key assumptions used to determine the recoverable amount of assets (cash-generating units) during the period.

Transitional Provisions

124. On the date of this Standard becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Standard. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Standard becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves.

125. Any impairment loss arising after the date of this Standard becoming mandatory should be recognised in accordance with this Standard (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

Illustrations

These illustrations do not form part of the Accounting Standard. The purpose of these Illustration is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

All these illustrations assume the enterprises concerned have no transactions other than those described.

Illustration 1 - Identification of Cash-Generating Units

The purpose of this Illustration is:

(a) to give an indication of how cash-generating units are identified in various situations; and

(b) *to highlight certain factors that an enterprise may consider in identifying the cash-generating unit to which an asset belongs.*

A - Retail Store Chain

Background

Al. Store X belongs to a retail store chain M. X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and salesmen) are decided by M. M also owns 5 other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X. X and 4 other stores were purchased 4 years ago and goodwill was recognised.

What is the cash-generating unit for X (X's cash-generating unit)?

Analysis

A2. In identifying X's cash-generating unit, an enterprise considers whether, for example:

(a) internal management reporting is organised to measure performance on a store-by-store basis; and

(b) the business is run on a store-by-store profit basis or on region/city basis.

A3. All M's stores are in different neighbourhoods and probably have different customer bases. So, although X is managed at a corporate level, X generates cash inflows that are largely independent from those of M's other stores. Therefore, it is likely that X is a cash-generating unit.

A4. If the carrying amount of the goodwill can be allocated on a reasonable and consistent basis to X's cash-generating unit, M applies the 'bottom-up' test described in paragraph 78 of this Standard. If the carrying amount of the goodwill cannot be allocated on a reasonable and consistent basis to X's cash-generating unit, M applies the 'bottom-up' and 'top-down' tests.

B - Plant for an Intermediate Step in a Production Process

Background

A5. A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same enterprise. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the reporting enterprise.

60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the reporting enterprise.

For each of the following cases, what are the cash-generating units for X and Y?

Case 1: X could sell the products it sells to Y in an active market. Internal transfer prices are higher than market prices.

Case 2: There is no active market for the products X sells to Y.

Analysis

Case 1

A6. X could sell its products on an active market and, so, generate cash inflows from continuing use that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y (see paragraph 68 of this Standard).

A7. It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the reporting enterprise. Therefore, its cash inflows from continuing use can be considered to be largely independent.

A8. Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the enterprise adjusts financial budgets/forecasts to reflect management's best estimate of future market prices for those of X's products that are used internally (see paragraph 68 of this Standard).

Case 2

A9. It is likely that the recoverable amount of each plant cannot be assessed independently from the recoverable amount of the other plant because:

(a) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent from those of Y; and

(b) the two plants are managed together.

A10. As a consequence, it is likely that X and Y together is the smallest group of assets that generates cash inflows from continuing use that are largely independent.

C - Single Product Enterprise

Background

A11. Enterprise M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold world-wide from either B or C. For example, B's production can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels of B and C depend on the allocation of sales between the two sites.

For each of the following cases, what are the cash-generating units for A, B and C?

Case 1: There is an active market for A's products.

Case 2: There is no active market for A's products.

Analysis

Case 1

A12. It is likely that A is a separate cash-generating unit because there is an active market for its products (see Example B-Plant for an Intermediate Step in a Production Process, Case 1).

A13. Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

A14. In determining the value in use of A and B plus C, M adjusts financial budgets/forecasts to reflect its best estimate of future market prices for A's products (see paragraph 68 of this Standard).

Case 2

A15. It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) there is no active market for A's products. Therefore, A's cash inflows depend on sales of the final product by B and C; and

(b) although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually.

A16. As a consequence, it is likely that A, B and C together (i.e., M as a whole) is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

D - Magazine Titles

Background

A17. A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating unit for an individual magazine title?

Analysis

A18. It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

A19. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash-generating unit.

E - Building: Half-Rented to Others and Half-Occupied for Own Use

Background

A20. M is a manufacturing company. It owns a headquarter building that used to be fully occupied for internal use. After down-sizing, half of the building is now used internally and half rented to third parties. The lease agreement with the tenant is for five years.

What is the cash-generating unit of the building?

Analysis

A21. The primary purpose of the building is to serve as a corporate asset, supporting M's manufacturing activities. Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the enterprise as a whole. So, it is likely that the cash-generating unit for the building is M as a whole.

A22. The building is not held as an investment. Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents.

Illustration 2 - Calculation of Value in Use and Recognition of an Impairment Loss

In this illustration, tax effects are ignored.

Background and Calculation of Value in Use

A23. At the end of 20X0, enterprise T acquires enterprise M for ₹ 10,000 lakhs. M has manufacturing plants in 3 countries. The anticipated useful life of the resulting merged activities is 15 years.

Schedule 1. Data at the end of 20X0 (Amount in ₹ lakhs)

End of 20X0	*Allocation of purchase price*	*Fair value of identifiable assets*	*Goodwill*[1]
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	5,000	3,500	1,500
Total	10,000	7,000	3,000

A24. T uses straight-line depreciation over a 15-year life for the Country A assets and no residual value is anticipated. In respect of goodwill, T uses straight-line amortisation over a 5 year life.

A25. In 20X4, a new government is elected in Country A. It passes legislation significantly restricting exports of T's main product. As a result, and for the foreseeable future, T's production will be cut by 40%.

A26. The significant export restriction and the resulting production decrease require T to estimate the recoverable amount of the goodwill and net assets of the Country A operations. The cash-generating unit for the goodwill and the identifiable assets of the Country A operations is the Country A operations, since no independent cash inflows can be identified for individual assets.

A27. The net selling price of the Country A cash-generating unit is not determinable, as it is unlikely that a ready buyer exists for all the assets of that unit.

A28. To determine the value in use for the Country A cash-generating unit (see Schedule 2), T:

(a) prepares cash flow forecasts derived from the most recent financial budgets/forecasts for the next five years (years 20X5-20X9) approved by management;

(b) estimates subsequent cash flows (years 20X10-20X15) based on declining growth rates. The growth rate for 20X10 is estimated to be 3%. This rate is lower than the average long-term growth rate for the market in Country A; and

(c) selects a 15% discount rate, which represents a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the Country A cash-generating unit.

Recognition and Measurement of Impairment Loss

A29. The recoverable amount of the Country A cash-generating unit is 1,360 lakhs: the higher of the net selling price of the Country A cash- generating unit (not determinable) and its value in use (₹ 1,360 lakhs).

A30. T compares the recoverable amount of the Country A cash-generating unit to its carrying amount (see Schedule 3).

A31. T recognises an impairment loss of ₹ 307 lakhs immediately in the statement of profit and loss. The carrying amount of the goodwill that relates to the Country A operations is eliminated before reducing the carrying amount of other identifiable assets within the Country A cash-generating unit (see paragraph 87 of this Standard).

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(1) Activities in each country are the smallest cash-generating units to which goodwill can be allocated on a reasonable and consistent basis (allocation based on the purchase price of the activities in each country, as specified in the purchase agreement).

A32. Tax effects are accounted for separately in accordance with AS 22, Accounting for Taxes on Income.

Schedule 2. Calculation of the value in use of the Country A cash-generating unit at the end of 20X4 (Amount in ₹ lakhs)

Year	*Long-term growth rates*	*Future cash flows*	*Present value factor at 15% discount rate*[3]	*Discounted future cash flows*
20X5 (n=1)		230[(1)]	0.86957	200
20X6		253[(1)]	0.75614	191
20X7		273[(1)]	0.65752	180
20X8		290[(1)]	0.57175	166
20X9		304[(1)]	0.49718	151
20X10	3%	313[(2)]	0.43233	135
20X11	–2%	307[(2)]	0.37594	115
20X12	–6%	289[(2)]	0.32690	94
20X13	–15%	245[(2)]	0.28426	70
20X14	–25%	184[(2)]	0.24719	45
20X15	–67%	61[(2)]	0.21494	13
Value in use				1,360

Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the end of 20X4 (Amount in ₹ lakhs)

End of 20X4	*Goodwill*	*Identifiable assets*	*Total*
Historical cost	1,000	2,000	3,000
Accumulated depreciation / amortisation (20X1-20X4)	(800)	(533)	(1,333)
Carrying amount	200	1,467	1,667
Impairment Loss	(200)	(107)	(307)
Carrying amount after impairment loss	0	1,360	1,360

Illustration 3 - Deferred Tax Effects

A33. An enterprise has an asset with a carrying amount of ₹ 1,000 lakhs. Its recoverable amount is ₹ 650 lakhs. The tax rate is 30% and the carrying amount of the asset for tax purposes is ₹ 800 lakhs. Impairment losses are not allowable as deduction for tax purposes. The effect of the impairment loss is as follows:

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[3] The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

(1) Based on management's best estimate of net cash flow projections (after the 40% cut).

(2) Based on an extrapolation from preceding year cash flow using declining growth rates.

	Amount in ₹ lakhs
Impairment Loss recognised in the statement of profit and loss	350
Impairment Loss allowed for tax purposes	----
— Timing Difference	350
Tax Effect of the above timing difference at 30%	
(deferred tax asset)	105
Less: Deferred tax liability due to difference in depreciation for accounting	
purposes and tax purposes [(1,000 – 800) x 30%]	60
Deferred tax asset	45

A34. In accordance with AS 22, Accounting for Taxes on Income, the enterprise recognises the deferred tax asset subject to the consideration of prudence as set out in AS 22.

Illustration 4 - Reversal of an Impairment Loss

Use the data for enterprise T as presented in Illustration 2, with supplementary information as provided in this illustration. In this illustration tax effects are ignored.

Background

A35. In 20X6, the government is still in office in Country A, but the business situation is improving. The effects of the export laws on T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase by 30%. This favourable change requires T to re-estimate the recoverable amount of the net assets of the Country A operations (see paragraphs 94-95 of this Standard). The cash-generating unit for the net assets of the Country A operations is still the Country A operations.

A36. Calculations similar to those in Illustration 2 show that the recoverable amount of the Country A cash-generating unit is now ₹ 1,710 lakhs.

Reversal of Impairment Loss

A37. T compares the recoverable amount and the net carrying amount of the Country A cash-generating unit.

Schedule 1. Calculation of the carrying amount of the Country A cash- generating unit at the end of 20X6 (Amount in ₹ lakhs)

End of 20X4 (Example 2)

	Goodwill	*Identifiable assets*	*Total*
Historical cost	*1,000*	*2,000*	*3,000*
Accumulated depreciation/amortisation (4 years)	*(800)*	*(533)*	*(1,333)*
Impairment loss	*(200)*	*(107)*	*(307)*
Carrying amount after impairment loss	*0*	*1,360*	*1,360*

End of 20X6

Additional depreciation (2 years)[1]	*–*	*(247)*	*(247)*
Carrying amount	*0*	*1,113*	*1,113*
Recoverable amount			*1,710*
Excess of recoverable amount over carrying amount			*597*

A38. There has been a favourable change in the estimates used to determine the recoverable amount of the Country A net assets since the last impairment loss was recognised. Therefore, in accordance with paragraph 98 of this Standard, T recognises a reversal of the impairment loss recognised in 20X4.

A39. In accordance with paragraphs 106 and 107 of this Standard, T increases the carrying amount of the Country A identifiable assets by ₹ 87 lakhs (see Schedule 3), i.e., up to the lower of recoverable amount (₹ 1,710 lakhs) and the identifiable assets' depreciated historical cost (₹ 1,200 lakhs) (see Schedule 2). This increase is recognised in the statement of profit and loss immediately.

Schedule 2. Determination of the depreciated historical cost of the Country

A identifiable assets at the end of 20X6 (Amount in ₹ lakhs)

End of 20X6	*Identifiable assets*
Historical cost	2,000
Accumulated depreciation (133.3 * 6 years)	(800)
Depreciated historical cost	1,200
Carrying amount (Schedule 1)	1,113
Difference	87

Schedule 3. Carrying amount of the Country A assets at the end of 20X6 (Amount in ₹ lakhs)

End of 20X6	*Goodwill*	*Identifiable assets*	*Total*
Gross carrying amount	1,000	2,000	3,000
Accumulated depreciation/amortisation	(800)	(780)	(1,580)
Accumulated impairment loss	(200)	(107)	(307)
Carrying amount	0	1,113	1,113
Reversal of impairment loss	0	87	87
Carrying amount after reversal of impairment loss	0	1,200	1,200

Illustration 5 - Treatment of a Future Restructuring

In this illustration, tax effects are ignored.

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(1) After recognition of the impairment loss at the end of 20X4, T revised the depreciation charge for the Country A identifiable assets (from ₹ 133.3 lakhs per year to ₹ 123.7 lakhs per year), based on the revised carrying amount and remaining useful life (11 years).

Background

A40. At the end of 20X0, enterprise K tests a plant for impairment. The plant is a cash-generating unit. The plant's assets are carried at depreciated historical cost. The plant has a carrying amount of ₹ 3,000 lakhs and a remaining useful life of 10 years.

A41. The plant is so specialised that it is not possible to determine its net selling price. Therefore, the plant's recoverable amount is its value in use. Value in use is calculated using a pre-tax discount rate of 14%.

A42. Management approved budgets reflect that:

(a) at the end of 20X3, the plant will be restructured at an estimated cost of ₹ 100 lakhs. Since K is not yet committed to the restructuring, a provision has not been recognised for the future restructuring costs; and

(b) there will be future benefits from this restructuring in the form of reduced future cash outflows.

A43. At the end of 20X2, K becomes committed to the restructuring. The costs are still estimated to be ₹ 100 lakhs and a provision is recognised accordingly. The plant's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph A47 and a current discount rate is the same as at the end of 20X0.

A44. At the end of 20X3, restructuring costs of ₹ 100 lakhs are paid. Again, the plant's estimated future cash flows reflected in the most recent management approved budgets and a current discount rate are the same as those estimated at the end of 20X2.

At the End of 20X0

Schedule 1. Calculation of the plant's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X1	300	263
20X2	280	215
20X3	420(1)	283
20X4	520(2)	308
20X5	350(2)	182
20X6	420(2)	191
20X7	480(2)	192
20X8	480(2)	168
20X9	460(2)	141
20X10	400(2)	108
Value in use		2,051

(1) Excludes estimated restructuring costs reflected in management budgets.

(2) Excludes estimated benefits expected from the restructuring reflected in management budgets.

[1] Excludes estimated restructuring costs reflected in management budgets.
[2] Excludes estimated benefits expected from the restructuring reflected in management budgets.

A45.The plant's recoverable amount (value in use) is less than its carrying amount. Therefore, K recognises an impairment loss for the plant.

Schedule 2. Calculation of the impairment loss at the end of 20X0 (Amount in ₹ lakhs)

	Plant
Carrying amount before impairment loss	3,000
Recoverable amount (Schedule 1)	2,051
Impairment loss	(949)
Carrying amount after impairment loss	2,051

At the End of 20X1

A46. No event occurs that requires the plant's recoverable amount to be re- estimated. Therefore, no calculation of the recoverable amount is required to be performed.

At the End of 20X2

A47. The enterprise is now committed to the restructuring. Therefore, in determining the plant's value in use, the benefits expected from the restructuring are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. In accordance with paragraphs 94-95 of this Standard, the recoverable amount of the plant is re-determined at the end of 20X2.

Schedule 3. Calculation of the plant's value in use at the end of 20X2 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X3	*420*[(1)]	*368*
20X4	570[(2)]	439
20X5	380[(2)]	256
20X6	450[(2)]	266
20X7	510[(2)]	265
20X8	510[(2)]	232
20X9	480[(2)]	192
20X10	410[(2)]	144
Value in use		2,162

A48. The plant's recoverable amount (value in use) is higher than its carrying amount (see Schedule 4). Therefore, K reverses the impairment loss recognised for the plant at the end of 20X0.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X2 (Amount in ₹ lakhs)

Plant

[(1)] Excludes estimated restructuring costs because a liability has already been recognised.

[(2)] Includes estimated benefits expected from the restructuring reflected in management budgets.

Carrying amount at the end of 20X0 (Schedule 2)	2,051
End of 20X2	
Depreciation charge (for 20X1 and 20X2 Schedule 5)	(410)
Carrying amount before reversal	1,641
Recoverable amount (Schedule 3)	2,162
Reversal of the impairment loss	521
Carrying amount after reversal	2,162
Carrying amount: depreciated historical cost (Schedule 5)	2,400[(1)]

At the End of 20X3

A49. There is a cash outflow of ₹ 100 lakhs when the restructuring costs are paid. Even though a cash outflow has taken place, there is no change in the estimated future cash flows used to determine value in use at the end of 20X2. Therefore, the plant's recoverable amount is not calculated at the end of 20X3

Schedule 5. Summary of the carrying amount of the plant (Amount in ₹ lakhs)

End of year	*Depreciated historical cost*	*Recoverable amount charge*	*Adjusted depreciation*	*Impairment loss after*	*Carrying amount impairment*
20X0	3,000	2,051	0	(949)	2,051
20X1	2,700	n.c.	(205)	0	1,846
20X2	2,400	2,162	(205)	521	2,162
20X3	2,100	n.c.	(270)	0	1,892

n.c. = not calculated as there is no indication that the impairment loss may have increased/decreased.

Illustration 6 - Treatment of Future Capital Expenditure

In this illustration, tax effects are ignored.

Background

A50. At the end of 20X0, enterprise F tests a plane for impairment. The plane is a cash-generating unit. It is carried at depreciated historical cost and its carrying amount is ₹ 1,500 lakhs. It has an estimated remaining useful life of 10 years.

A51. For the purpose of this illustration, it is assumed that the plane's net selling price is not determinable. Therefore, the plane's recoverable amount is its value in use. Value in use is calculated using a pre-tax discount rate of 14%.

A52. Management approved budgets reflect that:

(a) in 20X4, capital expenditure of ₹ 250 lakhs will be incurred to renew the engine of the plane; and

(b) this capital expenditure will improve the performance of the plane by decreasing fuel consumption.

[(1)] The reversal does not result in the carrying amount of the plant exceeding what its carrying amount would have been at depreciated historical cost. Therefore, the full reversal of the impairment loss is recognised.

A53. At the end of 20X4, renewal costs are incurred. The plane's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph A56 and a current discount rate is the same as at the end of 20X0.

At the End of 20X0

Schedule 1. Calculation of the plane's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X1	221.65	194.43
20X2	214.50	165.05
20X3	205.50	138.71
20X4	247.25(1)	146.39
20X5	253.25(2)	131.53
20X6	248.25(2)	113.10
20X7	241.23(2)	96.40
20X8	255.33(2)	89.51
20X9	242.34(2)	74.52
20X10	228.50(2)	61.64
Value in use		1,211.28

A54. The plane's carrying amount is less than its recoverable amount (value in use). Therefore, F recognises an impairment loss for the plane.

Schedule 2. Calculation of the impairment loss at the end of 20X0 (Amount in ₹ lakhs)

	Plane
Carrying amount before impairment loss	1,500.00
Recoverable amount (Schedule 1)	1,211.28
Impairment loss	(288.72)
Carrying amount after impairment loss	1,211.28

Years 20X1-20X3

A55. No event occurs that requires the plane's recoverable amount to be re-estimated. Therefore, no calculation of recoverable amount is required to be performed.

At the End of 20X4

A56. The capital expenditure is incurred. Therefore, in determining the plane's value in use, the future benefits expected from the renewal of the engine are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. As a consequence, in accordance with paragraphs 94-95 of this Standard, the recoverable amount of the plane is recalculated at the end of 20X4.

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(1) Excludes estimated renewal costs reflected in management budgets.

(2) Excludes estimated benefits expected from the renewal of the engine reflected in management budgets.

Schedule 3. Calculation of the plane's value in use at the end of 20X4 (Amount in ₹ lakhs)

Year	*Future cash flows*[1]	*Discounted at 14%*
20X5	303.21	265.97
20X6	327.50	252.00
20X7	317.21	214.11
20X8	319.50	189.17
20X9	331.00	171.91
20X10	279.99	127.56
Value in use		1,220.72

A57. The plane's recoverable amount (value in use) is higher than the plane's carrying amount and depreciated historical cost (see Schedule 4). Therefore, K reverses the impairment loss recognised for the plane at the end of 20X0 so that the plane is carried at depreciated historical cost.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X4 (Amount in ₹ lakhs)

	Plane
Carrying amount at the end of 20X0 (Schedule 2)	1,211.28
End of 20X4	
Depreciation charge (20X1 to 20X4-Schedule 5)	(484.52)
Renewal expenditure	250.00
Carrying amount before reversal	976.76
Recoverable amount (Schedule 3)	1,220.72
Reversal of the impairment loss	173.24
Carrying amount after reversal	1,150.00
Carrying amount: depreciated historical cost (Schedule 5)	1,150.00[1]

Schedule 5. Summary of the carrying amount of the plane (Amount in ₹ lakhs)

Year	*Depreciated historical cost*	*Recoverable amount*	*Adjusted depreciation charge*	*Impairment loss*	*Carrying amount after impairment*
20X0	1,500.00	1,211.28	0	(288.72)	1,211.28
20X1	1,350.00	n.c.	(121.13)	0	1,090.15
20X2	1,200.00	n.c.	(121.13)	0	969.02
20X3	1,050.00	n.c.	(121.13)	0	847.89

(1) Includes estimated benefits expected from the renewal of the engine reflected in management budgets.

(1) The value in use of the plane exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the plane exceeding depreciated historical cost.

20X4	900.00		(121.13)		
Renewal	250.00		–		
	1,150.00	1,220.72	(121.13)	173.24	1,150.00
20X5	958.33	n.c.	(191.67)	0	958.33

n.c. = not calculated as there is no indication that the impairment loss may have increased/decreased.

Illustration 7 - Application of the 'Bottom-Up' and 'Top-Down' Tests to Goodwill

In this illustration, tax effects are ignored.

A58. At the end of 20X0, enterprise M acquired 100% of enterprise Z for ₹ 3,000 lakhs. Z has 3 cash-generating units A, B and C with net fair values of ₹ 1,200 lakhs, ₹ 800 lakhs and ₹ 400 lakhs respectively. M recognises goodwill of ₹ 600 lakhs (₹ 3,000 lakhs less ₹ 2,400 lakhs) that relates to Z.

A59. At the end of 20X4, A makes significant losses. Its recoverable amount is estimated to be ₹ 1,350 lakhs. Carrying amounts are detailed below.

Schedule 1. Carrying amounts at the end of 20X4 (Amount in ₹ lakhs)

End of 20X4	*A*	*B*	*C*	*Goodwill*	*Total*
Net carrying amount	1,300	1,200	800	120	3,420

A - Goodwill Can be Allocated on a Reasonable and Consistent Basis

A60. At the date of acquisition of Z, the net fair values of A, B and C are considered a reasonable basis for a pro-rata allocation of the goodwill to A, B and C.

Schedule 2. Allocation of goodwill at the end of 20X4

End of 20X0	A	B	C	Total
Net fair values	1,200	800	400	2,400
Pro-rata	50%	33%	17%	100%
End of 20X4				
Net carrying amount	1,300	1,200	800	3,300
Allocation of goodwill				
(using the pro-rata above)	60	40	20	120
Net carrying amount	1,360	1,240	820	3,420
(after allocation of goodwill				

A61. In accordance with the 'bottom-up' test in paragraph 78(a) of this Standard, M compares A's recoverable amount to its carrying amount after the allocation of the carrying amount of goodwill.

Schedule 3. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X4	*A*
Carrying amount after allocation of goodwill (Schedule 2)	1,360
Recoverable amount	1,350
Impairment loss	10

A62. M recognises an impairment loss of ₹ 10 lakhs for A. The impairment loss is fully allocated to the goodwill in accordance with paragraph 87 of this Standard.

B - Goodwill Cannot Be Allocated on a Reasonable and Consistent Basis

A63. There is no reasonable way to allocate the goodwill that arose on the acquisition of Z to A, B and C. At the end of 20X4, Z's recoverable amount is estimated to be ₹ 3,400 lakhs.

A64. At the end of 20X4, M first applies the 'bottom-up' test in accordance with paragraph 78(a) of this Standard. It compares A's recoverable amount to its carrying amount excluding the goodwill.

Schedule 4. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X4	*A*
Carrying amount	1,300
Recoverable amount	1,350
Impairment loss	0

A65. Therefore, no impairment loss is recognised for A as a result of the 'bottom-up' test.

A66. Since the goodwill could not be allocated on a reasonable and consistent basis to A, M also performs a 'top-down' test in accordance with paragraph 78(b) of this Standard. It compares the carrying amount of Z as a whole to its recoverable amount (Z as a whole is the smallest cash-generating unit that includes A and to which goodwill can be allocated on a reasonable and consistent basis).

Schedule 5. Application of the 'top-down' test (Amount in ₹ lakhs)

End of 20X4	*A*	*B*	*C*	*Goodwill*	*Z*
Carrying amount	1,300	1,200	800	120	3,420
Impairment loss arising from the 'bottom-up' test	0	–	–	–	0
Carrying amount after the 'bottom-up' test	1,300	1,200	800	120	3,420
Recoverable amount					3,400
Impairment loss arising from 'top-down' test					20

A67. Therefore, M recognises an impairment loss of ₹ 20 lakhs that it allocates fully to goodwill in accordance with paragraph 87 of this Standard.

Illustration 8 - Allocation of Corporate Assets

In this illustration tax effects are ignored.

Background

A68. Enterprise M has three cash-generating units: A, B and C. There are adverse changes in the technological environment in which M operates. Therefore, M conducts impairment tests of each of its cash-generating units. At the end of 20X0, the carrying amounts of A, B and C are ₹ 100 lakhs, ₹ 150 lakhs and ₹ 200 lakhs respectively.

A69. The operations are conducted from a headquarter. The carrying amount of the headquarter assets is ₹ 200 lakhs: a headquarter building of ₹ 150 lakhs and a research centre of ₹ 50 lakhs. The relative carrying amounts of the cash-generating units are a reasonable indication of the proportion of the head-quarter building devoted to each cash-generating unit. The carrying amount of the research centre cannot be allocated on a reasonable basis to the individual cash-generating units.

A70. The remaining estimated useful life of cash-generating unit A is 10 years. The remaining useful lives of B, C and the headquarter assets are 20 years. The headquarter assets are depreciated on a straight-line basis.

A71. There is no basis on which to calculate a net selling price for each cash-generating unit. Therefore, the recoverable amount of each cash- generating unit is based on its value in use. Value in use is calculated using a pre-tax discount rate of 15%.

Identification of Corporate Assets

A72. In accordance with paragraph 85 of this Standard, M first identifies all the corporate assets that relate to the individual cash-generating units under review. The corporate assets are the headquarter building and the research centre.

A73. M then decides how to deal with each of the corporate assets:

(a) the carrying amount of the headquarter building can be allocated on a reasonable and consistent basis to the cash-generating units under review. Therefore, only a 'bottom-up' test is necessary; and

(b) the carrying amount of the research centre cannot be allocated on a reasonable and consistent basis to the individual cash- generating units under review. Therefore, a 'top-down' test will be applied in addition to the 'bottom-up' test.

Allocation of Corporate Assets

A74. The carrying amount of the headquarter building is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

Schedule 1. Calculation of a weighted allocation of the carrying amount of the headquarter building (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*	*Total*
Carrying amount	100	150	200	450
Useful life	10 years	20 years	20 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	100	300	400	800
Pro-rata allocation of the building	12.5%	37.5%	50%	100%
	(100/800)	(300/800)	(400/800)	
Allocation of the carrying amount of the building (based on pro-rata above)	19	56	75	150
Carrying amount (after allocation of the building)	119	206	275	600

Determination of Recoverable Amount

A75. The 'bottom-up' test requires calculation of the recoverable amount of each individual cash-generating unit. The 'top-down' test requires calculation of the recoverable amount of M as a whole (the smallest cash- generating unit that includes the research centre).

Schedule 2. Calculation of A, B, C and M's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	A		B		C		M	
	Future cash flows	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*
1	2	3	4	5	6	7	8	9
1	18	16	9	8	10	9	39	34
2	31	23	16	12	20	15	72	54
3	37	24	24	16	34	22	105	69
4	42	24	29	17	44	25	128	73
5	47	24	32	16	51	25	143	71
6	52	22	33	14	56	24	155	67
7	55	21	34	13	60	22	162	61
8	55	18	35	11	63	21	166	54
9	53	15	35	10	65	18	167	48
10	48	12	35	9	66	16	169	42
11			36	8	66	14	132	28
12			35	7	66	12	131	25
13			35	6	66	11	131	21
14			33	5	65	9	128	18
15			30	4	62	8	122	15
16			26	3	60	6	115	12
17			22	2	57	5	108	10
18			18	1	51	4	97	8
19			14	1	43	3	85	6
20			10	1	35	2	71	4
Value in use		199		164		271		720[(1)]

[(1)] It is assumed that the research centre generates additional future cash flows for the enterprise as a whole. Therefore, the sum of the value in use of each individual cash- generating unit is less than the value in use of the business as a whole. The additional cash flows are not attributable to the headquarter building.

Calculation of Impairment Losses

A76. In accordance with the 'bottom-up' test, M compares the carrying amount of each cash-generating unit (after allocation of the carrying amount of the building) to its recoverable amount.

Schedule 3. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*
Carrying amount (after allocation of the building) (Schedule 1)	119	206	275
Recoverable amount (Schedule 2)	199	164	271
Impairment loss	0	(42)	(4)

A77. The next step is to allocate the impairment losses between the assets of the cash-generating units and the headquarter building.

Schedule 4 Allocation of the impairment losses for cash-generating units B and C (Amount in ₹ lakhs)

Cash-generating unit	*B*	*C*
To headquarter building	(12) (42*56/206)	(1) (4*75/275)
To assets in cash-generating unit	(30) (42*150/206)	(3) (4*200/275)
	(42)	(4)

A78. In accordance with the 'top-down' test, since the research centre could not be allocated on a reasonable and consistent basis to A, B and C's cash-generating units, M compares the carrying amount of the smallest cash- generating unit to which the carrying amount of the research centre can be allocated (i.e., M as a whole) to its recoverable amount.

Schedule 5. Application of the 'top-down' test (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*	*Building*	*Research centre*	*M*
Carrying amount	100	150	200	150	50	650
Impairment loss arising from the 'bottom-up' test	–	(30)	(3)	(13)	–	(46)
Carrying amount after The 'bottom-up' test	100	120	197	137	50	604
Recoverable amount (Schedule 2)						720
Impairment loss arising from 'top-down' test						0

A79. Therefore, no additional impairment loss results from the application of the 'top-down' test. Only an impairment loss of ₹ 46 lakhs is recognised as a result of the application of the 'bottom-up' test.

AS 29* : Provisions, Contingent Liabilities and Contingent Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Pursuant to this Accounting Standard coming into effect, all paragraphs of Accounting Standards (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5(5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion). 9.2, 10, 11, 12 and 16), stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of this Standard is also to lay down appropriate accounting for contingent assets.

Scope

1. This Standard should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

- ***(a) those resulting from financial instruments[2] that are carried at fair value;***
- ***(b) those resulting from executory contracts, except where the contract is onerous;***

Explanation:

- ***(i) An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Thus, for a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.***
- ***(ii) If an enterprise has a contract that is onerous, the present obligation under the contract is recognised and measured as a provision as per this Standard.***

  The application of the above explanation is illustrated in Illustration 10 of Illustration C attached to the Standard.

- ***(c) those arising in insurance enterprises from contracts with policy-holders; and***
- ***(d) those covered by another Accounting Standard.***

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* Issued in 2003.

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2 For the purpose of this Standard, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

2. This Standard applies to financial instruments (including guarantees) that are not carried at fair value.

3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.

4. This Standard applies to provisions, contingent liabilities and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS 7, Construction Contracts);

(b) taxes on income (see AS 22, Accounting for Taxes on Income);

(c) leases (see AS 19, Leases). However, as AS 19 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases; and

(d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).[3]

6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of AS 9.

7. This Standard defines provisions as liabilities which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.

8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9. This Standard applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

Definitions

10. The following terms are used in this Standard with the meanings specified:

10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

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[3] AS 15 (issued 1995) has since been revised and is now titled as 'Employee Benefits'.

10.3 An <u>obligating event</u> is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

10.4 A <u>contingent liability</u> is:

- ***(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or***
- ***(b) a present obligation that arises from past events but is not recognised because:***
  - ***(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or***
  - ***(ii) a reliable estimate of the amount of the obligation cannot be made.***

10.5 A <u>contingent asset</u> is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise.

10.6 <u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 <u>Possible obligation</u> - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

10.8 A <u>restructuring</u> is a programme that is planned and controlled by management, and materially changes either:

- ***(a) the scope of a business undertaken by an enterprise; or***
- ***(b) the manner in which that business is conducted.***

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

12. Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement. By contrast:

- (a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and
- (b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

13. In this Standard, the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

Recognition

Provisions

14. A provision should be recognised when:

- ***(a) an enterprise has a present obligation as a result of a past event;***
- ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
- ***(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.***

Present Obligation

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

- (a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
- (b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

Past Event

16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large.

20. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

21. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard[4], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

23. Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 68).

Contingent Liabilities

26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14).

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[4] The interpretation of 'probable' in this Standard as 'more likely than not' does not necessarily apply in other Accounting Standards.

29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Contingent Assets

30. An enterprise should not recognise a contingent asset.

31. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

33. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

34. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Measurement

Best Estimate

35. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.

36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

37. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

Risks and Uncertainties

38. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

39. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that

income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

40. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 67(b).

Future Events

41. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

42. Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

43. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

44. Gains from the expected disposal of assets should not be taken into account in measuring a provision.

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

47. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

48. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.

49. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

50. In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

51. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

53. A provision should be used only for expenditures for which the provision was originally recognised.

54. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

55. Provisions should not be recognised for future operating losses.

56. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

57. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

58. The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

59. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.

60. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

61. An enterprise cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

62. A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

63. A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

64. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

65. As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

66. For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period; (b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities), may not comply with paragraph 66 above.

67. An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities) may not comply with paragraph 67 above.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 35-45;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

69. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 67 (a) and (b) and 68 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

70. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 66-68 in a way that shows the link between the provision and the contingent liability.

71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Transitional Provisions

73. All the existing provisions for decommissioning, restoration and similar liabilities (see paragraph 35) should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.

Illustration A

Tables - Provisions, Contingent Liabilities and Reimbursements

The purpose of this illustration is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Ac- counting Standard.

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.

There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67).	No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68).	No provision is recognised (paragraph 26). No disclosure is required (paragraph 68).

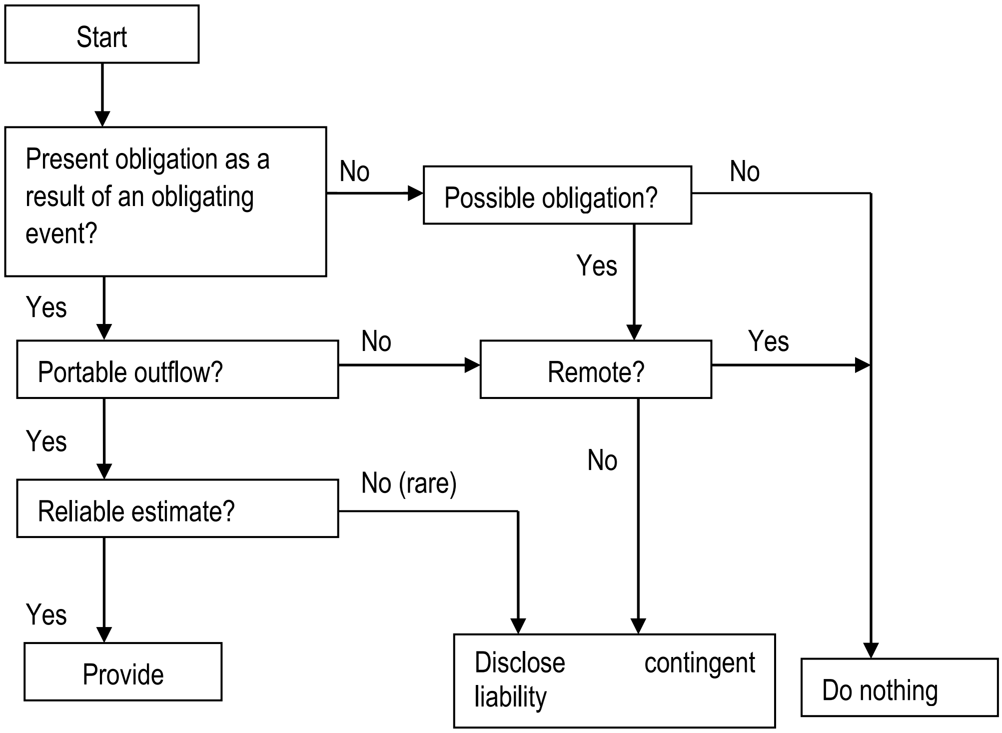
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	**The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.**	**The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.**
The enterprise has no liability for the amount to be reimbursed (paragraph 50).	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 46 and 47).	The expected reimbursement is not recognised as an asset (paragraph 46).
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement [paragraph 67(c)].	The expected reimbursement is disclosed [paragraph 67(c)].

Illustration B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

Illustration C Illustrations: Recognition

This illustration illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the Illustration have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some Illustrations the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the Illustrations.

The cross references provided in the Illustrations indicate paragraphs of the Accounting Standard that are particularly relevant. The illustration should be read in the context of the full text of the Accounting Standard.

Illustration 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Illustration 2: Contaminated Land - Legislation Virtually

Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

Illustration 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Illustration 4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement -

Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 11, 14 and 23).

Illustration 5: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 March 2006

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Illustration 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

Illustration 7: A Single Guarantee

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement -

No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

Illustration 8 : A Court Case

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

Illustration 9A: Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Illustration 9B: Refurbishment Costs – Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in illustration 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Illustration 10: An Onerous Contract

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event-The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable, (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion-A provision is recognised for the best estimate of the unavoidable lease payments.

Illustration D

Illustrations: Disclosure

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

An illustration of the disclosures required by paragraph 67 is provided below.

Illustration 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of ₹ 60,000 has been recognised. The following information is disclosed:

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

An illustration is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

Illustration 2 Disclosure Exemption

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of ₹ 1000 lakh. The enterprise recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 66 and 67 of the Standard. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1000 lakh. The information usually required by AS 29, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

PART – III

GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

The following is the text of the guidance note issued with a view to clarify the important terms (including phrases) commonly used in the preparation and presentation of 'general purpose financial statements'. These statements include balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for the use of shareholders/members, creditor, employees and public at large.

Introduction

1. The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. As such it does not purport to provide a comprehensive or rigid dictionary.

2. The basic considerations to be borne in mind when selecting terms for use in the financial statements are clarity, significance and consistency.

3. This guidance note does not primarily cover the terms used in a specific sense by certain specialised institutions, e.g., banks, insurance companies, financial institutions or electricity companies. However, it is possible that some of the terms defined here may have common application for such institutions.

4. Many of the terms have, over a period of time, acquired a worldwide usage and recognition. Therefore, while formulating this guidance note, the Accounting Standards Board has taken into consideration the terminologies in use in various countries as formulated by their respective professional bodies.

5. The terms have been defined in this note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings when used in the context of certain special enactments.

6. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

General Definitions

1.01 Absorption Costing

A method whereby the *cost* is determined so as to include the appropriate share of both *variable* and *fixed costs*.

1.02 Acceptance

The drawee's signed assent on *bill of exchange*, to the order of the drawer. This term is also used to describe a *bill of exchange* that has been accepted.

1.03 Account Receivable

See **Sundry Debtor**

1.04 Accounting Policies

The specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

1.05 Accrual

Recognition of *revenues* and *costs* as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to *assets* and *liabilities* as they occur irrespective of the actual receipts or payments.

1.06 Accrual Basis of Accounting

The method of recording transactions by which *revenues, costs, assets* and *liabilities* are reflected in the accounts in the period in which they accrue. The 'accrual basis of accounting' includes considerations relating to *deferrals*, allocations, *depreciation* and *amortisation*. This basis is also referred to as **mercantile basis of accounting**.

1.07 Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

1.08 Accrued Expense

An *expense* which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

1.09 Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

1.10 Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

1.11 Accumulated Depletion

The total to date of the periodic *depletion* charges on *wasting assets*.

1.12 Accumulated Depreciation

The total to date of the periodic *depreciation* charges on *depreciable assets*.

1.13 Actual Cost

See **Cost**

1.14 Ad-valorem

A method of levying tax or duty on goods by using their assessable value as the tax base.

1.15 Added Value

See **Value Added**

1.16 Added Value Statement

See **Value Added Statement**

1.17 Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

1.18 Amortisable Amount

See **Amortisation**

1.19 Amortisation

The gradual and systematic writing off of an *asset* or an account over an appropriate period. The amount on which *amortisation* is provided is referred to as *amortisable amount*. *Depreciation* accounting is a form of amortisation applied to *depreciable assets*. *Depletion* accounting is another form of amortisation applied to *wasting assets*. Amortisation also refers to gradual extinction or *provision* for extinction of a debt by gradual *redemption* or *sinking fund* payments or the gradual writing off to *revenue* of miscellaneous expenditure carried forward, e.g., *share issue expenses, preliminary expenses*, etc.

1.20 Amortised Value

The *amortisable amount* less any portion already provided by way of *amortisation*.

1.21 Annual Report

The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet, profit and loss statement* and notes on accounts, the *auditor's report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

1.22 Appropriation Account

An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends, reserves*, etc.

1.23 Assets

Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

1.24 Auditor's Report

The formal expression of opinion by an independent external auditor on the financial statements of an enterprise including such reservations, qualifications and negations as may be called for and incorporating, where appropriate, such statutory affirmations as may be prescribed.

1.25 Authorised Share Capital

The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital.**

1.26 Average Cost

The *cost* of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost.**

2.01 Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable.

2.02 Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its *assets, liabilities, capital, reserves* and other account balances at their respective *book values*.

2.03 Bill of Exchange

An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of a certain person or to the bearer of the instrument.

2.04 Bond

See **Debenture**

2.05 Bonus Shares

Shares allotted by capitalisation of the *reserves* or *surplus* of a corporate enterprise.

2.06 Book Value

The amount at which an item appears in the books of account or financial statements. It does not refer to any particular basis on which the amount is determined e.g., *cost*, replacement value, etc.

3.01 Call

A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

3.02 Called-up Share Capital

That part of the *subscribed share capital* which shareholders have been required to pay.

3.03 Capital

Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

3.04 Capital Assets

Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

3.05 Capital Commitment

Future *liability* for capital expenditure in respect of which contracts have been made.

3.06 Capital Employed

The finances deployed by an enterprise in its *net fixed assets, investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

3.07 Capital Loss

See **Capital Profit**

3.08 Capital Profit

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a *capital asset* over its *cost*. When the result of this computation is negative, it is referred to as **capital loss**.

3.09 Capital Redemption Reserve

A *reserve* created on *redemption* of the *redeemable preference shares* of a corporate enterprise out of its *profits* which would otherwise have been available for distribution as *dividend*.

3.10 Capital Reserve

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*.

3.11 Capital Work-in-progress

Expenditure on *capital assets* which are in the process of construction or completion.

3.12 Cash Basis of Accounting

The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

3.13 Cash Discount

A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

3.14 Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation*, *amortisation*, etc. When the result of the computation is negative, it is termed as **cash loss**.

3.15 Changes in Financial Position, Statement of

A financial statement which summarises, for the period covered by it, the changes in the financial position including the sources from which funds were obtained by the enterprise and the specific uses to which such funds were applied. This is also called the **funds flow statement.**

3.16 Charge

An encumbrance on an *asset* to secure an indebtedness or other obligations. It may be fixed or floating.

3.17 Cheque

A *bill of exchange* drawn upon a specified banker and not expressed to be payable otherwise than on demand.

3.18 Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

3.19 Contingency

A condition or situation, the ultimate outcome of which, *gain* or *loss*, will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

3.20 Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

3.21 Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

3.22 Contra Account

One or two or more accounts which partially or wholly off-set another or other accounts.

3.23 Cost

The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

3.24 Cost of Purchase

The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

3.25 Cost-plus Contract

A contract under which the contractor is reimbursed for allowable or otherwise defined *costs* as increased by a percentage of such *costs* or an agreed fee.

3.26 Cost of Goods Sold

The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

3.27 Cost of Sales

Cost of goods sold plus selling and administrative expenses.

3.28 Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes *costs* which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

3.29 Convertible Bond

See **Convertible Debenture**

3.30 Convertible Debenture

A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

3.31 Creditor

See **Sundry Creditor**

3.32 Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

3.33 Cumulative Preference Shares

A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

3.34 Current Assets

Cash and other *assets* that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.

3.35 Current Liability

Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

4.01 Debenture

A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

4.02 Debenture Redemption Reserve

A *reserve* created for the *redemption* of *debentures* at a future date.

4.03 Debtor

See **Sundry Debtor**

4.04 Deferral

Postponement of recognition of a *revenue* or *expense* after its related receipt or payment (or incurrence of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

4.05 Deferred Expenditure

Expenditure for which payment has been made or a *liability* incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as **deferred revenue expenditure.**

4.06 Deferred Revenue

Revenue or *income* received or recorded before it is earned and carried forward to a subsequent period or periods to which it relates.

4.07 Deferred Revenue Expenditure

See **Deferred Expenditure**

4.08 Deficiency

The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

4.09 Deficit

The debit balance in the profit and loss statement.

4.10 Depletion

A measure of exhaustion of a *wasting asset* represented by periodic write off of *cost* or other substituted value.

4.11 Depreciable Amount

The historical cost, or other amount substituted for historical cost of a *depreciable asset* in the financial statements, less the estimated residual value.

4.12 Depreciable Asset

Asset which is expected to be used during more than one accounting period, has a limited *useful life*, and is held by an enterprise for use in the production or supply of goods, and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

4.13 Depreciation

A measure of the wearing out, consumption or other loss of value of a *depreciable asset* arising from use, effluxion of time or *obsolescence* through technology and market changes. It is allocated so as to charge a fair proportion in each accounting period during the *useful life* of the *asset*. It includes *amortisation* of *assets* whose *useful life* is predetermined and *depletion* of *wasting assets*.

4.14 Depreciation Method

Any method of calculating *depreciation* for an accounting period.

4.15 Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

4.16 Development Allowance Reserve

A *reserve* created in compliance with one of the conditions for claiming development allowance under the Income-tax Act, 1961.

4.17 Development Rebate Reserve

A *reserve* created in compliance with one of the conditions for claiming development rebate under the Income-tax Act, 1961.

4.18 Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

4.19 Direct Cost

An item of *cost* that can be reasonably identified with a specific unit of product or with a specific operation or other cost center.

4.20 Direct Costing

A method whereby the *cost* is determined so as to include the appropriate share of *variable costs* only, all *fixed costs* being charged against *revenue* in the period in which they are incurred.

4.21 Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

4.22 Dividend

A distribution to shareholders out of *profits* or *reserves* available for this purpose.

4.23 Dividend Equalisation Reserve

A *reserve* created to maintain the rate of *dividend* in future years.

5.01 Earnings Per Share

The earnings in monetary terms attributable to each *equity share*, based on the *net profit* for the period, before taking into account *prior period items, extraordinary items* and adjustments resulting from changes in *accounting policies* but after deducting tax appropriate thereto and preference *dividends*, divided by the number of equity shares issued and ranking for dividend in respect of that period.

5.02 Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners.

5.03 Equity Share

A share which is not a preference share. Also sometimes called **ordinary share.**

5.04 Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

5.05 Expense

A *cost* relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

5.06 Expired Cost

That portion of an *expenditure* from which no further benefit is expected. Also termed as **expense**.

5.07 Extraordinary Item

Gain or loss which arises from events or transactions that are distinct from ordinary activities of the enterprise and which are both material and expected not to recur frequently or regularly. This would also include material adjustments necessitated by circumstances, which, though related to previous periods, are determined in the current period.

6.01 Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and not under any compulsion to transact.

Arm's length is a term applied to any transaction on the assumption that the parties to the transaction would act without being influenced by each other or by any other person.

6.02 Fictitious Asset

Item grouped under *assets* in a *balance sheet* which has no real value (e.g. the debit balance of the *profit and loss statement*).

6.03 First Charge

A *charge* having priority over other charges.

6.04 First In, First Out (FIFO)

Computation of the *cost* of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

6.05 Fixed Asset

Asset held for the purpose of providing or producing goods or services and that is not held for resale in the normal course of business.

6.06 Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

6.07 Fixed Deposit

Deposit for a specified period and at specified rate of interest.

6.08 Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

6.09 Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

6.10 Foreign Currency, Translation of

The process of expressing amounts stated in a foreign currency into equivalent amounts in local currency by using an exchange rate between the two currencies.

6.11 Foreign Currency Conversion

The process of expressing amounts stated in a foreign currency into equivalent amounts in local currency by using the exchange rate at which the foreign currency is bought or sold.

6.12 Forfeited Share

A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

6.13 Free Reserve

A *reserve* the utilisation of which is not restricted in any manner.

6.14 Functional Classification

A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

6.15 Fund

An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

6.16 Fundamental Accounting Assumptions

Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

6.17 Funds Flow Statement

See **Changes in Financial Position, Statement of 7.01 Gain**

A monetary benefit, *profit* or advantage resulting from a transaction or group of transactions.

7.02 General Reserve

A *revenue reserve* which is not earmarked for a specific purpose.

7.03 Going Concern Assumption

An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

7.04 Goodwill

An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

7.05 Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

7.06 Gross Sales

See **Sales Turnover**

7.07 Gross Turnover

See **Sales Turnover**

8.01 Income

See **Revenue**

8.02 Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement.**

8.03 Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

8.04 Internal Audit

An independent appraisal activity within an enterprise whether by the staff of the enterprise or by a firm of accountants appointed for that purpose, for the review of accounting, financial and other operations and controls as a basis for service to management. It involves a specialised application of the techniques of auditing.

8.05 Internal Check

A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee or group of employees is checked continuously by correlating it with the work of others. An essential feature is that no one employee or group of employees has exclusive control over any transaction or group of transactions.

8.06 Internal Control

The entire system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the *assets* and secure as far as possible the accuracy and completeness of the records.

8.07 Interim Report

The information provided with reference to a date before the close of the accounting period by the management of an enterprise to owners or other interested persons concerning its operations or financial position.

8.08 Inventory

Tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

8.09 Investment

Expenditure on *assets* held to earn interest, *income, profit* or other benefits.

8.10 Investments

Assets held not for operational purposes or for rendering services i.e. assets other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

8.11 Investment Allowance Reserve

A *reserve* created in compliance with one of the conditions for claiming investment allowance under the Income-tax Act, 1961.

8.12 Issued Share Capital

That portion of the *authorised share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

9.01 Last In, First Out (LIFO)

Computation of the *cost* of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

9.02 Liability

The financial obligation of an enterprise other than owners' funds.

9.03 Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that other's *assets*/property.

9.04 Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

9.05 Loss

See Profit

10.01 Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

10.02 Mercantile Basis of Accounting

See **Accrual Basis of Accounting**

10.03 Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability.* The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

11.01 Net Assets

The excess of the *book value* of *assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds.**

11.02 Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

11.03 Net Loss

See **Net Profit**

11.04 Net Profit

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

11.05 Net Realisable Value

The actual/estimated selling price of an *asset* in the ordinary course of the business less cost of completion and cost necessarily to be incurred in order to make the sale.

11.06 Net Sales

See **Sales Turnover**

11.07 Net Turnover

See **Sales Turnover**

11.08 Net Worth

See **Net Assets**

11.09 Nominal Share Capital

See **Authorised Share Capital**

12.01 Obsolescence

Diminution in the value of an *asset* by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the *asset*, or legal or other restrictions.

12.02 Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

13.01 Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

13.02 Pari Passu Charge

Charge created by an enterprise on its *assets* in favour of more than one person on the condition that each such person has equal rights of realization out of the assets as the other(s).

13.03 Pledge

Deposit of goods by one person (pledgor or pawnor) to another person (pledgee or pawnee) as a security for payment of a debt or performance of a promise. The pledgee has a special *lien*/right on the property in the pledged goods with a right to sell the same after notice if the pledgor fails to discharge the debt or perform his promise on the stipulated date.

13.04 Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

13.05 Preferential Payment

Payment which in a winding up or insolvency has to be made in priority to all other debts as per statute.

13.06 Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

13.07 Pre-paid Expense

Payment for *expense* in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

13.08 Prime Cost

The total *cost* of direct materials, direct wages and other direct production expenses.

13.09 Prior Period Item

A material charge or credit which arises in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

13.10 Profit

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**. Also see **gross profit, operating profit, net profit**.

13.11 Profit and Loss Statement

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

13.12 Promissory Note

An instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

13.13 Propriety Concept

A concept of evaluating performance or specific transactions of an enterprise with reference to the tests of commonly accepted norms, customs and standards of conduct including those based on considerations of public interest.

13.14 Provision

An amount written off or retained by way of providing for *depreciation* or diminution in value of *assets* or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

13.15 Provision for Doubtful Debts

A *provision* made for debts considered doubtful of recovery.

13.16 Prudence

A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses, even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

13.17 Public Deposits

Fixed deposits accepted by an enterprise from the public in accordance with the prevailing Rules made in this behalf.

14.01 Redeemable Preference Share

The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

14.02 Redemption

Repayment as per given terms normally used in connection with preference shares and *debentures*.

14.03 Reduction of Capital

The extinguishment or reduction of shareholders' liability on any of the shares of a corporate enterprise in respect of the *share capital* not fully paid up or the cancellation of *paid-up share capital* of a company which is not represented by available *assets*. It also refers to the return of any *paid-up share capital* in excess of requirements.

14.04 Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of *assets* or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

14.05 Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

14.06 Revenue

The gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and *dividends*. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. It excludes amounts collected on behalf of third parties such as certain taxes. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

14.07 Revenue and Expense Statement

See **Income and Expenditure Statement**

14.08 Revenue Reserve

Any reserve other than a capital reserve.

14.09 Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

15.01 Sales Turnover

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

15.02 Secured Loan

Loan secured wholly or partly against an *asset*.

15.03 Self-Insurance

The assumption by an enterprise of a risk which is not covered by an external insurance agency and for which internal allocations or *provisions* have been made.

15.04 Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

15.05 Share Discount

The excess of the face value of shares over their issue price.

15.06 Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual *assets* after meeting prior claims.

15.07 Shareholders' Funds

See **Net Assets**

15.08 Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

15.09 Share Premium

The excess of the issue price of shares over their face value.

15.10 Short-term Liability

See **Current Liability**

15.11 Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

15.12 Social Cost Benefit Analysis

The identification, measurement and reporting of *social costs* and *benefits* related to a project or an enterprise.

15.13 Social Cost

The cost or the loss to society resulting from the operations of an enterprise in its particular circumstances. Such costs are often not readily measurable in monetary terms. This term is also used in a specific sense to denote the costs incurred by an enterprise in providing social amenities.

15.14 Social Benefit

The benefits or income to society resulting from operations of an enterprise in its particular circumstances. Such benefits are often not readily measurable in monetary terms.

15.15 Standard Cost

A pre-determined *cost* of an activity, operation, process or product, established as a basis for control and reporting.

15.16 Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life.

15.17 Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

15.18 Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in financial statements.

15.19 Sundry Creditor

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditor** or **account payable**.

15.20 Sundry Debtor

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtor, trade debtor, account receivable**.

15.21 Surplus

Credit balance in the *profit and loss statement* after providing for proposed appropriations, e.g., *dividend* or *reserves*.

16.01 Test Check

Examination of representative items selected from an account or record for the purpose of arriving at an opinion on the entire account or record.

16.02 Trade Creditor

See Sundry Creditor

16.03 Trade Debtor

See **Sundry Debtor**

16.04 Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

16.05 Transfer Price

The price charged (or value assigned) to a product or service which is transferred within an enterprise from one segment/division to another.

17.01 Unclaimed Dividend

Dividend which has been declared by a corporate enterprise and a warrant or a *cheque* in respect whereof has been despatched but has not been encashed by the shareholder concerned.

17.02 Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

17.03 Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

17.04 Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

17.05 Useful Life

Life which is either (i) the period over which a *depreciable asset* is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the *asset* by the enterprise.

18.01 Value Added

The increase in value of a product or service resulting from an alteration in the form, location or availability excluding the cost of bought-out materials or services. This is also referred to as **added value**.

18.02 Value Added Statement

A statement of the value added that an enterprise has been able to generate and its distribution among those contributing to its generation. This is also referred to as **added value statement.**

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Guidance Note on Accrual Basis of Accounting

1. Introduction

1.1 Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS-1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

1.2 There are three bases of accounting in use, viz., (i) accrual (ii) cash and (iii) hybrid. The Companies (Amendment) Act, 1988, has amended section 209 of the Companies Act, 1956 with effect from 15th June, 1988, making it obligatory on all companies to maintain their accounts on accrual basis and according to the double entry system of accounting. In view of this amendment all companies will now be required to keep their accounts on accrual basis of accounting, in respect of any accounting year closing on or after 15th June, 1988.

1.3 This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting.

2. Accrual Basis of Accounting

2.1 The term "Accrual" has been explained in the Accounting Standard on Disclosure of Accounting Policies (AS-1), as under:

"Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate".

2.2 The Guidance Note on Terms Used in Financial Statements, issued by the Accounting Standards

Board of the ICAI, explains 'Accrual Basis of Accounting' as under:

"The method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. The 'Accrual Basis of Accounting' includes considerations relating to deferrals, allocations, depreciation and amortisation. This basis is also referred to as 'Mercantile Basis of Accounting'."

Accrual Basis of Accounting

2.3 Accrual basis of accounting, thus, attempts to record the financial effects of the transactions, events, and circumstances of an enterprises in the period in which they occur rather than recording them in the period(s) in which cash is received or paid by the enterprise. It recognises that the buying, producing, selling and other economic events that affect enterprise's performance often do not coincide with the cash receipts and payments of the period. The goal of accrual basis of accounting is to relate the accomplishments (measured in the form of revenue) and the efforts (measured in terms of cost) so that reported net income measures an enterprise's performance during a period instead of merely listing its cash receipts and payments. Apart from income measurement, accrual basis of accounting recognises assets, liabilities or components of revenues and expenses for amounts received or paid in cash in past, and amounts expected to be received or paid in cash in the future.

2.4 The major difference between accrual accounting and accounting based on cash receipts and outlays, is in timing of recognition of revenues, expenses, gains and losses. Cash receipts in a particular period may largely reflect the effects of activities of the enterprise in the earlier periods, while many of the cash outlays may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash outlays of an enterprise for a short period cannot indicate how much of the cash received is return *of* investment and how much is return *on* investment and thus cannot indicate whether or to what extent an enterprise is successful or unsuccessful.

2.5 The following are the essential features of accrual basis of accounting:

(i) Revenue is recognised as it is earned.

(ii) Costs are matched either against revenues so recognised or against the relevant time period to determine periodic income, and

(iii) Costs which are not charged to income are carried forward and are kept under continuous review. Any cost that appears to have lost its utility or its power to generate future revenue is written-off as a loss.

2.6 The above features of accrual basis of accounting are discussed in the following paragraphs.

3. Revenue Recognition

3.1 The Accounting Standard on "Revenue Recognition" (AS-9) issued by ICAI deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. This standard lays down rules for recognition of revenue arising in the course of the ordinary activities of the enterprise from (i) sale of goods, (ii) rendering of services, and (iii) use of resources of the enterprise by others yielding interest, royalties and dividends.

3.2 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of service or the use of resources of the enterprise by others it would not be unreasonable to expect ultimate collection.

3.3 An essential criterion for the recognition of revenue is that the consideration receivable from the sale of goods, the rendering of services or from the use by others of resources of the enterprise is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.4 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue for the period in which it is properly recognised according to the principles discussed herein.

3.5 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. It is possible that the uncertainty of collection may be either in respect of the entire transaction or a part thereof. For that part in respect of which there is no uncertainty of collection, the revenue is immediately recognised and for the remaining part the recognition of revenue is postponed. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. It is necessary to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties. 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 installments. 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.

3.6 Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 3.7 and 3.8 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection.

3.7 In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods. Thus, when such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

3.8 In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

3.9 The use of resources of the enterprise by others yielding interest, royalties and dividends is recognised when no significant uncertainty as to measurability or collectability exists. The terms interest, royalties and dividends mean -

(i) Interest - charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties - charges for the use of such assets as know-how, patents, trademarks and copyrights;

(iii) dividends - rewards from the holding of investments in shares.

3.10 The revenues from the above sources are recognised on the following basis:

(i) Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period of maturity.

(ii) Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

(iii) Dividends from investments in shares accrue when the owner's right to receive payment is established.

Similar considerations would apply where the resources of the enterprise are used by others and yield revenue such as rent.

3.11 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittances is anticipated, revenue recognition may need to be postponed.

3.12 The accrual basis of accounting necessitates adjustments for income received in advance as well as for outstanding income at the end of the period of accounting since the receipts during the period may not coincide with what is properly recognisable as income for the period.

4. Rules for Expense Recognition

4.1 The Guidance Note on Terms Used in Financial Statements, explains the term 'Expense' as under:

"A cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period".

4.2 In the accrual basis of accounting, costs are matched either against revenues or against the relevant time period to determine periodic income.

Further, costs which are not charged against income of the period are carried forward. If any particular item of cost has lost its utility or its power to generate future revenue the same is written off as an expense or a loss.

4.3 Under accrual basis of accounting, expenses are recognised by the following approaches:

(i) Identification with revenue transactions

Costs directly associated with the revenue recognised during the relevant period (in respect of which whether money has been paid or not) are considered as expenses and are charged to income for the period.

(ii) Identification with a period of time

In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time. Such costs are regarded as 'period costs' and are expensed in the relevant period, e.g., salaries, telephone, traveling, depreciation on office building etc.

Similarly, the costs the benefits of which do not clearly extend beyond the accounting period are also charged as expenses.

4.4 Expenses relating to a future period are accounted for as prepaid expenses even though they are paid for in the current accounting period.

Similarly, expenses of the current year, for which payment has not yet been made (outstanding expenses) are charged to the profit and loss account for the current accounting period.

4.5 The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

(a) it is probable that at the date of the financial statements events subsequent thereto will confirm that (after taking into account any related probable recovery) an asset has been impaired or a liability has been incurred as at that date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

4.6 The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 4.5 is not met, unless the possibility of a loss is remote.

5. Recognition of Assets and Liabilities

5.1 As in the case of revenues and expenses which are recognised under the accrual basis of accounting, as they are earned or incurred (and not as money is received or paid), the transactions related to assets and liabilities are recognised as they occur irrespective of the actual receipts or payments.

6. Concept of Materiality

6.1 Section 209(3) of the Companies Act, 1956 requires that every company has to keep the books of account in such a manner that they give a 'true and fair' view of its state of affairs and that the books are maintained on the accrual basis of accounting.

6.2 The concept of 'true and fair' view also recognises that the concept of materiality must be given due importance in the preparation and presentation of financial statements. As explained in para 17 of Accounting Standard on 'Disclosure of Accounting Policies' (AS-1), financial statements should disclose all "material" items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements.

6.3 The accrual basis of accounting does not necessarily imply that detailed calculations are required to be made in respect of even the smallest and immaterial amounts of revenue and expenditure and co-relate the same on the basis of the principle of accrual. For example, it may not be improper to write off a small calculator costing ₹.100 even though it is expected to be used for more than one year.

7. Change in the Basis of Accounting

7.1 When an enterprise which was earlier following cash basis of accounting for all or any of its transactions, changes over to the accrual basis of accounting, the effect of the change should be ascertained with reference to the transactions of the previous accounting periods also, to the extent such transactions have an impact on the current financial position of the enterprise.

The fact of such change should be disclosed in the financial statements. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made to reflect the effect of such change. Where the effect of the change is not ascertainable, wholly or in part, the fact should be indicated. If the change has no material effect on the financial statements for the current period but is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

8. Authoritative Pronouncements of the Institute vis-a-vis Accrual Accounting

8.1 The Council of the ICAI and its various committees have issued various Guidance Notes, Statements and Accounting Standards. The accounting treatments contained in these documents are primarily based on accrual accounting. Thus, adoption of accounting treatments recommended in these documents would ensure that a company has followed accrual basis of accounting. The Appendix to this guidance note contains some special circumstances of recognition of revenue and expenses as dealt with in the aforesaid documents issued by the Institute. The Appendix also contains illustrations of situations where due to uncertainty of collection, revenue recognition may be postponed.

9. Auditor's Responsibility

9.1 Where a company has maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor should state in his report that, as far as this aspect is concerned, the company has maintained proper books of account as required by law.

Where a company has not maintained its books of account in a manner that all material transactions are accounted for on accrual basis as discussed above, the auditor will have to qualify his report or give a negative opinion with regard to the following assertions:

(a) Whether proper books of account as required by law have been kept by the company.

(b) Whether the accounts give the information required by this Act in the manner so required and give a true and fair view of:

   (i) in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and

   (ii) in the case of the profit and loss account, of the profit or loss for its financial year.

Appendix

This Appendix is illustrative only. The purpose of the Appendix is to illustrate the application of the Guidance Note on Accrual Basis of Accounting to some of the important commercial situations.

Revenue Recognition

1. Sale of Goods

(i) Delivery is delayed at buyer's request and buyer takes title and accepts billing

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

(ii) Delivered subject to conditions

(a) installation and inspection i.e. goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory tested television receiver normally only requires unpacking and connecting of power and antenna.)

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) *Consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor*

Revenue should not be recognised until the goods are sold to a third party.

(e) Cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

(iii) Sales where the purchaser makes a series of installment payments to the seller, and the seller delivers the goods only when the final payment is received

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

(iv) Special order and shipments i.e. where payment (or partialpayment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

(v) Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

(vi) Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale

Revenue from such sales can generally be recognised if significant risks of ownership have passed, however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(vii) Subscriptions for publications

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

(viii) Installments sales

When the consideration is receivable in installments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

2. Rendering of Services

(i) Installation fees

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

(ii) Advertising and Insurance Agency Commissions

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

(iii) Financial service commissions

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made, or added to a loan or other account and settled in stages.

The recognition of such revenue should, therefore, have regard to:

(a) Whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

(iv) Admission fees

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

(v) Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalized. If the membership fee permits only membership and all other services or products are paid for separately, or is there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

3. Uncertainty of Collection

In respect of the following items of revenue, if 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:

(i) Claim for escalation of price under a contract.

(ii) Export incentives due from the Government or any statutory authority.

(iii) Drawback claims, cash subsidies, benefits of Import Licenses etc. received from the Government or any statutory authority.

(iv) Interest due or receivable on loans or other dues when the recovery of the amount is in dispute or is doubtful.

(v) Insurance claim in respect of loss of goods or loss of profits, when the amount receivable is not certain or capable or being determined.

4. Construction Contracts*

In accounting for construction contracts in financial statements either the percentage of completion method or the completed contract method1 may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be adopted for all other contracts which meet similar criteria.

Liability for Expenditure

Gratuity

Under accrual basis of accounting it is necessary to provide for accruing liability in each accounting period.

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Guidance Note on Accounting for Corporate Dividend Tax

1. The Finance Act, 1997, has introduced Chapter XIID on "Special Provisions Relating to Tax on Distributed Profits of Domestic Companies" [hereinafter referred to as 'CDT' (Corporate Dividend Tax)]. The relevant extracts of sections 115O and 115Q of the Income-tax Act, 1961, governing CDT have been reproduced in Annexure I. This Guidance Note is being issued to provide guidance on accounting for CDT.

2. The salient features of CDT are as below:

(i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.

(ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.

(iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.

(iv) The rate of CDT is ten per cent.

(v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.

(vi) CDT is payable to the credit of the Central Government within 14 days of -

(a) declaration of any dividend,

(b) distribution of any dividend, or

(c) payment of any dividend,

whichever is the earliest.

(vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.

(viii) The expression 'dividend' shall have the same meaning as is given to 'dividend' in clause (22) of Section 2 but shall not include sub-clause (e) thereof. (The relevant extracts of Section 2(22) of the Income-tax Act, 1961, have been reproduced in Annexure II).

* Accounting Standard (AS) 7, 'Construction Contracts' (revised) issued by the Institute of Chartered Accountants of India, permits the use of only percentage of completion method for accounting for construction contracts. AS 7 (revised) comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature.

Accounting for CDT

3. According to generally accepted accounting principles, the provision for dividend is recognised in the financial statements of the year to which the dividend relates. In view of this, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year.

Disclosure and Presentation of CDT in Financial Statements

4. It is noted that clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956[!], requires the disclosure of "the amount of charge for Indian Income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation." It is also noted that Part II of Schedule VI[!] only lays down the information to be disclosed in the profit and loss account. However, as a matter of convention and to improve readability, the information in the profit and loss account is generally shown in two parts, viz., the first part contains the information which is required to arrive at the figure of the current year's profit - often referred to as 'above the line', and the second part which discloses, inter alia, information involving the appropriations of the current year's profits - often referred to as 'below the line'.

5. Since dividends are disclosed 'below the line', a question arises with regard to disclosure and presentation of CDT, as to whether the said tax should also be disclosed 'below the line' or should be disclosed along with the normal income-tax provision for the year 'above the line'.

6. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

Recommendations

7. CDT liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised.

8. CDT liability should be disclosed separately in the profit and loss account, 'below the line', as follows:

Dividend	xxxxx	
Corporate Dividend Tax thereon	xxxxx	xxxxx

9. Provision for Corporate Dividend Tax should be disclosed separately under the head 'Provisions' in the balance sheet.

Annexure I

Relevant Extracts of the Provisions under Chapter XII D of the Income-tax Act, 1961, regarding Special Provisions relating to tax on distributed profits of domestic companies.

115 O. Tax on Distributed Profits of Domestic Companies

(1) Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way

[!] ***Now Schedule III to the Companies Act, 2013.***

of dividends (whether interim or otherwise) on or after the 1st day of June, 1997, whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of ten per cent.

(1A) Notwithstanding that no income-tax is payable by a domestic company on its total income computed in accordance with the provisions of this Act, the tax on distributed profits under subsection

(1) shall be payable by such company.

(2) The principal officer of the domestic company and the company shall be liable to pay the tax on distributed profits to the credit of the Central Government within fourteen days from the date of -

   (a) declaration of any dividend; or
   (b) distribution of any dividend; or
   (c) payment of any dividend,

   whichever is earliest.

(3) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefore shall be claimed by the company or by any other person in respect of the amount of tax so paid.

(4) No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

115 Q

Explanation —— For the purposes of this Chapter, the expression "dividend" shall have the same meaning as is given to "dividend" in clause (22) of Section 2 but shall not include sub-clause (e) thereof.

Annexure II

Relevant extracts of the definition of the term dividend as per section 2(22) of the Income Tax Act, 1961.

2(22) 1"Dividend includes -

(a) any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company;
(b) any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalized or not;
(c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;
(d) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;
(e) but 'dividend' does not include -

   (i) a distribution made in accordance with sub-clause (c) or sub-clause (d) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets;

(ii) any advance or loan made to a shareholder 4[or the said concern] by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off.

Explanation 1. - The expression 'accumulated profits', wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948, and before the 1st day of April,1956.

Explanation 2. - The expression 'accumulated profits' in sub-clauses (a), (b), (d) and (e), shall include all profits of the company up to the date of distribution or payment referred to in those sub-clauses and in sub-clause (c) shall include all profits of the company up to the date of liquidation, 5[but shall not, where the liquidation is consequent on the compulsory acquisition of its undertaking by the Government or a corporation owned or controlled by the Government under any law for the time being in force, include any profits of the company prior to three successive previous years immediately preceding the previous year in which such acquisition took place].

GN(A) 12 (Revised 2000)

Guidance Note on Accounting Treatment for Excise Duty

Introduction

1. The Institute of Chartered Accountants of India had issued a Guidance Note on Accounting Treatment for Excise Duties in 1979. In order to bring uniformity in the accounting treatment of excise duty and inventory valuation, the Guidance Note was revised in 1988. Keeping in view further developments, viz., issuance of the revised Accounting Standard (AS) 2, "Valuation of Inventories" (which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature), it has been decided to revise this Guidance Note again. This revised Guidance Note is being issued in supersession of the earlier Guidance Note issued in 1988 and is effective in respect of accounting periods beginning on or after April 1,1999.

2. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as 'CENVAT').

3. At the outset, this Guidance Note briefly deals with normally accepted accounting principles for inventory valuation as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories" issued by the Institute of Chartered Accountants of India, and nature of excise duty. For details, reference should be made to revised Accounting Standard (AS) 2 and Central Excise Act, Rules, Notifications and Circulars.

Normally Accepted Accounting Principles for Inventory Valuation

4. Normally accepted accounting principles with regard to the valuation of inventories (i.e., materials or supplies to be consumed in the production process or in the rendering of services, work-in-process and finished goods), as prescribed in revised Accounting Standard (AS) 2, "Valuation of Inventories", are reproduced below:

"5. Inventories should be valued at the lower of cost and net realisable value.

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs

incurred in bringing the inventories to their present location and condition.

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. 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. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities."

"11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories."

Nature of Excise Duty

5. Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. This prescription is contained in the Central Excise Rules, 1944, which provide that excise duty shall be collected at the time of removal of goods from factory premises or from approved place of storage (Rule 49). Rate of duty and tariff valuation to be applied is the one in force on that date, i.e., the date of removal (Rule 9A) and not the date of manufacture. This difference in the point of time between taxable event, viz., manufacture and that of its collection has been examined and discussed in a number of judgements. For instance, the Supreme Court in the case of Wallace Flour Mills Co. Ltd. vs. CCE [1989 (44) ELT 598] summed up the legal position as under:

"It is well settled by the scheme of the Act as clarified by several decisions that even though the taxable event is the manufacture or production of an excisable article, the duty can be levied and collected at a later stage for administrative convenience. The Scheme of the said Act read with the relevant rules framed under the Act particularly Rule 9A of the said rules, reveals that the taxable event is the fact of manufacture or production of an excisable article, the payment of duty is related to the date of removal of such article from the factory."

Supreme Court in another case, viz., CCE vs. Vazir Sultan Tobacco Co. [1996 (83) ELT 3] held as under:

"We are of the opinion that Section 3 cannot be read as shifting the levy from the stage of manufacture or production of goods to the stage of removal. The levy is and remains upon the manufacture or production alone. Only the collection part of it is shifted to the stage of removal."

6. The levy of excise duty is not restricted only to excisable goods manufactured and intended for sale. It is also leviable on excisable goods manufactured or produced in a factory for internal consumption. Such intermediate products may be used in manufacture of final products or for repairs within the factory or for use as capital goods within the factory. Excisable goods so used for captive consumption may be eligible for exemption under specific notifications issued from time to time. Finished excisable goods cleared from the place of removal may also be eligible for whole or partial duty exemption in terms of notifications issued from time to time. Such exemption, subject to specified limits, if any, may relate to a manufacturer, e.g., a small-scale industrial unit. Exemption may be goods specific, e.g., handicrafts are currently wholly exempt from duty. The exemption may also be end-use specific, e.g., goods for use by defence services. Excisable goods can be removed for export out of India either wholly without payment of duty or under bond or on payment of duty under claim for rebate of duty paid.

7. Excisable goods, after completion of their manufacturing process, are required to be kept in a storeroom or other identified place of storage in a factory till the time of their clearance. Each such storeroom or storage place is required to be declared to the Excise Authorities and approved by them. Such storeroom or storage place is generally referred to as a Bonded Storeroom. Dutiable goods are also allowed, subject to approval of Excise Authorities, to be removed without payment of duty, to a Bonded Warehouse outside factory. In such cases, excise duty is collected at the time of clearance of goods from such Bonded Warehouses.

8. Amount of excise duty forming part of the sale price of the goods is required to be indicated separately in all documents relating to assessment of duty, e.g., excise invoice used for clearance of excisable goods (Section 12A). It is, however, open to a manufacturer to recover excise duty separately or not to make a separate recovery but charge a consolidated sale price inclusive of excise duty. The incidence of excise duty is deemed to be passed on to the buyer, unless contrary is proved by the payer of excise duty (Section 12B).

Excise Duty as an Element of Cost

9. In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses.

10. Admittedly, excise duty is an indirect tax but it cannot, for that reason alone, be treated differently from other expenses. Excise duty arises as a consequence of manufacture of excisable goods irrespective of the manner of use/disposal of goods thereafter, e.g., sale, destruction and captive consumption. It does not cease to be a levy merely because the same may be remitted by appropriate authority in case of destruction or exempted in case goods are used for further manufacture of excisable goods in the factory. Tax (other than a tax on income or sale) payable by a manufacturer is as much a cost of manufacture as any other expenditure incurred by him and it does not cease to be an expenditure merely because it is an exaction or a levy or because it is unavoidable. In fact, in a wider context, any expenditure is an imposition which a manufacturer would like to minimise.

11. Excise duty contributes to the value of the product. A "duty paid" product has a higher value than a product on which duty remains to be paid and no sale or further utilisation of excisable goods can

take place unless the duty is paid. It is, therefore, a necessary expense which must be incurred if the goods are to be put in the location and condition in which they can be sold or further used in the manufacturing process.

12. Excise duty cannot, therefore, be treated differently from other expenses for the purpose of determination of cost for inventory valuation. To do so would be contrary to the basic objective of carrying forward the cost related to inventories until these are sold or consumed.

13. As stated in para 6 above, liability to excise duty arises even on excisable goods manufactured and used in further manufacturing process. In such a case, excise duty paid (if the same is not exempted) on the intermediary product becomes a manufacturing expense. Excise duty paid on such intermediary products must, therefore, be included in the valuation of work-in-process or finished goods manufactured by the subsequent processing of such products.

Provision for Unpaid Excise Duty

14. Since the point of time at which duty is collected is not necessarily the point of time at which the liability to pay the duty arises, situations will often arise when duty remains to be collected on goods which have been manufactured.

The most common of these situations arises when the goods are stored under bond, i.e., in a Bonded Store Room, and the duty is paid when the goods are removed from such Bonded Store Room.

15. Divergent views exist as to whether provision should be made in the accounts for the liability in respect of goods which are not cleared or which are lying in bond at the balance sheet date.

16. The arguments in favour of the creation of liability are briefly summarized under:

(a) The liability for excise duty arises at the point of time at which the manufacture is completed and it is only its collection which is deferred; and

(b) failure to provide for the liability will result in the balance sheet not showing a true and fair view of the state of affairs of the enterprise.

17. The arguments against the creation of the liability, briefly summarised, are as under:

(a) Though the liability for excise duty arises at the point of time at which the manufacture is completed, it gets quantified only when goods are cleared from the factory or the bonded warehouse;

(b) the actual liability for excise duty may get modified by the time the goods are cleared from the factory or bonded warehouse;

(c) where goods are damaged or destroyed before clearance, excise duty may be waived by the competent authority and therefore the duty may never be paid; and

(d) failure to provide for the liability does not affect the profits or losses.

18. Since the liability for excise duty arises when the manufacture of the goods is completed, it is necessary to create a provision for liability of unpaid excise duty on stocks lying in the factory or bonded warehouse. It is true that the recovery of the duty is deferred till the goods are removed from the factory or the bonded warehouse and the exact quantification will, therefore, be at the time of removal and that estimate of duty made on balance sheet date may change on account of subsequent events, e.g., change in the rate of duty and exports under bond. But, this is true of many other items also, e.g., provision for gratuity and this cannot be an argument for not making a provision for existing liability on estimated basis.

19. The estimate of such liability can be made at the rates in force on the balance sheet date. For this purpose, other factors affecting liability should also be considered, e.g., exemptions being availed by

the enterprise, pattern of sales –export, domestic etc. Thus, if a small-scale undertaking is availing the benefit of exemption allowed in a particular financial year and declares that it wishes to avail such exemption during next financial year also, excise duty liability should be calculated after taking into consideration the availability of exemption under the relevant notification. Similarly, if an enterprise is captively consuming all its production of a specific product and has been availing of exemption from payment of duty on that product, no provision for excise duty may be required in respect of non-duty paid stock of that product lying in factory or bonded warehouse. An auditor must, however, apply appropriate audit tests while verifying statements and declarations made by an enterprise in this regard.

Auditor's Responsibility

20. The auditor has a responsibility to express his opinion whether the financial statements on which he reports give a true and fair view of the operating results and state of affairs of the entity. In the case of companies, under MAOCARO, 1988, the auditor has to express an opinion whether the valuation of inventories is fair and proper in accordance with normally accepted accounting principles and is on the same basis as in the earlier years. If there is any change in the basis of valuation, the effect of such change, if material, is to be reported.

21. As explained in this Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation. Similarly, excise duty paid on purchases (other than those subsequently recoverable by the enterprise from the taxing authorities) as well as intermediary products used for manufacture should also be included in the valuation of work-in progress or finished goods.

22. If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report. In the case of a company, reference to this qualification should also be made in the auditor's report under section 227(4A) of the Companies Act, 1956.

23. Summary of Recommendations

(i) Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

(ii) Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods.

(iii) Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made.

(iv) Excise duty cannot be treated as a period cost.

(v) If the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

GN(A) 25 (Revised 2000)
Guidance Note on Accounting Treatment for MODVAT / CENVAT

(The following is the text of the Guidance Note on Accounting Treatment for MODVAT/CENVAT, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The Guidance Note on Accounting Treatment for MODVAT was first issued in March 1988. The Guidance Note was revised in July 1995 in view of extension of MODVAT Credit Scheme to capital goods. The Guidance Note is revised again with the issuance of revised Accounting Standard (AS) 2 on 'Valuation of Inventories', which has come into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature. This revised Guidance Note is issued in supersession of the earlier Guidance Note issued in July 1995, and is effective in respect of accounting for MODVAT for accounting periods beginning on or after April 1, 1999. With the substitution of the MODVAT Credit Scheme with CENVAT Credit Scheme w.e.f. 1.4.2000, this revised Guidance Note also deals with accounting treatment in respect of the latter Scheme.

Objective

2. The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT credit schemes are briefly set out hereinafter. Reference may be made to Central Excise Act, 1944, Central Excise Rules, 1944, Notifications and Circulars issued from time to time for details of the provisions of MODVAT/CENVAT Schemes. Guidance for accounting for excise duty is provided in the Guidance Note on Accounting Treatment for Excise Duty, which has been revised and issued separately.

MODVAT Credit Scheme (Upto 31.3.2000) – Salient

Features

3. Modified Value Added Tax (MODVAT) Scheme allows instant credit of specified duties paid on specified inputs used in or in relation to manufacture of specified final excisable goods to be utilised for payment of *552 Compendium of Guidance Notes – Accounting* excise duties in respect of such goods. The Scheme covers imported goods as also those acquired indigenously. Specified duty in relation to imported goods is countervailing duty and in case of indigenous goods is excise duty, additional excise duty under Additional Duties of Excise (Textile and Textile Articles) Act, 1978 as also additional excise duty under Additional Duties of Excise (Goods of Special Importance) Act, 1957.

4. MODVAT Scheme was introduced in 1986, effective from 1.3.86, with a view to reduce the cascading effect of duties. Initially, the Scheme was restrictive in its application in that

(i) it applied only to limited categories of inputs and final goods; and

(ii) use of inputs in or in relation to manufacture of final goods was essential for utilisation of duty credit for payment of excise duties on clearance of such final goods. In other words, correlation of inputs and final goods was essential though one to one correlation of inputs was not essential.

5 Significant amendments have since been made to the MODVAT Scheme and the scope of the Scheme has been expanded considerably. Salient features of the Scheme are summarised hereinafter.

6. The Scheme applies to inputs ('Input Duty Credit Scheme') and capital goods ('Capital Goods Duty Credit Scheme').

Input Duty Credit Scheme

7. Provisions in relation to this Scheme are contained in Rules 57A to 57J of the Central Excise Rules, 1944. The Scheme covers inputs and final products classifiable under any of the headings of the Chapters of the Central Excise Tariff Act, 1985. The salient features of the Input Duty Credit Scheme are as follows:

(i) The Scheme is operative only when excise duty is payable on final goods. Thus, MODVAT credit cannot be availed of if the final goods are exempted from duty or are chargeable to nil rate of duty. However, the Scheme is operative in case the final goods enjoy partial exemption from duty.

(ii) Correlation between inputs and final goods is not required, i.e., *Accounting Treatment for MODVAT/CENVAT 553* duty credit in respect of any input brought into the factory can be utilised for payment of duty on any final product manufactured in that factory even if that input is not used in or in relation to manufacture of that final product.

(iii) A manufacturer is required to debit RG 23A or account current with an amount equal to 10% of the value of inputs or partially processed inputs removed from his factory for job work. The said amount is available as credit on return of processed/final goods to his factory from job workers' premises or on clearance of such processed/final goods from job workers' premises, if so permitted by the Commissioner, within specified time period.

The debited amount is also available for adjustment against duty payable on such inputs or partially processed inputs not received back within specified time.

(iv) If common inputs are used in manufacture of final products which do not attract duty liability as also those which are chargeable to duty, manufacturer (except in specified cases) is required to pay an amount equal to 8% of the price of products not chargeable to duty at the time of clearance of such products.

8. Supreme Court in a recent judgement in the case of *CCE, Pune vs. Dai Ichi Karkaria Ltd.* [1999 (112) ELT 353; decided on 11.8.99] had occasion to summarise the Scheme. Relevant extract from the decision is reproduced below:

"It is clear from these Rules, as we read them, that a manufacturer obtains credit for the excise duty paid on raw material to be used by him in the production of an excisable product immediately it makes the requisite declaration and obtains an acknowledgement thereof.

It is entitled to use the credit at any time thereafter when making payment of excise duty on the excisable product. There is no provision in the Rules which provides for a reversal of the credit by the excise authorities except where it has been illegally or irregularly taken, in which event it stands cancelled or, if utilised, has to be paid for. We are here really concerned with credit that has been validly taken, and its benefit is available to the manufacturer without any limitation in time or otherwise unless the manufacturer itself chooses not to use the raw material in its excisable product. The credit is, therefore, indefeasible. It should also be noted there is no co-relation of the raw material and the final product; that is to say, it is not as if credit can be taken only on a final product that is manufactured out of the particular raw material to which the credit is related. The credit may be taken against the excise duty on a final product manufactured on the very day that it becomes available."

Capital Goods Duty Credit Scheme

9. Provisions in relation to this Scheme are contained in Rules 57Q to 57U of the Central Excise Rules, 1944. The salient features of the Capital Goods Duty Credit Scheme are as follows:

(i) The Scheme covers specified capital goods used in the factory of the manufacturer in relation to the production of specified final products;

(ii) A manufacturer would not be entitled to the MODVAT credit on capital goods until the capital goods are installed or, as the case may be, used for manufacture of excisable goods, in the factory of the manufacturer;

(iii) A manufacturer has option to:

  (a) avail MODVAT credit in respect of duty paid on capital goods as per the Rules; or

  (b) claim depreciation on duty element under Section 32 of the Income-tax Act, 1961 or claim deduction of duty element by way of revenue expenditure under any section of the Income-tax Act, 1961, as the case may be;

(iv) A manufacturer can claim MODVAT credit of the duty element of capital goods even if capital goods are acquired on lease, hire-purchase or loan agreement if specified duty is paid by manufacturer either directly to capital goods supplier or to the finance company before payment of first lease/hire-purchase or loan installment, as the case may be.

General

10. The general salient features relevant to Input Duty Credit Scheme and Capital Goods Duty Credit Scheme are as below:

(i) A manufacturer is required to comply with various procedural requirements, in particular, filing of declaration, and maintenance of register of receipts, issues and balance of inputs and capital goods in Form RG-23A Part I and RG-23C Part I, respectively.

It is also required to maintain registers related to MODVAT credit in respect of inputs and capital goods in Form RG-23A Part II and RG-23C Part II, respectively.

(ii) There is no time limit for utilisation of MODVAT credit. Government is, however, empowered to provide for lapsing of unutilised credit balances for specific products.

(iii) Cash refund of duty credit is not allowable except in case of export of goods if the manufacturer is unable to utilise duty credit towards payment of excise duty on clearance of final goods from his factory.

CENVAT Scheme (Effective From 1.4.2000) – Salient

Features

11. Modified Value Added Tax (MODVAT) scheme has been replaced by Central Value Added Tax (CENVAT) Scheme with effect from 1.4.2000.

The same is contained in newly inserted Rules 57AA to 57AK. CENVAT Scheme, in essence, is the same as MODVAT Scheme except that it is simpler in that, the erstwhile separate schemes for inputs and capital goods are merged into one under CENVAT Scheme. The scope of the Scheme is also expanded in that all inputs (except High Speed Diesel Oil and Petrol) and specified capital goods (except equipments or appliances used in office) are covered in the Scheme.

12. Procedural simplifications have been introduced and requirement of filing declarations has been dispensed with.

13. The major difference between MODVAT and CENVAT Schemes is in relation to capital goods. The CENVAT credit in respect of capital goods received in a factory at any point of time in a given financial year is allowed to be taken only for an amount not exceeding fifty percent of the duty paid on such capital goods in the same financial year. The balance of CENVAT credit can be taken in any financial year(s) subsequent to the financial year in which the capital goods were received in the factory of the manufacturer provided capital goods are still in the possession and use of the manufacturer of final products in such subsequent year(s). The condition of possession and use is not applicable to

components, spares and accessories, refactories and refractory materials and goods falling under Tariff Heading 68.02 and sub-heading 6801.10 of first Schedule of the Central Excise Tariff Act, 1985, if they are not removed without use.

14. Outstanding balances in MODVAT Credit accounts are allowed to be transferred to the CENVAT Credit accounts and utilized as per the CENVAT Scheme.

Accounting Treatment in case of Inputs Used in or in relation to Manufacture of Final Products

15. In the light of the basic features of 'MODVAT/CENVAT' discussed above, it may be stated that MODVAT/CENVAT is a procedure whereby the manufacturer can utilise credit for specified duty on inputs against duty payable on final products. Duty credit taken on inputs is of the nature of setoff available against the payment of excise duty on the final products.

16. Specified duty paid on inputs may be debited to a separate account, e.g., MODVAT/CENVAT Credit Receivable (Inputs) Account. As and when MODVAT/CENVAT credit is actually utilised against payment of excise duty on final products, appropriate accounting entries will be required to adjust the excise duty paid out of MODVAT/CENVAT Credit Receivable (Inputs) Account to the account maintained for payment/provision for excise duty on final product. In this case, the purchase cost of the inputs would be net of the specified duty on inputs. Therefore, the inputs consumed and the inventory of inputs would be valued on the basis of purchase cost net of the specified duty on inputs. The debit balance in MODVAT/CENVAT Credit Receivable (Inputs) Account should be shown on the assets side under the head 'advances'.

An illustration of the above method is given in Annexure 'A'.

17. It may be appropriate to quote the following paragraphs nos. 6 and 7, dealing with 'cost of inventories' and 'costs of purchase', of Accounting Standard (AS) 2 (Revised) on 'Valuation of Inventories', issued by the Institute of Chartered Accountants of India.

"6. The cost of inventories should comprise all costs of purchases, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase." Particular attention is invited to the paragraph related to 'costs of purchase', according to which, only those duties have to be included as costs of purchase which are not subsequently recoverable by the enterprise from the taxing authorities. Since the specified duty on inputs is available for setoff against the excise duty on final products, it is considered of the nature of duty recoverable from taxing authorities.

18. A question may arise as to when the 'MODVAT/CENVAT' credit should be taken if documents evidencing payment of specified duty on inputs are received later than the physical receipt of the goods. According to the accrual concept of accounting, one may account for such credit, provided one is reasonably certain of getting the said documents at a later date.

Change in Accounting Policy

19. In cases, where enterprises were accounting for MODVAT credit on inputs in accordance with the erstwhile inclusive method, i.e., the second alternative1 recommended in the earlier edition (1995) of the Guidance Note on Accounting Treatment for MODVAT, they will have to change the method of accounting in accordance with paragraph 16 of this Guidance Note. Accordingly, such an enterprise will

have to adjust the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, in such a way so that the opening stock should appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. This could be done by adjusting the amount of opening stock in respect of the accounting periods commencing on or after April 1, 1999, by the amount of the balance lying in the MODVAT credit availed account. Further, an amount equal to the balance of RG23A register, representing the MODVAT credit receivable in respect of the inputs purchased in the earlier years should be transferred to MODVAT Credit Receivable Account2 with a corresponding adjustment in the amount of opening stock. After the aforesaid adjustments, the MODVAT Credit Receivable Account should also appear at the amount which would have been arrived at had the method suggested in paragraph 16 of this Guidance Note been followed. An example illustrating the change in accounting policy has been given as Annexure B. Appropriate disclosures as per Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, are also required to be made in the financial statements for change in accounting policy.

Accounting Treatment – Job-work

Accounting treatment in case of inputs and/or partially processed inputs sent outside the factory to job-worker for further processing

20. In a case where an enterprise removes inputs as such or in a partially processed form to a place outside the factory for the purpose of testing, repairing, refining, reconditioning or carrying out any other operations necessary for manufacture of final products, the enterprise is required to debit MODVAT Credit Register (RG 23A) or account current with an amount equal to 10% of the value of inputs or partially processed inputs, as the case may be. The said debit is in the nature of deposit and is available for credit at the time of return of duly processed goods to the factory within the prescribed time. The said deposit is also available for adjustment against duty payment if the goods are not received back in the factory within the prescribed time limit. If this amount is debited to MODVAT Credit Register (RG 23A), the same should be accounted for as a deposit and should be debited to a separate account with appropriate nomenclature say, 'MODVAT Credit Deposit (Job work) Account' and credited to 'MODVAT Credit Receivable Account'. This deposit amount should be credited and 'MODVAT Credit Receivable Account' should be debited at the time of receipt of duly processed goods in the factory within the prescribed time limit or for adjustment of duty if the goods are not received back in the factory within the prescribed time limit. *This requirement of debit has been dispensed with under CENVAT Scheme.*

Accounting treatment in case of inputs received by enterprise for further processing on job-work basis

21. An enterprise may receive inputs from a principal for processing and/ or converting to final products on job work basis and may be required to avail MODVAT/CENVAT credit on such inputs and discharge duty liability on clearance of final products on behalf of the principal; the ownership of the inputs and final products continuing to be of the principal. In such cases, the enterprise should, at the time of taking MOVDAT/CENVAT credit, debit an appropriate account say, 'MODVAT/CENVAT Credit Receivable Account' and the account to be credited would depend upon the terms of job work with the principal. If the enterprise is required to bear excise duty burden, 'Excise Duty Account' should be credited. If, on the other hand, excise duty is to be paid on the principal's account, 'Principal Account' should be credited. Similarly, in former case, excise duty paid on clearance of final products should be debited to 'Excise Duty Account' and in latter case to 'Principal Account' and credited to 'MODVAT/CENVAT Credit Receivable Account'.

Accounting Treatment for MODVAT Credit in case of Capital Goods used for Manufacture of Specified Goods

22. In case an enterprise does not avail MODVAT credit on capital goods obviously no accounting treatment would be necessary. The following paragraphs apply only to those situations where an enterprise avails of MODVAT credit on capital goods.

23. Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, states, *inter-alia*, in para 9.1, as follows:

"The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price."

MODVAT credit can be considered is of the nature of a refundable tax. Therefore, MODVAT credit should be reduced from the purchase cost of capital goods concerned.

24. In view of the above, the specified duty on capital goods should be debited to separate account, e.g., MODVAT Credit Receivable (Capital Goods) Account. On actual utilisation, the account will be adjusted against excise duty on final products. Accordingly, the purchase cost of the capital goods would be net of the specified duty on capital goods. The unadjusted balance standing in the MODVAT Credit Receivable (Capital Goods) Account, if any, should be shown on the assets side under the head 'advances'.

25. MODVAT credit in respect of capital goods should be recognised in the books of account when the following conditions are satisfied:

(i) The enterprise is entitled to the MODVAT credit as per the Rules, and

(ii) There is a reasonable certainty that the MODVAT credit would be utilised.

Accounting Treatment for CENVAT Credit in case of Capital Goods

26. The nature of the CENVAT Credit in respect of capital goods is the same as that of MODVAT Credit. However, the CENVAT Credit in respect of capital goods is allowed for an amount not exceeding fifty percent of the duty paid on such capital goods in the financial year in which the goods are received in factory and the balance will be allowed in the subsequent year(s).

In case the conditions specified in para 25 above are met and the enterprise decides to take CENVAT credit, the entire amount of CENVAT Credit should be deducted from the cost of capital goods. The amount of CENVAT credit taken in the financial year, in which goods are received, should be debited to an appropriate account, say, 'CENVAT Credit Receivable (Capital Goods)

Account' and balance may be debited to another appropriate account, say, 'CENVAT Credit Deferred Account'. In the subsequent financial year(s), when balance 'CENVAT credit is availed of, the appropriate adjustment for the same should be made, i.e., amount of CENVAT credit availed of should be credited to 'CENVAT Credit Deferred Account' with a corresponding debit to 'CENVAT Credit Receivable (Capital Goods) Account'.

Accounting Treatment Where Capital Goods are acquired on Lease or Hire Purchase

27. MODVAT/CENVAT credit is available to the lessee or hirer where the capital goods have been acquired on lease or hire purchase. The accounting treatment in this regard is described hereinafter.

28. In the books of the lessor, where the financing arrangement also covers the specified duty on capital goods, the asset given on lease should be shown at purchase cost net of the specified duty on the capital goods. The specified duty on capital goods, which would be availed of as MODVAT/CENVAT credit by the lessee, should be recorded and disclosed separately as the duty recoverable from the lessee. This will not form part of 'Minimum Lease Payments' in view of the definition of the aforesaid term reproduced below from the Guidance Note on Accounting for Leases, issued by the Institute of Chartered Accountants of India:

"*Minimum Lease Payments:* The payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value."

Where the specified duty on capital goods does not form part of the financing arrangement and the lessee pays the duty directly to the supplier, obviously the same need not be recorded in the books of the lessor. In the books of the lessee, MODVAT/CENVAT credit receivable on the capital assets acquired on lease should be treated in the same manner as recommended in paras 24 and 26 above, except that the cost of the relevant leased capital asset and depreciation is not accounted in the books of the lessee.

29. Capital asset acquired on hire purchase should be recorded and disclosed at net cash value, i.e., cash value net of MODVAT/CENVAT credit receivable in the books of the hirer. The other accounting treatment in relation to MODVAT/CENVAT in the books of the hirer should be the same as if the asset has been acquired on outright purchase basis. The aforesaid accounting treatment, in the books of the hirer, should be made whether or not the specified duty on the capital goods forms part of the financing arrangement.

In the books of the vendor, in case the specified duty on capital goods forms part of the hire purchase arrangement and the benefit of MODVAT/CENVAT credit is available to the hirer, the vendor should book the sale in the normal course inclusive of the specified duty on the capital goods. However, where the specified duty on the capital goods does not form part of the financing arrangement and the hirer directly assumes the liability in respect thereof, the same need not be recorded in the books of the vendor.

Review of Balances in MODVAT/CENVAT Credit Receivable Accounts

30. Balances in MODVAT/CENVAT Credit Receivable Accounts, pertaining to both inputs and capital goods, should be reviewed at the end of the year and if it is found that the balances of the MODVAT/CENVAT credit are not likely to be used in the normal course of business within a reasonable time, then, notwithstanding the right to carry forward such excess credit in the Excise Rules, the non-useable excess credit should be adjusted in the accounts. The consequence would be that the balances of the MODVAT/ CENVAT Credit Receivable Accounts in the financial accounts may be lower than the credit available as per the MODVAT/CENVAT Credit registers. In such a case, a reconciliation statement would have to be prepared indicating the amounts adjusted so that a track is kept for the difference between the balances and the difference between the financial accounts and the credit available as per the excise registers can be explained in subsequent years also.

31. (a) The above adjustment related to input credit should be made to the raw material or input purchase account. The effect of this would be to increase the cost of purchase and thereby to increase the cost of inputs for the purpose of accounting for consumption and valuation of closing stocks. Where it is not possible to debit or identify this excess credit to a particular lot or lots of materials purchased, such excess credit may be apportioned over the entire purchases of raw materials, components etc., entitled to MODVAT/CENVAT credit during the year on pro-rata basis.

(b) The adjustment of excess credit related to capital goods should be made to the concerned Capital Goods Account. The excess MODVAT/ CENVAT credit, either availed or deferred, which relates to fixed assets acquired, should be added to the cost of the relevant fixed asset. For accounting purposes, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset. In case the fixed asset no longer exists, the relevant amount should be written-off in the profit and loss account. To facilitate aforesaid treatment, MODVAT/CENVAT credit record should be maintained fixed asset-wise in the relevant RG Register. In relation to capital goods other than fixed assets, the accounting treatment for the excess MODVAT/CENVAT credit would be the same as stated in para 31(a) above. It is, therefore, advisable that MODVAT/CENVAT Credit Receivable (Capital Goods) Account is maintained separately for fixed assets and other capital goods.

(c) For capital goods acquired on lease, the amount of excess MODVAT/ CENVAT credit should be written-off on a pro-rata basis along with the lease rentals.

32. Where, at any time during the year, it is revealed that the terms and conditions subject to which the benefit of MODVAT/CENVAT credit is available, have not been complied with or are not being capable of compliance, e.g., where the inputs are destroyed prior to the manufacture of final product or the relevant plant and machinery cannot be put to use for the manufacture of final product, appropriate adjustments should be made in the accounts to reverse such credit which cannot be availed of, as recommended in para 31 (a) for inputs and 31 (b) and (c) for capital goods.

Accounting Treatment for Duty Demands paid by Debit to MODVAT/CENVAT Credit Balance – Inputs and/ or Capital Goods

33. An enterprise may choose to discharge excise duty demands made by Central Excise Department from time to time by way of debit to MODVAT/ CENVAT credit balance pertaining either to inputs or to capital goods. In that case, the duty demand so paid out of the MODVAT/CENVAT credit *564 Compendium of Guidance Notes – Accounting* balance should be debited to appropriate account, depending upon the nature of demand and credit should be given to MODVAT/CENVAT Credit Receivable Account. For example, if the duty demand pertains to excise duty on finished goods, the same should be debited to excise duty account. If, on the other hand, it pertains to disallowance of MODVAT/CENVAT credit taken on purchase of raw materials during the year, the same should be added to the cost of inputs. Appropriate adjustment in that case would have to be made while valuing inventory of inputs. If the duty demand pertains to disallowance of MODVAT/CENVAT credit in respect of purchases effected in earlier years, the accounting treatment would depend on whether the said inputs are consumed or are available in stock. If they are consumed, the disallowance should be debited to excise duty account and treated as expense of the current year. If raw materials are still lying in stock, duty demand should be added to the cost of stock of inputs.

Valuation of Inventories of Inputs

34. The inventory of inputs should be valued at net of input duty. In other words, the specified duty paid on inputs will not form part of the cost of inventories. Balance in MODVAT/CENVAT Credit Receivable (Inputs) Account should be shown in the Balance Sheet under the head ‘advances’ on the assets side.

35. In some cases ‘inputs’ may be exempted from excise duty in the hands of the supplier, e.g., job charges are exempt from excise duty provided the prescribed procedures are observed. Small-scale suppliers who are in the exempted category may also supply the inputs free from the levy of excise duty. In such circumstances normal valuation rules in determining the cost of inventories are to be

applied as these are not subject to the specified duty on inputs relief. Where purchases are made from the dealers who are not eligible under the Central Excise Rules to pass MODVAT/CENVAT credit and, therefore, cannot issue an invoice in accordance with the aforesaid Rules, the valuation should be made at the actual cost inclusive of excise duty.

36. In some cases, the same item of input can be obtained from different sources, some of them may be able to provide the required documents evidencing payment of duty while others may not be able to provide the required documents. In such cases where it is not possible for the buyer to take advantage of the MODVAT/CENVAT credit, the closing stock of inputs of such items should be valued inclusive of the specified duty on inputs. *Accounting Treatment for MODVAT/CENVAT 565* 37. If any input is used for the production of more than one final product, some of which are excisable while others are either not chargeable to excise duty or chargeable at nil rate of duty, and separate inventory of the input is not maintained, the entire inventory of inputs should be valued at net of input duty. However, if separate inventory is being maintained, the inventory of inputs useable for final products chargeable to excise duty should be valued at net of input duty and the inventory of inputs useable for final products not chargeable to duty should be valued at the actual cost inclusive of excise duty.

38. While valuing inventories of final products 4, the value of inputs should be net of the duty on inputs, that is, the purchase cost as reduced by the MODVAT/CENVAT credit.

Valuation of Inventory of Capital Goods

39. Inventories of capital goods should be valued net of MODVAT/ CENVAT credit taken on capital goods. In other words, specified duties paid on such capital goods will not form part of their cost.

Note: For Accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India.

ANNEXURE A

Illustration of Accounting for MODVAT/CENVAT Credit on Inputs

The illustration is based on the following assumptions:

(i) There is an opening stock of 10 units purchased at ₹ 10/- per unit (Excise duty paid on these units was @ ₹ 2/- per unit).

(ii) 100 units of raw materials are purchased at ₹ 10/- per unit, plus ₹ 2/-for excise duty, aggregating to ₹ 12/-.

(iii) 70 units of raw material are consumed in a process involving manufacture of a component. All the 70 units are sold in the year. The balance 40 units are manufactured and sold in the subsequent year.

(iv) The manufactured components are sold at a price of ₹ 15/- per unit (including excise duty ₹ 3/- per unit).

(v) MODVAT/CENVAT credit is available on the raw material purchased and can be set-off against the excise duty payable on the final product.

(vi) Conversion costs are ignored.

Profit & Loss Account

Particulars	Units	Rate	Amount		Particulars	Units	Rate	Amount
To Opening Stock of Raw Materials	10	10	100		By Sales	70	15	1,050
To Purchases of Raw Materials	100	10	1,000					

	110	10	1,100					
Less: Stock of Raw Materials	40	10	400	700				
To Excise Duty	70	3		210				
To Gross Profit				140				
				1,050				1,050

Note

1. Opening balance of the MODVAT/CENVAT Credit Receivable Account is ₹ 20/-.
2. Besides showing stock of raw materials at ₹ 400/-, the Balance Sheet would also reflect, 'MODVAT/CENVAT Credit Receivable Account' at ₹ 10/-, arising out of the following entries:

(a) Purchase A/c Dr. 1,000

MODVAT/CENVAT Credit Receivable A/c Dr. 200

To Sundry Creditors 1,200

(Being the purchase of 100 units at ₹ 10/- plus ₹ 2/- for excise duty in respect of which the company is eligible to claim MODVAT/CENVAT credit)

(b) Excise Duty A/c Dr. 210

To MODVAT/CENVAT Credit Receivable A/c 210

(Being the payment of excise duty out of MODVAT/CENVAT credit available to the company)

Balance Sheet

Liabilities	Amount	Assets	Amount
		Current Assets, Loans and Advances	
		(A) Current Assets	
		Inventory of raw materials	400
		(B) Loans and Advances	
		MODVAT/CENVAT Credit Receivable A/c	10

The opening balances of inventories of raw materials and MODVAT/CENVAT Receivable Account, for the next year, would be ₹ 400/- and ₹ 10/-, respectively.

ANNEXURE 'B'

Illustration of Change in Accounting Policy

(See paragraph 19 of the Guidance Note)

Continuing the illustration given in Annexure 'A' and supposing that an enterprise followed the erstwhile inclusive method for accounting for MODVAT credit, the accounting treatment as per this method would be as follows:

Profit & Loss Account

Particulars	Units	Rate	Amount	Particulars	Units	Rate	Amount
To Opening Stock of Raw Materials	10	12	120	By Sales	70	15	1,050
To Purchases of Raw Materials	100	12	1,200				

	110	12	1,320				
Less: Stock of Raw Materials	40	12	480				
Raw Material consumed	70	12	840				
Less: MODVAT Credit	70	2	140				
	70	10	700				
To Excise Duty	70	3	210				
To Gross Profit			140				
			1,050				1,050

Note:

(1) Opening Balance of MODVAT Credit Availed A/c was Nil.

(2) Besides showing stock of raw material at ₹480, the balance of 'MODVAT Credit Availed Account' would be ₹ 70, arising out of the following entries:

(a) At the time when credit is availed of and adjusted against the excise duty which becomes payable:

Excise Duty A/c Dr. ₹ 210

To MODVAT Credit Availed A/c ₹ 210

(Being the payment of excise duty from the MODVAT Credit available to the company)

(b) At the year end, to the extent raw material items have been consumed in the production:

MODVAT Credit Availed A/c Dr. ₹ 140

To Material Consumed ₹ 140

(Being the set off the MODVAT credit availed against materials consumed)

Balance Sheet

Liabilities	Amount	Assets		Amount
		Current Assets, Loans and Advances		
		(A) Current Assets		
		Inventory of Raw Material	480	
		Less: MODVAT Credit Availed A/c	70	410

In the above example, the RG 23A register would show a balance of ₹ 10 representing the MODVAT credit receivable in respect of inputs purchased.

Now the enterprise changes the accounting policy to that recommended in paragraph 16 the Guidance Note.

In that case, the following journal entries will be passed (See paragraph 19):

I. MODVAT Credit Availed A/c Dr. ₹ 70

To Opening Stock ₹ 70

(Being the opening stock adjusted by the balance of MODVAT Credit Availed Account).

II. MODVAT Credit Receivable A/c Dr. ₹ 10

To Opening Stock ₹ 10

(Being an amount equal to the balance of RG 23A register, representing the MODVAT credit receivable in respect of inputs purchased transferred to MODVAT Credit Receivable Account)

As a result of above entries, the figures of opening stock and MODVAT Credit Receivable A/c would appear at ₹ 400 (i.e. ₹480-70-10) and ₹10 respectively. It may be noted that these figures are the same had the method suggested in paragraph 16 of the Guidance Note been followed.

(See note to the balance sheet in the illustration given in Annexure A of the Guidance Note).

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Guidance Note on Accounting for Employee Share-based Payments

(The following is the text of the Guidance Note on Accounting for Employee Share-based Payments, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. Some employers use share-based payments as a part of remuneration package for their employees. Such payments generally take the forms of Employee Stock Option Plans (ESOPs), Employee Stock Purchase Plans (ESPPs) and stock appreciation rights. ESOPs are plans under which an enterprise grants options for a specified period to its employees to purchase its shares at a fixed or determinable price. ESPPs are plans under which the enterprise grants rights to its employees to purchase its shares at a stated price at the time of public issue or otherwise. Stock appreciation rights is a form of employee share-based payments whereby the employees become entitled to a future cash payment or shares based on the increase in the price of the shares from a specified level over a specified period. Apart from using share-based payments to compensate employees for their services, such payments are also used by an employer as an incentive to the employees to remain in its employment or to reward them for their efforts in improving its performance.

2. Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute of Chartered Accountants of India is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. The Guidance Note recognises that there are two methods of accounting for employee share-based payments, viz., the fair value method and the intrinsic value method and permits as an alternative the intrinsic value method with fair value disclosures. Once the Accounting Standard dealing with Share based Payments comes into force, this Guidance Note will automatically stand withdrawn.

Scope

3. This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., ESOPs, ESPPs and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

4. For the purposes of this Guidance Note, a transfer of shares or stock options of an enterprise by its shareholders to its employees is also an employee share-based payment, unless the transfer is clearly for a purpose other than payment for services rendered to the enterprise. This also applies to transfers of shares or stock options of the parent of the enterprise, or shares or stock options of another enterprise in the same group1 as the enterprise, to the employees of the enterprise.

5. For the purposes of this Guidance Note, a transaction with an employee in his/her capacity as a holder of shares of the enterprise is not an employee share-based payment. For example, if an enterprise grants all holders of a particular class of its shares the right to acquire additional shares or stock options of the enterprise at a price that is less than the fair value of those shares or stock

options, and an employee receives such a right because he/she is a holder of shares or stock options of that particular class, the granting or exercise of that right is not subject to the requirements of this Guidance Note.

6. For the purposes of this Guidance Note, a grant of shares to the employees at the time of public issue is not an employee share-based payment if the price and other terms at which the shares are offered to employees are the same or similar to those at which the shares have been offered to general investors, for example, in a public issue an enterprise grants shares to its employees as a preferential allotment while the price and other terms remain the same as those to other investors.

Definitions

7. For the purpose of this Guidance Note, the following terms are used with the meanings specified:

Employee Stock Option is a contract that gives the employees of the enterprise the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the enterprise at a fixed or determinable price.

Employee Stock Option Plan is a plan under which the enterprise grants Employee Stock Options.

Employee Stock Purchase Plan is a plan under which the enterprise offers shares to its employees as part of a public issue or otherwise.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Exercise means making of an application by the employee to the enterprise for issue of shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Exercise Period is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the Employee Stock Option Plan.

Expected Life of an Option is the period of time from grant date to the date on which an option is expected to be exercised.

Exercise Price is the price payable by the employee for exercising the option granted to him in pursuance of the Employee Stock Option Plan.

Fair Value is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Grant Date is the date at which the enterprise and its employees agree to the terms of an employee share-based payment plan. At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic Value is the amount by which the quoted market price of the underlying share in case of a listed enterprise or the value of the underlying

Accounting for share determined by an independent valuer in case of an unlisted enterprise, exceeds the exercise price of an option.

Market Condition is a condition upon which the exercise price, vesting or exercisability of a share or a stock option depends that is related to the market price of the shares of the enterprise, such as attaining a specified share price or a specified amount of intrinsic value of a stock option, or achieving a specified target that is based on the market price of the shares of the enterprise relative to an index of market prices of shares of other enterprises.

Reload Feature is a feature that provides for an automatic grant of additional stock options whenever the option holder exercises previously granted options using the shares of the enterprise, rather than cash, to satisfy the exercise price.

Reload Option is a new stock option granted when a share of the enterprise is used to satisfy the exercise price of a previous stock option.

Repricing of an employee stock option means changing the existing exercise price of the option to a different price.

Stock Appreciation Rights are the rights that entitle the employees to receive cash or shares for an amount equivalent to any excess of the market value of a stated number of enterprise's shares over a stated price. The form of payment may be specified when the rights are granted or may be determined when they are exercised; in some plans, the employee may choose the form of payment.

Vest is to become entitled to receive cash or shares on satisfaction of any specified vesting conditions under an employee share-based payment plan.

Vesting Period is the period between the grant date and the date on which all the specified vesting conditions of an employee share-based payment plan are to be satisfied.

Vesting Conditions are the conditions that must be satisfied for the employee to become entitled to receive cash, or shares of the enterprise, pursuant to an employee share-based payment plan. Vesting conditions include service conditions, which require the employee to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the enterprise's share price over a specified period of time).

Volatility is a measure of the amount by which a price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period.

Accounting

8. For accounting purposes, employee share-based payment plans are classified into the following categories:

(a) *Equity-settled:* Under these plans, the employees receive shares.

(b) *Cash-settled:* Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.

(c) *Employee share-based payment plans with cash alternatives*: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

9. A share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended herein below is based on the fair value method. The application of the intrinsic value method is explained thereafter in paragraph 40.

Equity-Settled Employee Share-Based Payment Plans

Recognition

10. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the subsequent paragraphs of this Guidance Note.

11. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account.

12. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

Determination of vesting period

13. A grant of shares or stock options to an employee is typically conditional on the employee remaining in the employment of the enterprise for a specified period of time. Thus, if an employee is granted stock options conditional upon completing three years' service, then the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over that three-year vesting period.

14. There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the share price of the enterprise. Thus, if an employee is granted stock options conditional upon the achievement of a performance condition and remaining in the employment of the enterprise until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over the expected vesting period. The enterprise should estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted, and should not be subsequently revised. If the performance condition is not a market condition, the enterprise should revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Measurement

15. Typically, shares (under ESPPs) or stock options (under ESOPs) are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the shares or stock options granted. Furthermore, shares or stock options are sometimes granted as part of a bonus arrangement, rather than as a part of basic pay, e.g., as an incentive to the employees to remain in the employment of the enterprise or to reward them for their efforts in improving the performance of the enterprise. By granting shares or stock options, in addition to other remuneration, the enterprise is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of the services received, the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted.

Determining the fair value of shares or stock options granted

16. An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 18 to 21). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 18 to 21).

17. Appendix I contains further guidance on the measurement of the fair value of shares and stock options, focusing on the specific terms and conditions that are common features of a grant of shares or stock options to employees.

Treatment of vesting conditions

18. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 20.

19. To apply the requirements of paragraph 18, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest, subject to the requirements of paragraph 20.

2The term 'forfeiture' is used to refer only to an employee's failure to earn a vested right to obtain shares or stock options because the specified vesting conditions are not satisfied.

20. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. Therefore, for grants of shares or stock options with market conditions, the enterprise should recognise the services received from an employee who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified period of service), irrespective of the fact whether that market condition is satisfied.

Treatment of a reload feature

21. For options with a reload feature, the reload feature should not be taken into account when estimating the fair value of options granted at the grant date. Instead, a reload option should be accounted for as a new option grant, if and when a reload option is subsequently granted.

After vesting date

22. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt

of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

Appendix II contains various illustrations of the accounting for equity settled employee share-based payment plans that do not involve modifications to the terms and conditions of the grants.

Modifications to the terms and conditions on which shares or stock options were granted, including cancellations and settlements

23. An enterprise might modify the terms and conditions on which the shares or stock options were granted. For example, it might reduce the exercise price of options granted to employees (i.e., reprice the options), which increases the fair value of those options.

24. The enterprise should recognise, as a minimum, the services received measured at the grant date fair value of the shares or stock options granted, unless those shares or stock options do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of (a) any modifications to the terms and conditions on which the shares or stock options were granted, or (b) a cancellation or settlement of that grant of shares or stock options. In addition, the enterprise should recognise the effects of modifications that increase the total fair value of the employee share-based payment plan or are otherwise beneficial to the employee.

25. The requirements of paragraph 24 should be applied as follows:

(a) If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, the enterprise should include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the shares or stock options granted. The incremental fair value granted is the difference between the fair value of the modified shares or stock options and that of the original shares or stock options, both estimated as at the date of the modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified shares or stock options vest, in addition to the amount based on the grant date fair value of the original shares or stock options, which is recognized over the remainder of the original vesting period. If the modification occurs after the vesting date, the incremental fair value granted is recognised immediately, or over the vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to those modified shares or stock options.

(b) Similarly, if the modification increases the number of shares or stock options granted, the enterprise should include the fair value of the additional shares or stock options granted, measured at the date of the modification, in the measurement of the amount recognised for services received as consideration for the shares or stock options granted, consistent with the requirements in (a) above. For example,

    if the modification occurs during the vesting period, the fair value of the additional shares or stock options granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional shares or stock options vest, in addition to the amount based on the grant date fair value of the shares or stock options originally granted, which is recognised over the remainder of the original vesting period.

(c) If the enterprise modifies the vesting conditions in a manner that is beneficial to the employee, for example, by reducing the vesting period or by modifying or eliminating a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

26. Furthermore, to apply the requirements of paragraph 24, if the enterprise modifies the terms or conditions of the shares or stock options granted in a manner that reduces the total fair value of the employee share-based payment plan, or is not otherwise beneficial to the employee, the enterprise should nevertheless continue to account for the services received as consideration for the shares or stock options granted as if that modification had not occurred (other than a cancellation of some or all the shares or stock options granted, which should be accounted for in accordance with paragraph 27). For example:

(a) if the modification reduces the fair value of the shares or stock options granted, measured immediately before and after the modification, the enterprise should not take into account that decrease in fair value and should continue to measure the amount recognised for services received as consideration for the shares or stock options based on the grant date fair value of the shares or stock options granted.

(b) if the modification reduces the number of shares or stock options granted to an employee, that reduction should be accounted for as a cancellation of that portion of the grant, in accordance with the requirements of paragraph 27.

(c) if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, for example, by increasing the vesting period or by modifying or adding a performance condition (other than a market condition, changes to which are accounted for in accordance with (a) above), the enterprise should not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20.

27. If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) the enterprise should account for the cancellation or settlement as an acceleration of vesting, and should therefore recognize immediately the amount that otherwise would have been recognised for services received over the remaining vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognised as an expense.

(c) if new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options, in accordance with paragraphs 24 to 26. For the purposes of the aforesaid paragraphs, the incremental fair value granted is the difference between the fair value of the replacement shares or stock options and the net fair value of the cancelled shares or stock options, at the date the replacement shares or stock options are granted. The net fair value of the cancelled shares or stock options is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the shares or stock options that is deducted from the relevant equity account in accordance with (b) above.

28. If an enterprise settles in cash vested shares or stock options, the payment made to the employee should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options, measured at the settlement date. Any such excess should be recognised as an expense.

Appendix III contains illustrations on modifications to the terms and conditions on which stock options were granted.

Cash-Settled Employee Share-Based Payment Plans

29. An enterprise might grant rights such as stock appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than shares), based on the increase in the share price of the enterprise from a specified level over a specified period of time. Or an enterprise might grant to its employees a right to receive a future cash payment by granting to them a right to shares (including shares to be issued upon the exercise of stock options) that are redeemable, either mandatorily (e.g., upon cessation of employment) or at the option of the employee.

Recognition

30. An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in a cash-settled employee share-based payment plan when it receives the services with a corresponding increase in liability by creating a provision therefor.

31. The enterprise should recognise the services received, and the liability to pay for those services, as the employees render service. For example, some stock appreciation rights vest immediately, and the employees are therefore not required to complete a specified period of service to become entitled to the cash payment. In the absence of evidence to the contrary, the enterprise should presume that the services rendered by the employees in exchange for the stock appreciation rights have been received. Thus, the enterprise should recognise immediately the services received and a liability to pay for them. If the stock appreciation rights do not vest until the employees have completed a specified period of service, the enterprise should recognise the services received, and a liability to pay for them, as the employees render service during that period.

Measurement

32. For cash-settled employee share-based payment plan, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise should remeasure the fair value of the liability at each reporting date and at the date of the settlement, with any changes in fair value recognised in profit or loss for the period.

33. The liability should be measured, initially and at each reporting date until settled, at the fair value of the stock appreciation rights, by applying an option pricing model taking into account the terms and conditions on which the stock appreciation rights were granted, and the extent to which the employees have rendered service to date.

Appendix IV contains an illustration of a cash-settled employee share based payment plan.

Employee Share-Based Payment Plans with Cash

Alternatives

Employee share-based payment plans in which the terms of the arrangement provide the employee with a choice of settlement

34. If an enterprise has granted the employees the right to choose whether a share-based payment

plan is settled in cash or by issuing shares, the plan has two components, viz., (i) liability component, i.e., the employees' right to demand settlement in cash, and (ii) equity component, i.e., the employees' right to demand settlement in shares rather than in cash. The enterprise should first measure, on the grant date, fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of cash settlement. The fair value so arrived at should be considered as the fair value of the liability component. The enterprise should also measure the fair value of the employee share-based payment plan presuming that all employees will exercise their option in favour of equity settlement. In case the fair value under equity- settlement is greater than the fair value under cash settlement, the excess should be considered as the fair value of the equity component. Otherwise, the fair value of the equity component should be considered as zero. The fair value of the equity component should be accounted for in accordance with the recommendations in respect of 'Equity-settled employee share-based payment plan'. The fair value of the liability component should be accounted for in accordance with the recommendations in respect of 'Cash-settled employee share-based payment plan'.

35. At the date of settlement, the enterprise should remeasure the liability to its fair value. If the enterprise issues shares on settlement rather than paying cash, the amount of liability should be treated as the consideration for the shares issued.

36. If the enterprise pays in cash on settlement rather than issuing shares, that payment should be applied to settle the liability in full. By electing to receive cash on settlement, the employees forgo their right to receive shares. The enterprise should transfer any balance in the relevant equity account (e.g., Stock Options Outstanding Account) to general reserve.

Appendix V contains an illustration of an employee share-based payment plan with cash alternatives.

Employee share-based payment plans in which the terms of the arrangement provide the enterprise with a choice of settlement

37. For an employee share-based payment plan in which the terms of the arrangement provide the enterprise with the choice of whether to settle in cash or by issuing shares, the enterprise should determine whether it has a present obligation to settle in cash and account for the share based payment plan accordingly. The enterprise has a present obligation to settle in cash if the choice of settlement in shares has no commercial substance (e.g., because the enterprise is legally prohibited from issuing shares), or the enterprise has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the employee asks for cash settlement.

38. If the enterprise has a present obligation to settle in cash, it should account for the transaction in accordance with the requirements in respect of 'Cash-settled employee share-based payment plan'.

39. If no such obligation exists, the enterprise should account for the transaction in accordance with the requirements in respect of 'Equity settled employee share-based payment plan'. Upon settlement:

(a) If the enterprise elects to settle in cash, the cash payment should be accounted for as a deduction from the relevant equity account (e.g., Stock Options Outstanding Account) except as noted in (c) below.

(b) If the enterprise elects to settle by issuing shares, the balance in the relevant equity account should be treated as consideration for the shares issued except as noted in (c) below.

(c) If the enterprise elects the settlement alternative with the higher fair value (e.g., the enterprise elects to settle in cash the amount of which is more than the fair value of the shares had the enterprise elected to settle in shares), as at the date of settlement, the enterprise should recognise an additional expense for the excess value given, i.e., the difference between the cash paid and the fair value of the shares that would otherwise have been issued, or the difference between the fair value of the shares issued and the amount of cash that would otherwise have been paid, whichever is applicable.

Intrinsic Value Method

40. Accounting for employee share-based payment plans dealt with here to before is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. For example, an option with an exercise price of ₹ 100 on an equity share whose current quoted market price is ₹ 125, has an intrinsic value of ₹ 25 per share on the date of its valuation. If the quoted market price is not available on the grant date then the share price nearest to that date is taken. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, *mutatis mutandis*, in place of the fair value as described in paragraphs 10 to 39.

Examples of equity-settled employee share-based payment plan and cash settled employee share-based payment plan, using intrinsic value method, are given in Illustration 1 of Appendix II and the Illustration in Appendix IV, respectively.

Recommendation

41. It is recommended that accounting for employee share-based payment plans should be based on the fair value approach as described in paragraphs 10 to 39. However, intrinsic value method as described in paragraph 40 is also permitted.

Graded Vesting

42. In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

An illustration of an employee share-based payment plan having graded vesting is given in Appendix VI.

Employee Share-Based Payment Plan Administered Through a Trust

43. An enterprise may administer an employee share-based payment plan through a trust constituted for this purpose. The trust may have different kinds of arrangements, for example, the following:

(a) The enterprise allots shares to the trust as and when the employees exercise stock options.

(b) The enterprise provides finance to the trust for subscription to the shares issued by the enterprise at the beginning of the plan.

(c) The enterprise provides finance to the trust to purchase shares from the market at the beginning of the plan.

44. Since the trust administers the plan on behalf of the enterprise, it is recommended that irrespective of the arrangement for issuance of the shares under the employee share-based payment plan, the enterprise should recognise in its separate financial statements the expense on account of services received from the employees in accordance with the recommendations contained in this Guidance Note. Various aspects of accounting for employee share-based payment plan administered

through a trust under the arrangements mentioned above, are illustrated in Appendix VII, for the purpose of preparation of separate financial statements.

45. For the purpose of preparation of consolidated financial statements as per Accounting Standard (AS) 21, 'Consolidated Financial Statements', issued by the Institute of Chartered Accountants of India, the trust created for the purpose of administering employee share-based compensation, should not be considered. This is because the standard requires consolidation of only those controlled enterprises which provide economic benefits to the enterprise and, accordingly, consolidation of entities, such as, gratuity trust, provident fund trust, etc., is not required. The nature of a trust established for administering employee share-based compensation plan is similar to that of a gratuity trust or a provident fund trust as it does not provide any economic benefit to the enterprise in the form of, say, any return on investment.

Earnings Per Share Implications

46. For the purpose of calculating Basic Earnings Per Share as per Accounting Standard (AS) 20, 'Earnings Per Share', shares or stock options granted pursuant to an employee share-based payment plan, including shares or options issued to an ESOP trust, should not be included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, shares or stock options so granted should be considered as dilutive potential equity shares for the purpose of calculating Diluted Earnings Per Share. Diluted Earnings Per Share should be based on the actual number of shares or stock options granted and not yet forfeited, unless doing so would be anti-dilutive.

47. For computations required under paragraph 35 of AS 20 with regard to shares or stock options granted pursuant to an employee share-based payment plan, the assumed proceeds from the issues should include the exercise price and the unamortised compensation cost which is attributable to future services.

An example to illustrate computation of Earnings Per Share in a situation where the enterprise has granted stock options to its employees is given in Appendix VIII.

Disclosures

48. An enterprise should describe the method used to account for the employee share-based payment plans. Where an enterprise uses the intrinsic value method, it should also disclose the impact on the net results and EPS – both basic and diluted – for the accounting period, had the fair value method been used.

49. An enterprise should disclose information that enables users of the financial statements to understand the nature and extent of employee share-based payment plans that existed during the period.

50. To give effect to the principle in paragraph 49, the enterprise should disclose at least the following:

(a) a description of each type of employee share-based payment plan that existed at any time during the period, including the general terms and conditions of each plan, such as vesting requirements, the maximum term of options granted, and the method of settlement (e.g., whether in cash or equity). An enterprise with substantially similar types of plans may aggregate this information, unless separate disclosure of each arrangement is necessary to satisfy the principle in paragraph 49.

(b) the number and weighted average exercise prices of stock options for each of the following groups of options:

  (i) outstanding at the beginning of the period;

  (ii) granted during the period;

  (iii) forfeited during the period;

  (iv) exercised during the period;

  (v) expired during the period;

  (vi) outstanding at the end of the period; and

  (vii) exercisable at the end of the period.

(c) for stock options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the enterprise may instead disclose the weighted average share price during the period.

(d) for stock options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life (comprising the vesting period and the exercise period). If the range of exercise prices is wide, the outstanding options should be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

51. An enterprise should disclose the following information to enable users of the financial statements to understand how the fair value of shares or stock options granted, during the period, was determined:

(a) for stock options granted during the period, the weighted average fair value of those options at the grant date and information on how that fair value was measured, including:

  (i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life (comprising the vesting period and the exercise period), expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

  (ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and

  (iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition.

(b) for other instruments granted during the period (i.e., other than stock options), the number and weighted average fair value of those instruments at the grant date, and information on how that fair value was measured, including:

  (i) if fair value was not measured on the basis of an observable market price, how it was determined;

  (ii) whether and how expected dividends were incorporated into the measurement of fair value; and

  (iii) whether and how any other features of the instruments granted were incorporated into the measurement of fair value.

(c) for employee share-based payment plans that were modified during the period:

  (i) an explanation of those modifications;

(ii) the incremental fair value granted (as a result of those modifications); and

(iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

52. An enterprise should disclose the following information to enable users of the financial statements to understand the effect of employee share-based payment plans on the profit or loss of the enterprise for the period and on its financial position:

(a) the total expense recognised for the period arising from employee share-based payment plans in which the services received did not qualify for recognition as a part of the cost of an asset and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled employee share-based payment plans;

(b) for liabilities arising from employee share-based payment plans:

(i) the total carrying amount at the end of the period; and

(ii) the total intrinsic value at the end of the period of liabilities for which the right of the employee to cash or other assets had vested by the end of the period (e.g., vested stock appreciation rights).

Appendix IX contains illustrative disclosures.

Effective Date

53. This Guidance Note applies to employee share-based payment plans the grant date in respect of which falls on or after April 1, 2005.

Appendix I

Estimating the Fair Value of Shares or Stock Options Granted

1. The appendix discusses measurement of the fair value of shares and stock options granted, focusing on the specific terms and conditions that are common features of a grant of shares or stock options to employees. Therefore, it is not exhaustive.

Shares

2. The fair value of the shares granted should be measured at the market price of the shares of the enterprise (or an estimated value based on the valuation report of an independent valuer, if the shares of the enterprise are not publicly traded), adjusted to take into account the terms and conditions upon which the shares were granted (except for vesting conditions that are excluded from the measurement of fair value in accordance with paragraphs 18 to 20 of the text of the Guidance Note).

3. For example, if the employee is not entitled to receive dividends during the vesting period, this factor should be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after vesting date, that factor should be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. Restrictions on transfer or other restrictions that exist during the vesting period should not be taken into account when estimating the grant date fair value of the shares granted, because those restrictions stem from the existence of vesting conditions, which are accounted for in accordance with paragraphs 18 to 20 of the text of the Guidance Note.

Stock Options

4. For stock options granted to employees, in many cases market prices are not available, because the options granted are subject to terms and conditions that do not apply to traded options. If traded options with similar terms and conditions do not exist, the fair value of the options granted should be estimated by applying an option pricing model.

5. The enterprise should consider factors that knowledgeable, willing market participants would consider in selecting the option pricing model to apply. For example, many employee options have long lives, are usually exercisable during the period between vesting date and the end of the life of the option, and are often exercised early. These factors should be considered when estimating the grant date fair value of the options. For many enterprises, this might preclude the use of the Black-Scholes-Merton formula, which does not allow for the possibility of exercise before the end of the option's life (comprising the vesting period and the exercise period) and may not adequately reflect the effects of expected early exercise. It also does not allow for the possibility that expected volatility and other model inputs might vary over the option's life. However, for stock options with relatively short contractual lives (comprising the vesting period and the exercise period), or that must be exercised within a short period of time after vesting date, the factors identified above may not apply. In these instances, the Black-Scholes-Merton formula may produce a value that is substantially the same as a more flexible option pricing model.

6. All option pricing models take into account, as a minimum, the following factors:

(a) the exercise price of the option;
(b) the life of the option;
(c) the current price of the underlying shares;
(d) the expected volatility of the share price;
(e) the dividends expected on the shares (if appropriate); and
(f) the risk-free interest rate for the life of the option.

7. Other factors that knowledgeable, willing market participants would consider in setting the price should also be taken into account (except for vesting conditions and reload features that are excluded from the measurement of fair value in accordance with paragraphs 18 to 21 of the text of the Guidance Note).

8. For example, a stock option granted to an employee typically cannot be exercised during specified periods (e.g., during the vesting period or during periods specified, if any, by securities regulators). This factor should be taken into account if the option pricing model applied would otherwise assume that the option could be exercised at any time during its life. However, if an enterprise uses an option pricing model that values options that can be exercised only at the end of the options' life, no adjustment is required for the inability to exercise them during the vesting period (or other periods during the options' life), because the model assumes that the options cannot be exercised during those periods.

9. Similarly, another factor common to employee stock options is the possibility of early exercise of the option, for example, because the option is not freely transferable, or because the employee must exercise all vested options upon cessation of employment. The effects of expected early exercise should be taken into account, as discussed in paragraphs 16 to 21 of this Appendix.

10. Factors that a knowledgeable, willing market participant would not consider in setting the price of a stock option should not be taken into account when estimating the fair value of stock options granted. For example, for stock options granted to employees, factors that affect the value of the option from the perspective of the individual employee only are not relevant to estimating the price that would be set by a knowledgeable, willing market participant.

Inputs to option pricing models

11. In estimating the expected volatility of and dividends on the underlying shares, the objective is to approximate the expectations that would be reflected in a current market or negotiated exchange price for the option. Similarly, when estimating the effects of early exercise of employee stock options, the objective is to approximate the expectations that an outside party with access to detailed information about employees' exercise behaviour would develop based on information available at the grant date.

12. Often, there is likely to be a range of reasonable expectations about future volatility, dividends and exercise behaviour. If so, an expected value should be calculated, by weighting each amount within the range by its associated probability of occurrence.

13. Expectations about the future are generally based on experience, modified if the future is reasonably expected to differ from the past. In some circumstances, identifiable factors may indicate that unadjusted historical experience is a relatively poor predictor of future experience. For example, if an enterprise with two distinctly different lines of business disposes of the one that was significantly less risky than the other, historical volatility may not be the best information on which to base reasonable expectations for the future.

14. In other circumstances, historical information may not be available. For example, a newly listed enterprise will have little, if any, historical data on the volatility of its share price. Unlisted and newly listed enterprises are discussed further below.

15. In summary, an enterprise should not simply base estimates of volatility, exercise behaviour and dividends on historical information without considering the extent to which the past experience is expected to be reasonably predictive of future experience.

Expected early exercise

16. Employees often exercise stock options early, for a variety of reasons. For example, employee stock options are typically nontransferable. This often causes employees to exercise their stock options early, because that is the only way for the employees to liquidate their position. Also, employees who cease employment are usually required to exercise any vested options within a short period of time, otherwise the stock options are forfeited. This factor also causes the early exercise of employee stock options. Other factors causing early exercise are risk aversion and lack of wealth diversification.

17. The means by which the effects of expected early exercise are taken into account depends upon the type of option pricing model applied. For example, expected early exercise could be taken into account by using an estimate of the expected life of the option (which, for an employee stock option, is the period of time from grant date to the date on which the option is expected to be exercised) as an input into an option pricing model (e.g., the Black-Scholes-Merton formula). Alternatively, expected early exercise could be modelled in a binomial or similar option pricing model that uses contractual life as an input.

18. Factors to consider in estimating early exercise include:

(a) the length of the vesting period, because the stock option typically cannot be exercised until the end of the vesting period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest. The implications of vesting conditions are discussed in paragraphs 18 to 20 of the text of the Guidance Note.

(b) the average length of time similar options have remained outstanding in the past.

(c) the price of the underlying shares. Experience may indicate that the employees tend to exercise options when the share price reaches a specified level above the exercise price.

(d) the employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (discussed further in paragraph 21 of this Appendix).

(e) expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility.

19. As noted in paragraph 17 of this Appendix, the effects of early exercise could be taken into account by using an estimate of the option's expected life as an input into an option pricing model. When estimating the expected life of stock options granted to a group of employees, the enterprise could base that estimate on an appropriately weighted average expected life for the entire employee group or on appropriately weighted average lives for subgroups of employees within the group, based on more detailed data about employees' exercise behaviour (discussed further below).

20. Separating an option grant into groups for employees with relatively homogeneous exercise behaviour is likely to be important. Option value is not a linear function of option term; value increases at a decreasing rate as the term lengthens. For example, if all other assumptions are equal, although a two-year option is worth more than a one-year option, it is not worth twice as much. That means that calculating estimated option value on the basis of a single weighted average life that includes widely differing individual lives would overstate the total fair value of the stock options granted. Separating options granted into several groups, each of which has a relatively narrow range of lives included in its weighted average life, reduces that overstatement.

21. Similar considerations apply when using a binomial or similar model. For example, the experience of an enterprise that grants options broadly to all levels of employees might indicate that top-level executives tend to hold their options longer than middle-management employees hold theirs and that lower-level employees tend to exercise their options earlier than any other group. In addition, employees who are encouraged required to hold a minimum amount of their employer's shares or stock options, might on average exercise options later than employees not subject to that provision. In those situations, separating options by groups of recipients with relatively homogeneous exercise behaviour will result in a more accurate estimate of the total fair value of the stock options granted.

Expected volatility

22. Expected volatility is a measure of the amount by which a price is expected to fluctuate during a period. The measure of volatility used in option pricing models is the annualised standard deviation of the continuously compounded rates of return on the share over a period of time. Volatility is typically expressed in annualised terms that are comparable regardless of the time period used in the calculation, for example, daily, weekly or monthly price observations.

23. The rate of return (which may be positive or negative) on a share for a period measures how much a shareholder has benefited from dividends and appreciation (or depreciation) of the share price.

24 The expected annualised volatility of a share is the range within which the continuously compounded annual rate of return is expected to fall approximately two-thirds of the time. For example, to say that a share with an expected continuously compounded rate of return of 12 per cent has a volatility of 30 per cent means that the probability that the rate of return on the share for one year will be between –18 per cent (12% –30%) and 42 per cent (12% + 30%) is approximately two-thirds. If the share price is ₹.100 at the beginning of the year and no dividends are paid, the year-end share price would be expected to be between ₹ 83.53 (₹.100 × e–0.18) and ₹.152.20 (₹ 100 × 0.42) approximately two-thirds of the time.

25. Factors to be considered in estimating expected volatility include:

(a) Implied volatility from traded stock options on the shares of the enterprise, or other traded instruments of the enterprise that include option features (such as convertible debt), if any.

(b) The historical volatility of the share price over the most recent period that is generally commensurate with the expected term of the option (taking into account the remaining contractual life of the option and the effects of expected early exercise).

(c) The length of time shares of an enterprise have been publicly traded. A newly listed enterprise might have a high historical volatility, compared with similar enterprises that have been listed longer. Further guidance for newly listed enterprises is given in paragraph 26 of this Appendix.

(d) The tendency of volatility to revert to its mean, i.e., its long-term average level, and other factors indicating that expected future volatility might differ from past volatility. For example, if share price of an enterprise was extraordinarily volatile for some identifiable period of time because of a failed takeover bid or a major restructuring, that period could be disregarded in computing historical average annual volatility.

(e) Appropriate and regular intervals for price observations. The price observations should be consistent from period to period.

For example, an enterprise might use the closing price for each week or the highest price for the week, but it should not use the closing price for some weeks and the highest price for other weeks.

Newly listed enterprises

26. As noted in paragraph 25 of this Appendix, an enterprise should consider historical volatility of the share price over the most recent period that is generally commensurate with the expected option term. If a newly listed enterprise does not have sufficient information on historical volatility, it should nevertheless compute historical volatility for the longest period for which trading activity is available. It could also consider the historical volatility of similar enterprises following a comparable period in their lives. For example, an enterprise that has been listed for only one year and grants options with an average expected life of five years might consider the pattern and level of historical volatility of enterprises in the same industry for the first six years in which the shares of those enterprises were publicly traded.

Unlisted enterprises

27. An unlisted enterprise will not have historical information upon which to base an estimate of expected volatility. It will therefore have to estimate expected volatility by some other means. The enterprise could consider the historical volatility of similar listed enterprises, for which share price or option price information is available, to use as the basis for an estimate of expected volatility. Alternatively, volatility of unlisted enterprises can be taken as zero.

Expected dividends

28. Whether expected dividends should be taken into account when measuring the fair value of shares or stock options granted depends on whether the employees are entitled to dividends or dividend equivalents. For example, if employees were granted options and are entitled to dividends on the underlying shares or dividend equivalents (which might be paid in cash or applied to reduce the exercise price) between grant date and exercise date, the options granted should be valued as if no dividends will be paid on the underlying shares, i.e., the input for expected dividends should be zero. Similarly, when the grant date fair value of shares granted to employees is estimated, no adjustment is required for expected dividends if the employees are entitled to receive dividends paid during the vesting period.

29. Conversely, if the employees are not entitled to dividends or dividend equivalents during the vesting period (or before exercise, in the case of an option), the grant date valuation of the rights to shares or options should take expected dividends into account. That is to say, when the fair value of an

option grant is estimated, expected dividends should be included in the application of an option pricing model. When the fair value of a share grant is estimated, that valuation should be reduced by the present value of dividends expected to be paid during the vesting period.

30. Option pricing models generally call for expected dividend yield. However, the models may be modified to use an expected dividend amount rather than a yield. An enterprise may use either its expected yield or its expected payments. If the enterprise uses the latter, it should consider its historical pattern of increases in dividends. For example, if policy of an enterprise has generally been to increase dividends by approximately 3 per cent per year, its estimated option value should not assume a fixed dividend amount throughout the option's life unless there is evidence that supports that assumption.

31. Generally, the assumption about expected dividends should be based on publicly available information. An enterprise that does not pay dividends and has no plans to do so should assume an expected dividend yield of zero. However, an emerging enterprise with no history of paying dividends might expect to begin paying dividends during the expected lives of its employee stock options. Those enterprises could use an average of their past dividend yield (zero) and the mean dividend yield of an appropriately comparable peer group.

Risk-free interest rate

32. Typically, the risk-free interest rate is the implied yield currently available on zero-coupon government issues, with a remaining term equal to the expected term of the option being valued (based on the option's remaining contractual life and taking into account the effects of expected early exercise). It may be necessary to use an appropriate substitute, if no such government issues exist or circumstances indicate that the implied yield on zero-coupon government issues is not representative of the risk free interest rate. Also, an appropriate substitute should be used if market participants would typically determine the risk-free interest rate by using that substitute, rather than the implied yield of zero-coupon government issues, when estimating the fair value of an option with a life equal to the expected term of the option being valued.

Capital structure effects

33. Typically, third parties, not the enterprise, write traded stock options. When these stock options are exercised, the writer delivers shares to the option holder. Those shares are acquired from existing shareholders. Hence the exercise of traded stock options has no dilutive effect.

34. In contrast, if stock options are written by the enterprise, new shares are issued when those stock options are exercised. Given that the shares will be issued at the exercise price rather than the current market price at the date of exercise, this actual or potential dilution might reduce the share price, so that the option holder does not make as large a gain on exercise as on exercising an otherwise similar traded option that does not dilute the share price.

35. Whether this has a significant effect on the value of the stock options granted depends on various factors, such as the number of new shares that will be issued on exercise of the options compared with the number of shares already issued. Also, if the market already expects that the option grant will take place, the market may have already factored the potential dilution into the share price at the date of grant.

36. However, the enterprise should consider whether the possible dilutive effect of the future exercise of the stock options granted might have an impact on their estimated fair value at grant date. Option pricing models can be adapted to take into account this potential dilutive effect.

Appendix II

Equity-Settled Employee Share-based Payment Plans

Illustration 1 : Stock Options With Service Condition Only

(A) Accounting during the vesting period

At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

Vesting Period	3 years
Exercise Period	3 years
Expected Life	5 years
Exercise Price	₹ 50
Market Price	₹ 50
Expected forfeitures per year	3%

The fair value of options, calculated using an option pricing model, is ₹ 15 per option. Actual forfeitures, during the year 1, are 5 per cent and at the end of year 1, the enterprise still expects that actual forfeitures would average 3 per cent per year over the 3-year vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected forfeiture rate for the entire award is changed to 6 per cent per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

Suggested Accounting Treatment

Year 1

1. At the grant date, the enterprise estimates the fair value of the options expected to vest at the end of the vesting period as below:

No. of options expected to vest = 300 x 1,000 x 0.97 x 0.97 x 0.97 = 2,73,802 options

Fair value of options expected to vest = 2,73,802 options x ₹ 15 = ₹ 41,07,030

2. At the balance sheet date, since the enterprise still expects actual forfeitures to average 3 per cent per year over the 3-year vesting period, no change is required in the estimates made at the grant date. The enterprise, therefore, recognises one-third of the amount estimated at (1) above (i.e., ₹ 41,07,030/3) towards the employee services received by passing the following entry:

Employee compensation expense A/c	Dr.	₹ 13,69,010	
To Stock Options Outstanding A/c			₹ 13,69,010

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Year 2

1. At the end of the financial year, management has changed its estimate of expected forfeiture rate from 3 per cent to 6 per cent per year. The revised number of options expected to vest is 2,49,175 (3,00,000 x .94 x .94 x .94). Accordingly, the fair value of revised options expected to vest is

₹ 37,37,625 (2,49,175 x ₹ 15). Consequent to the change in the expected forfeitures, the expense to be recognised during the year are determined as below:

Revised total fair value	₹ 37,37,625
Revised cumulative expense at the end of year 2= (₹ 37,37,625 x 2/3)	=₹ 24,91,750
Expense already recognised in year 1	=₹ 13,69,010
Expense to be recognised in year 2	=₹ 11,22,740

2. The enterprise recognises the amount determined at (1) above (i.e., ₹ 11,22,740) towards the employee services received by passing the following entry:

Employee compensation expense A/c	Dr.	₹ 11,22,740	
To Stock Options Outstanding A/c			₹ 11,22,740

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Year 3

1. At the end of the financial year, the enterprise would examine its actual forfeitures and make necessary adjustments, if any, to reflect expense for the number of options that actually vested. Considering that 840 employees have completed three years vesting period, the expense to be recognised during the year is determined as below:

No. of options actually vested = 840 x 300	= 2,52,000
Fair value of options actually vested (₹ 2,52,000 x ₹ 15)	= ₹ 37,80,000
Expense already recognised	₹ 24,91,750
Expense to be recognised in year 3	₹ 12,88,250

2. The enterprise recognises the amount determined at (1) above towards the employee services received by passing the following entry:

Employee compensation expense A/c	Dr.	₹ 12,88,250	
To Stock Options Outstanding A/c			₹ 12,88,250

(Being compensation expense recognised in respect of ESOP)

3. Credit balance in the 'Stock Options Outstanding A/c' may be disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

(B) Accounting at the time of exercise/expiry of the vested options

Continuing Illustration 1(A) above, the following further facts are provided:

(a) 200 employees exercise their right to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their right at the end of year 6.

(b) Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e., at the end of year 6.

(c) Face value of one share of the enterprise is ₹ 10.

Suggested Accounting Treatment

1. On exercise of the right to obtain shares, the enterprise issues shares to the respective employees on receipt of the exercise price. The shares so issued are considered to have been issued

on a consideration comprising the exercise price and the corresponding amount standing to the credit of the Stock Options Outstanding Account. In the present case, the exercise price is ₹ 50 per share and the amount of compensation expense recognised in the 'Stock Options Outstanding A/c' is ₹ 15 per option. The enterprise, therefore, considers the shares to be issued at a price of ₹ 65 per share.

2. The amount to be recorded in the 'Share Capital A/c' and the 'Securities Premium A/c', upon issuance of the shares, is calculated as below:

Particulars	*Exercise Date Year-end 5*	*Exercise Date Year-end 6*
No. of employees exercising option No. of shares issued on exercise @ 300 per employee	200 60,000	600 1,80,000
Exercise Price received @ ₹ 50 per share	30,00,0000	1,80,000
Corresponding amount recognised in the 'Stock Options Outstanding A/c' @ ₹ 15 per option	9,00,000	27,00,000
Total Consideration	39,00,000	1,17,00,000
Amount to be recorded in 'Share Capital A/c' @ ₹ 10 per share	6,00,000	18,00,000
Amount to be recorded in 'Securities Premium A/c' @ ₹ 55 per share	33,00,000	99,00,000
Total	39,00,000	1,17,00,000

3. The enterprise passes the following entries at end of year 5 and year 6, respectively, to record the shares issued to the employees upon exercise of options vested in them in pursuance of the Employee Stock Option Plan:

Year 5	Bank A/c	Dr.	₹ 30,00,000	
	Stock Options Outstanding A/c	Dr.	₹ 9,00,000	
	To Share Capital A/c			₹ 6,00,000
	To Securities Premium A/c			₹ 33,00,000
	(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)			
Year 6	Bank A/c	Dr.	₹ 90,00,000	
	Stock Options Outstanding A/c	Dr.	₹ 27,00,000	
	To Share Capital A/c			₹ 18,00,000
	To Securities Premium A/c			₹ 99,00,000
	(Being shares issued to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)			

4. At the end of year 6, the balance of ₹ 1,80,000 (i.e., 40 employees x 300 options x ₹ 15 per option) standing to the credit of the Stock Options Outstanding Account, in respect of vested options expiring unexercised, is transferred to general reserve by passing the following entry:

Stock Options Outstanding A/c	Dr.	₹ 1,80,000	
To General Reserve			₹ 1,80,000

(Being the balance standing to the credit of the Stock Options Outstanding Account, in respect of vested options expired unexercised, transferred to the general reserve)

(C) Intrinsic Value Method

The accounting treatment suggested in Illustrations 1(A) and 1(B) above is based on the fair value method. In case the enterprise follows the intrinsic value method instead of the fair value method, it would not recognise any compensation expense since the market price of the underlying share at the grant date is the same as the exercise price and the intrinsic value of the options is nil. However, in case the market price of the underlying share at the grant date is more than the exercise price, say, ₹ 52 per share, then the difference of ₹ 2 between the market value and the exercise price would be the intrinsic value of the option. In such a case, the enterprise would treat the said intrinsic value as compensation expense over the vesting period on the lines of Illustrations 1(A) and 1(B) above.

Illustration 2: Grant with A Performance Condition, in which the length of the Vesting Period Varies

At the beginning of year 1, the enterprise grants 100 stock options to each of its 500 employees, conditional upon the employees remaining in the employment of the enterprise during the vesting period. The options will vest at the end of year 1 if the earnings of the enterprise increase by more than 18 per cent; at the end of year 2 if the earnings of the enterprise increase by more than an average of 13 per cent per year over the two year period; and at the end of year 3 if the earnings of the enterprise increase by more than an average of 10 per cent per year over the three year period. The fair value of the options, calculated at the grant date using an option pricing model, is ₹ 30 per option. No dividends are expected to be paid over the three-year period.

By the end of year 1, the earnings of the enterprise have increased by 14 per cent, and 30 employees have left. The enterprise expects that earnings will continue to increase at a similar rate in year 2, and, therefore, expects that the options will vest at the end of year 2. The enterprise expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and, therefore, expects that options will vest in 440 employees at the end of year 2.

By the end of year 2, the earnings of the enterprise have increased by only 10 per cent and, therefore, the options do not vest at the end of year 2. 28 employees have left during the year. The enterprise expects that a further 25 employees will leave during year 3, and that the earnings of the enterprise will increase by at least 6 per cent, thereby achieving the average of 10 per cent per year.

By the end of year 3, 23 employees have left and the earnings of the enterprise have increased by 8 per cent, resulting in an average increase of 10.67 per cent per year. Therefore, 419 employees received 100 shares each at the end of year 3.

Suggested Accounting Treatment

1. In the given case, the length of the vesting period varies, depending on when the performance condition is satisfied. In such a situation, as per paragraph 14 of the text of the Guidance Note, the enterprise estimates the length of the expected vesting period, based on the most likely outcome of the performance condition, and revises that estimate, if necessary, if subsequent information indicates that the length of the vesting period is likely to differ from previous estimates.

2. The enterprise determines the compensation expense to be recognised each year as below:

Particulars	Year 1	Year 2	Year 3
Length of the expected vesting period (at the end of the year)	2 years	3 years	3 years
No. of employees expected to meet vesting conditions	440 employees	417 employees	419 employees
No. of options expected to vest	44,000	41,700	41,900
Fair value of options expected to vest @ ₹ 30 per option (₹)	13,20,000	12,51,000	12,57,000
Compensation expense accrued till the end of year (₹)	6,60,000 [13,20,000/2]	8,34,000 (12,51,000 * 2/3)	12,57,000

Compensation expense recognised till the end of previous year (₹)	Nil	6,60,000	8,34,000
Compensation expense to be recognized for the year (₹)	**6,60,000**	**1,74,000**	**4,23,000**

Illustration 3 : Grant with a Performance Condition, in which the number of Stock Options Varies

At the beginning of year 1, an enterprise grants stock options to each of its 100 employees working in the sales department. The stock options will vest at the end of year 3, provided that the employees remain in the employment of the enterprise, and provided that the volume of sales of a particular product increases by at least an average of 5 per cent per year. If the volume of sales of the product increases by an average of between 5 per cent and 10 per cent per year, each employee will receive 100 stock options. If the volume of sales increases by an average of between 10 per cent and 15 per cent each year, each employee will receive 200 stock options. If the volume of sales increases by an average of 15 per cent or more, each employee will receive 300 stock options.

On the grant date, the enterprise estimates that the stock options have a fair value of ₹ 20 per option. The enterprise also estimates that the volume of sales of the product will increase by an average of between 10 per cent and 15 per cent per year, and therefore expects that, for each employee who remains in service until the end of year 3, 200 stock options will vest. The enterprise also estimates, on the basis of a weighted average probability, 20 per cent of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the enterprise still expects that a total of 20 employees will leave by the end of year 3. Hence, the enterprise expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12 per cent and the enterprise expects this rate of increase to continue over the next 2 years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The enterprise now expects that only three more employees will leave during year 3, and therefore expects that a total of 15 employees will have left during the three-year period, and hence 85 employees are expected to remain. Product sales have increased by 18 per cent, resulting in an average of 15 per cent over the two years to date. The enterprise now expects that sales increase will average 15 per cent or more over the three-year period, and hence expects each sales employee to receive 300 stock options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The sales of the enterprise have increased by an average of 16 per cent over the three years. Therefore, each of the 86 employees receives 300 stock options.

Suggested Accounting Treatment

Since the number of options varies depending on the outcome of a performance condition that is not a market condition, the effect of that condition (i.e., the possibility that the number of stock options might be 100, 200 or 300) is not taken into account when estimating the fair value of the stock options at grant date. Instead, the enterprise revises the transaction amount to reflect the outcome of that performance condition, as illustrated below.

Year	Calculation	Compensation expense for period (₹)	Cumulative compensation expense (₹)
1.	80 employees × 200 options × ₹ 20 × 1/3	1,06,667	1,06,667
2.	(85 employees × 300 options × ₹ 20 × 2/3) – ₹ 1,06,667	2,33,333	3,40,000
3.	(86 employees × 300 options × ₹ 20 × 3/3) – ₹ 3,40,000	1,76,000	5,16,000

Illustration 4: Grant with a Performance Condition, in which the Exercise Price Varies

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. The exercise price is ₹ 40. However, the exercise price drops to ₹ 30 if the earnings of the enterprise increase by at least an average of 10 per cent per year over the three-year period.

On the grant date, the enterprise estimates that the fair value of the stock options, with an exercise price of ₹ 30, is ₹ 16 per option. If the exercise price is ₹ 40, the enterprise estimates that the stock options have a fair value of ₹ 12 per option. During year 1, the earnings of the enterprise increased by 12 per cent, and the enterprise expects that earnings will continue to increase at this rate over the next two years. The enterprise, therefore, expects that the earnings target will be achieved, and hence the stock options will have an exercise price of ₹ 30. During year 2, the earnings of the enterprise increased by 13 per cent, and the enterprise continues to expect that the earnings target will be achieved.

During year 3, the earnings of the enterprise increased by only 3 per cent, and therefore the earnings target was not achieved. The executive completes three years' service, and therefore satisfies the service condition. Because the earnings target was not achieved, the 10,000 vested stock options have an exercise price of ₹ 40.

Suggested Accounting Treatment

Because the exercise price varies depending on the outcome of a performance condition that is not a market condition, the effect of that performance condition (i.e. the possibility that the exercise price might be ₹ 40 and the possibility that the exercise price might be ₹ 30) is not taken into account when estimating the fair value of the stock options at the grant date. Instead, the enterprise estimates the fair value of the stock options at the grant date under each scenario (i.e. exercise price of ₹ 40 and exercise price of ₹ 30) and ultimately revises the transaction amount to reflect the outcome of that performance condition, as illustrated below:

Year	Calculation	Compensation expense for period (₹)	Cumulative compensation expense (₹)
1	10,000 options × ₹ 16 × 1/3	53,333	53,333
2.	(10,000 options × ₹ 16 × 2/3) ₹ 53,333	53,334	1,06,667
3.	(10,000 options × ₹ 12 × 3/3) – ₹ 1,06,667	13,333 1,	20,000

Illustration 5: Grant with A Market Condition

At the beginning of year 1, an enterprise grants 10,000 stock options to a senior executive, conditional upon the executive remaining in the employment of the enterprise until the end of year 3. However, the stock options cannot be exercised unless the share price has increased from ₹.50 at the beginning of year 1 to above ₹ 65 at the end of year 3. If the share price is above ₹ 65 at the end of year 3, the stock options can be exercised at any time during the next seven years, i.e. by the end of year 10.

The enterprise applies a binomial option pricing model, which takes into account the possibility that the share price will exceed ₹ 65 at the end of year 3 (and hence the stock options become exercisable) and the possibility that the share price will not exceed ₹ 65 at the end of year 3 (and hence the options will not become exercisable). It estimates the fair value of the stock options with this market condition to be ₹ 24 per option.

Suggested Accounting Treatment

Because paragraph 20 of the text of the Guidance Note requires the enterprise to recognise the services received from an employee who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the stock options at the grant date. Therefore, if the enterprise expects the executive to complete the three-year service period, and the executive does so, the enterprise recognises the following amounts in years 1, 2 and 3:

Year	Calculation	Compensation expense for period (₹)	Cumulative compensation expense (₹)
1.	10,000 options × ₹ 24 × 1/3	80,000	80,000
2.	(10,000 options × ₹ 24 × 2/3) – ₹ 80,000	80,000	1,60,000
3.	(10,000 options × ₹ 24) – ₹ 1,60,000	80,000	2,40,000

As noted above, these amounts are recognised irrespective of the outcome of the market condition. However, if the executive left during year 2 (or year 3), the amount recognised during year 1 (and year 2) would be reversed in year 2 (or year 3). This is because the service condition, in contrast to the market condition, was not taken into account when estimating the fair value of the stock options at grant date. Instead, the service condition is taken into account by adjusting the transaction amount to be based on the number of shares or stock options that ultimately vest, in accordance with paragraphs 18 and 19 of the text of the Guidance Note.

Illustration 6: Grant with A Market Condition, in Which the Length of the Vesting Period Varies

At the beginning of year 1, an enterprise grants 10,000 stock options with a ten-year life to each of ten senior executives. The stock options will vest and become exercisable immediately if and when the share price of the enterprise increases from ₹ 50 to ₹ 70, provided that the executive remains in service until the share price target is achieved.

The enterprise applies a binomial option pricing model, which takes into account the possibility that the share price target will be achieved during the ten-year life of the options, and the possibility that the target will not be achieved. The enterprise estimates that the fair value of the stock options at grant date is ₹ 25 per option. From the option pricing model, the enterprise determines that the mode of the distribution of possible vesting dates is five years. In other words, of all the possible outcomes, the most likely outcome of the market condition is that the share price target will be achieved at the end of year 5. Therefore, the enterprise estimates that the expected vesting period is five years. The enterprise also estimates that two executives will have left by the end of year 5, and therefore expects that 80,000 stock options (10,000 stock options x 8 executives) will vest at the end of year 5.

Throughout years 1-4, the enterprise continues to estimate that a total of two executives will leave by the end of year 5. However, in total three executives leave, one in each of years 3, 4 and 5. The share price target is achieved at the end of year 6. Another executive leaves during year 6, before the share price target is achieved.

Suggested Accounting Treatment

Paragraph 14 of the text of the Guidance Note requires the enterprise to recognise the services received over the expected vesting period, as estimated at grant date, and also requires the enterprise not to revise that estimate. Therefore, the enterprise recognises the services received from the executives over years 1 to 5. Hence, the transaction amount is ultimately based on 70,000 stock options (10,000 stock options × 7 executives who remain in service at the end of year 5). Although another executive left during year 6, no adjustment is made, because the executive had already completed the expected vesting period of 5 years. Therefore, the enterprise recognises the following amounts in years 1-5:

Year	Calculation	Compensation expense for period (₹)	Cumulative compensation expense (₹)
1	80,000 options × ₹ 25 × 1/5	4,00,000	4,00,000
2.	(80,000 options × ₹ 25 × 2/5) – ₹ 4,00,000	4,00,000	8,00,000
3.	(80,000 options × ₹ 25 × 3/5) – ₹ 8,00,000	4,00,000	12,00,000
4.	4 (80,000 options × ₹ 25 × 4/5) – ₹ 12,00,000	4,00,000	16,00,000
5.	(70,000 options × ₹ 25) – ₹ 16,00,000	1,50,000	17,50,000

Illustration 7: Employee Share Purchase Plan

An enterprise offers all its 1,000 employees the opportunity to participate in an employee stock purchase plan. The employees have two weeks to decide whether to accept the offer. Under the terms of the plan, the employees are entitled to purchase a maximum of 100 shares each. The purchase price will be 20 per cent less than the market price of the shares of the enterprise at the date the offer is accepted, and the purchase price must be paid immediately upon acceptance of the offer. All shares purchased must be held in trust for the employees, and cannot be sold for five years. The employee is not permitted to withdraw from the plan during that period. For example, if the employee ceases employment during the five-year period, the shares must nevertheless remain in the plan until the end of the five-year period. Any dividends paid during the five-year period will be held in trust for the employees until the end of the five-year period.

In total, 800 employees accept the offer and each employee purchases, on average, 80 shares, i.e., the employees purchase a total of 64,000 shares. The weighted-average market price of the shares at the purchase date is ₹ 30 per share, and the weighted-average purchase price is ₹.24 per shares.

Suggested Accounting Treatment

Paragraph 15 of the text of the Guidance Note provides that the enterprise should measure the fair value of the employee services received by reference to the fair value of the shares or stock options granted. To apply this requirement, it is necessary first to determine the type of instrument granted to the employees. Although the plan is described as an employee stock purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, stock option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the share price of the enterprise at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan.

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph 3 of the Appendix I to the Guidance Note states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the enterprise should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the enterprise estimates that the fair value of each restricted share is ₹ 28. In this case, the fair value of the instruments granted is ₹ 4 per share (being the fair value of the restricted share of ₹ 28 less the purchase price of ₹ 24). Because 64,000 shares were purchased, the total fair value of the instruments granted is ₹ 2,56,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 11 of the text of the Guidance Note, the enterprise should recognise an expense of ₹ 2,56,000 immediately.

Appendix III

Modifications to the Term and Conditions of Equity-Settled Employee Share-based Payment Plans

Illustration 1: Grant of Stock Options that are Subsequently Repriced

At the beginning of year 1, an enterprise grants 100 stock options to each of its 500 employees. The grant is conditional upon the employee remaining in service over the next three years. The enterprise estimates that the fair value of each option is ₹ 15. On the basis of a weighted average probability, the enterprise estimates that 100 employees will leave during the three-year period and therefore forfeit their rights to the stock options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the share price of the enterprise has dropped, and the enterprise reprices its stock options, and that the repriced stock options vest at the end of year 3. The enterprise estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the three-year vesting period is 110 employees. During year 2, a further 35 employees leave, and the enterprise estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the three-year vesting period to 105 employees. During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the stock options vested at the end of year 3.

The enterprise estimates that, at the date of repricing, the fair value of each of the original stock options granted (i.e., before taking into account the repricing) is ₹ 5 and that the fair value of each repriced stock option is ₹ 8.

Suggested Accounting Treatment

Paragraph 24 of the text of the Guidance Note requires the enterprise to recognise the effects of modifications that increase the total fair value of the employee share-based payment plans or are otherwise beneficial to the employee. If the modification increases the fair value of the shares or stock options granted (e.g., by reducing the exercise price), measured immediately before and after the modification, paragraph 25(a) of the text of this Guidance Note requires the enterprise to include the incremental fair value granted (i.e., the difference between the fair value of the modified instrument and that of the original instrument, both estimated as at the date of the modification) in the measurement of the amount recognised for services received as consideration for the instruments granted. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified instruments vest, in addition to the amount based on the grant date fair value of the original instruments, which is recognised over the remainder of the original vesting period.

The incremental value is ₹ 3 per stock option (₹ 8 – ₹ 5). This amount is recognised over the remaining two years of the vesting period, along with remuneration expense based on the original option value of ₹ 15.

The amounts recognised towards employees services received in years 1-3 are as follows:

Year	Calculation	Compensation expense for period (₹)	Cumulative compensation expense (₹)
1	(500 – 110) employees ×100 options × ₹ 15 × 1/3	1,95,000	1,95,000
2.	(500 – 105) employees × 100 options × (₹ 15 × 2/3 + ₹ 3 × 1/2) – ₹ 1,95,000	2,59,250	4,54,250
3.	(500 – 103) employees × 100 options × (₹ 15 + ₹ 3) – ₹ 4,54,250	2,60,350	7,14,600

Illustration 2: Grant of Stock Options with A Vesting Condition that is Subsequently Modified

At the beginning of year 1, the enterprise grants 1,000 stock options to each member of its sales team, conditional upon the employees remaining in the employment of the enterprise for three years, and the team selling more than 50,000 units of a particular product over the three-year period. The fair value of the stock options is ₹ 15 per option at the date of grant.

During year 2, the enterprise increases the sales target to 1,00,000 units. By the end of year 3, the enterprise has sold 55,000 units, and the stock options do not vest. Twelve members of the sales team have remained in service for the three-year period.

Suggested Accounting Treatment

Paragraph 19 of the text of the Guidance Note requires, for a performance condition that is not a market condition, the enterprise to recognise the services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and to revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise revises the estimate to equal the number of instruments that ultimately vested. However, paragraph 24 of the text of the Guidance Note requires, irrespective of any modifications to the terms and conditions on which the instruments were granted, or a cancellation or settlement of that grant of instruments, the enterprise to recognise, as a minimum, the services received, measured at the grant date fair value of the instruments granted, unless those instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. Furthermore, paragraph 26(c) of the text of this Guidance Note specifies that, if the enterprise modifies the vesting conditions in a manner that is not beneficial to the employee, the enterprise does not take the modified vesting conditions into account when applying the requirements of paragraphs 18 to 20 of the text of the Guidance Note.

Therefore, because the modification to the performance condition made it less likely that the stock options will vest, which was not beneficial to the employee, the enterprise takes no account of the modified performance condition when recognising the services received. Instead, it continues to recognise the services received over the three-year period based on the original vesting conditions. Hence, the enterprise ultimately recognizes cumulative remuneration expense of ₹ 1,80,000 over the three-year period (12 employees × 1,000 options × ₹ 15).

The same result would have occurred if, instead of modifying the performance target, the enterprise had increased the number of years of service required for the stock options to vest from three years to ten years. Because such a modification would make it less likely that the options will vest, which would not be beneficial to the employees, the enterprise would take no account of the modified service condition when recognising the services received. Instead, it would recognise the services received from the twelve employees who remained in service over the original three-year vesting period.

Appendix IV

Cash-Settled Employee Share-based Payment Plans

Continuing, Illustration 1(A) of Appendix II, suppose the enterprise has granted stock appreciation rights (SARs) to its employees, instead of the options whereby the enterprise pays cash to the employees equal to the intrinsic value of the SARs as on the exercise date. The SARs are granted on the condition that the employees remain in its employment for the next three years. The contractual life [comprising the vesting period (3 years) and the exercise period (2 years)] of SARs is 5 years.

The other facts of the Illustration are the same as those in Illustration 1(A) of Appendix II. However, it is also assumed that at the end of year 3, 400 employees exercise their SARs, another 300 employees exercise their SARs at the end of year 4 and the remaining 140 employees exercise their SARs at the end of year 5.

The enterprise estimates the fair value of the SARs at the end of each year in which a liability exists and the intrinsic value of the SARs at the end of years 3, 4 and 5. The values estimated by the enterprise are as below:

Year	Fair Value	Intrinsic Value
1	₹ 15.30	
2	₹ 16.50	
3	₹ 19.20	₹ 16.00
4	₹ 21.30	₹ 21.00
5		₹ 26.00

Suggested Accounting Treatment

1. The expense to be recognised each year in respect of SARs are determined as below:

Year 1

No. of SARs expected to vest (as per the original estimate)

1,000 x 300 x 0.97 x 0.97 x 0.97	=	2,73,802 SARs

Provision required at the year-end

2,73,802 SARs x ₹ 15.30 x 1/3	=	₹ 13,96,390
Less: provision at the beginning of the year		Nil
Expense for the year		₹ 13,96,390

Year 2

No. of SARs expected to vest (as per the revised estimate)

1,000 x 300 x 0.94 x 0.94 x 0.94	=	2,49,175 SARs

Provision required at the year-end 2,49,175 SARs x ₹ 16.50 x 2/3 =	₹ 27,40,925
Less: provision at the beginning of the year	₹ (13,96,390)
Expense for the year	₹ 13,44,535
Year 3	
No. of SARs actually vested 840 employees x 300 SARs	2,52,000 SARs
No. of SARs exercised at the year-end 400 employees x 300 SARs	1,20,000 SARs
No. of SARs outstanding at the year-end	1,32,000 SARs
Provision required in respect of SARs outstanding at the year-end	
1,32,000 SARs x ₹ 19.20 =	₹ 25,34,400
Plus: Cash paid on exercise of SARs by employees1,20,000 SARs x ₹ 16.00	= ₹ 19,20,000
Total	₹ 44,54,400
Less: provision at the beginning of the year	₹ (27,40,925)
Expense for the year	₹ 17,13,475
Year 4	
No. of SARs outstanding at the beginning of the year	1,32,000 SARs
No. of SARs exercised at the year-end 300 employees x 300 SARs	90,000 SARs
No. of SARs outstanding at the year-end	42,000 SARs
Provision required in respect of SARs outstanding at the year-end	
42,000 SA₹ x ₹ 21.30 =	₹ 8,94,600
Plus: Cash paid on exercise of SARs 90,000 SARs x ₹ 21.00	=₹.18,90,000
Total	₹ 27,84,600
Less: provision at the beginning of the year	₹ (25,34,400)
Expense for the year	₹ 2,50,200
Year 5	
No. of SARs outstanding at the beginning of the year	42,000 SARs
No. of SARs exercised at the year-end 140 employees x 300 SARs	42,000 SARs
No. of SARs outstanding at the year-end	Nil
Provision required in respect of SARs outstanding at the year-end	Nil
Plus: Cash paid on exercise of SARs 42,000 SARs x ₹ 26.00 =	₹ 10,92,000
Total	₹ 10,92,000
Less: provision at the beginning of the year	₹ (8,94,600)
Expense for the year	₹ 1,97,400

2. The enterprise passes the following entry, in each of the years, to recognise the compensation expense determined as above:

Employee compensation expense A/c	Dr. _________	
To Provision for payment of SARs A/c		_________

(Being compensation expense recognised in respect of SARs)

3. The enterprise passes the following entry, in the years 3, 4 and 5, to record the cash paid on exercise of SARs:

Provision for payment of SARs A/c	Dr. _________	
To Bank A/c		_________

(Being cash paid on exercise of SARs)

4. Balance in the 'Provision for payment of SARs Account', outstanding at year-end, is disclosed in the balance sheet, as a provision under the heading 'Current Liabilities and Provisions'.

Intrinsic Value Method

The accounting treatment suggested above is based on the fair value method. In case the enterprise has followed the intrinsic value method instead of the fair value method, it would make all the computations suggested above on the basis of intrinsic value of SARs on the respective dates instead of the fair value. To illustrate, suppose the intrinsic value of SARs at the grant date is ₹ 6 per right. The intrinsic values of the SARs on the subsequent dates are as below:

Year	Intrinsic Value
1	₹ 9.00
2	₹ 12.00
3	₹ 16.00
4	₹ 21.00
5	₹ 26.00

In the above case, the enterprise would determine the expense to be recognised each year in respect of SARs as below:

Year 1

No. of SARs expected to vest (as per the original estimate)	
1,000 x 300 x 0.97 x 0.97 x 0.97	= 2,73,802 SARs
Provision required at the year-end 2,73,802 SARs x ₹ 9.00 x 1/3	= ₹ 8,21,406
Less: provision at the beginning of the year	Nil
Expense for the year	₹ 8,21,406

Year 2

No. of SARs expected to vest (as per the revised estimate)	
1,000 x 300 x 0.94 x 0.94 x 0.94	= 2,49,175 SARs
Provision required at the year-end	
2,49,175 SARs x ₹ 12.00 x 2/3	= ₹ 19,93,400
Less: provision at the beginning of the year	₹ (8,21,406)
Expense for the year	₹ 11,71,994

Year 3

No. of SARs actually vested 840 employees x 300 SARs	2,52,000 SARs
No. of SARs exercised at the year-end 400 employees x 300 SARs	1,20,000 SARs
No. of SARs outstanding at the year-end	1,32,000 SARs

Provision required in respect of SARs outstanding at the year-end		
1,32,000 SARs x ₹ 16.00		= ₹ 21,12,000
Plus: Cash paid on exercise of SARs by employees 1,20,000 SARs x ₹ 16.00		= ₹ 19,20,000
Total		₹ 40,32,000
Less: provision at the beginning of the year		₹ (19,93,400)
Expense for the year		₹ 20,38,600
Year 4		
No. of SARs outstanding at the beginning of the year		1,32,000 SARs
No. of SARs exercised at the year-end 300 employees x 300 SARs		90,000 SARs
No. of SARs outstanding at the year-end		42,000 SARs
Provision required in respect of SARs outstanding at the year-end		
42,000 SARs x ₹ 21.00	= ₹ 8,82,000	
Plus: Cash paid on exercise of SARs 90,000 SARs x ₹ 21.00 =		₹ 18,90,000
Total		₹ 27,72,000
Less: provision at the beginning of the year		₹ (21,12,000)
Expense for the year		₹ 6,60,000
Year 5		
No. of SARs outstanding at the beginning of the year		42,000 SARs
No. of SARs exercised at the year-end 140 employees x 300 SARs		42,000 SARs
No. of SARs outstanding at the year-end		Nil
Provision required in respect of SARs outstanding at the year-end		Nil
Plus: Cash paid on exercise of SARs 42,000 SARs x ₹ 26.00 =		₹ 10,92,000
Total		₹ 10,92,000
Less: provision at the beginning of the year		₹ (8,82,000)
Expense for the year		₹ 2,10,000

Appendix V

Employee Share-based Payment Plan with Cash Alternatives

Illustration:

An enterprise grants to an employee the right to choose either a cash payment equal to the value of 1,000 shares, or 1,200 shares. The grant is conditional upon the completion of three years' service. If the employee chooses the equity alternative, the shares must be held for three years after vesting date. The face value of shares is ₹ 10 per share.

At grant date, the fair value of the shares of the enterprise (without considering post-vesting restrictions) is ₹ 50 per share. At the end of years 1, 2 and 3, the said fair value is ₹ 52, ₹ 55 and ₹ 60 per share respectively. The enterprise does not expect to pay dividends in the next three years. After taking into account the effects of the post-vesting transfer restrictions, the enterprise estimates that the grant date fair value of the equity alternative is ₹ 48 per share.

At the end of year 3, the employee chooses:

Scenario 1: The cash alternative

Scenario 2: The equity alternative

Suggested Accounting Treatment

1. The employee share-based payment plan granted by the enterprise has two components, viz., (i) a liability component, i.e., the employees' right to demand settlement in cash, and (ii) an equity component, i.e., the employees' right to demand settlement in shares rather than in cash. The enterprise measures, on the grant date, the fair value of two components as below:

Fair value under equity settlement 1,200 shares x ₹ 48 =	₹ 57,600
Fair value under cash settlement 1,000 shares x ₹ 50 =	₹ 50,000
Fair value of the equity component (₹ 57,600 – ₹ 50,000) =	₹ 7,600
Fair value of the liability component	₹ 50,000

2. The enterprise calculates the expense to be recognised in respect of the liability component at the end of each year as below:

Year 1

Provision required at the year-end	1,000 x ₹ 52.00 x 1/3 =	₹ 17,333
Less: provision at the beginning of the year		Nil
Expense for the year		₹ 17,333

Year 2

Provision required at the year-end 1,000 x ₹ 55.00 x 2/3 =	₹ 36,667
Less: provision at the beginning of the year	₹ 17,333
Expense for the year	₹ 19,334

Year 3

Provision required at the year-end	1,000 x ₹ 60.00 =	₹ 60,000
Less: provision at the beginning of the year		₹ 36,667
Expense for the year		₹ 23,333

3. The expense to be recognised in respect of the equity component at the end of each year is one third of the fair value (₹ 7,600) determined at (1) above.

4. The enterprise passes the following entry at the end of each of the years to recognise compensation expense towards liability component determined at (2) above:

Employee compensation expense A/c Dr. _________

To Provision for liability component of employee share-based payment plan __________

(Being compensation expense recognised in respect of liability component of employee share-based payment plan with cash alternative)

5. The enterprise passes the following entry at the end of each of the year to recognise compensation expense towards equity component determined at (3) above:

Employee compensation expense A/c	Dr.	_________	
To Stock Options Outstanding A/c			_________

(Being compensation expense recognised in respect of equity component of employee share-based payment plan with cash alternative)

6. Provision for liability component of employee share-based payment plan, outstanding at year-end, is disclosed in the balance sheet, as a provision under the heading 'Current Liabilities and Provisions'. Credit balance in the 'Stock Options Outstanding A/c' is disclosed under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

7. The enterprise passes the following entry on the settlement of the employee share-based payment plan with cash alternative:

Scenario 1: *The cash alternative*

Provision for liability component of employee share-based payment plan	Dr.	₹ 60,000	
To Bank A/c			₹ 60,000

(Being cash paid on exercise of cash alternative under the employee share-based payment plan)

Stock Options Outstanding A/c	Dr.	₹ 7,600	
To General Reserve			₹ 7,600

(Being the balance standing to the credit of the Stock Options Outstanding Account transferred to the general reserve upon exercise of cash alternative)

Scenario 2: *The equity alternative*

Stock Options Outstanding A/c	Dr.	₹ 7,600	
Provision for liability component of employee share-based payment plan	Dr.	₹ 60,000	
To Share Capital A/c (1,000 shares x ₹ 10)			₹ 10,000
To Securities Premium A/c			₹ 57,600

(Being shares issued on exercise of equity alternative under the employee share-based payment plan)

Appendix VI

Graded Vesting

Continuing Illustration 1(A) of Appendix II, suppose that the options granted vest according to a graded schedule of 25 per cent at the end of the year 1, 25 per cent at the end of the year 2, and the remaining 50 per cent at the end of the year 3. The expected lives of the options that vest at the end of the year 1, 2 and 3 are 2.5 years, 4 years and 5 years respectively. The fair values of these options, computed based on their respective expected lives, are ₹ 10, ₹ 13 and ₹ 15 per option, respectively. It is also assumed that expected forfeiture rate is 3% per year and does not change during the vesting period.

Suggested Accounting Treatment

1. Since the options granted have a graded vesting schedule, the enterprise segregates the total plan into different groups, depending upon the vesting dates and treats each of these groups as a separate plan.

2. The enterprise determines the number of options expected to vest under each group as below:

Vesting Date (Year-end) Options expected to vest

1 300 options x 1,000 employees x 25% x 0.97 = 72,750 options

2 300 options x 1,000 employees x 25% x 0.97 x .97= 70,568 options

3 300 options x 1,000 employees x 50% x 0.97x .97 x .97 =1,36,901 options

Total options expected to vest 2,80,219 options

3. Total compensation expense for the options expected to vest is determined as follows:

Vesting Date (Year-end)	Expected Vesting (No. of Options)	Value per Option (₹)	Compensation Expense (₹)
1	72,750	10	7,27,500
2	70,568	13	9,17,384
3	1,36,901	15	20,53,515
	Total		36,98,399

4. Compensation expense, determined as above, is recognised over the respective vesting periods. Thus, the compensation expense of ₹ 7,27,500 attributable to 72,750 options that vest at the end year 1, is allocated to the year 1. The expense of ₹ 9,17,384 attributable to the 70,568 options that vest at the end of year 2 is allocated over their 2-year vesting period (year 1 and year 2). The expense of ₹ 20,53,515 attributable to the 1,36,901 options that vest at the end of year 3 is allocated over their 3-year vesting period (year 1, year 2 and year 3). Total compensation expense of ₹ 36,98,399, determined at the grant date, is attributed to the years 1, 2 and 3 as below:

Vesting Date	Cost to be recognised		
(End of year)	Year 1	Year 2	Year 3
1	7,27,500		
2	4,58,692	4,58,692	
3	6,84,505	6,84,505	6,84,505
Cost for the year	18,70,697	11,43,197	6,84,505
Cumulative cost	18,70,697	30,13,894	36,98,399

Intrinsic Value Method

The accounting treatment suggested above is based on the fair value method. In case the enterprise has followed the intrinsic value method instead of the fair value method, it would make computations suggested above on the basis of intrinsic value of options at the grant date (which would be the same for all groups) instead of the fair value. To illustrate, suppose the intrinsic value of the option at the grant date is ₹ 6 per option. In such a case, total compensation expense for the options expected to vest would be

Vesting Date (End of year)	Expected Vesting (No. of Options)	Value per Option (₹)	Compensation Expense (₹)
1	72,750	6	4,36,500
2	70,568	6	4,23,408
3	1,36,901	6	8,21,406
	Total		16,81,314

Total compensation expense of ₹ 16,81,314, determined at the grant date, would be attributed to the years 1, 2 and 3 as below:

Vesting Date	Cost to be recognised		
(End of year)	Year 1	Year 2	Year 3
1	4,36,500		
2	2,11,704	2,11,704	
3	2,73,802	2,73,802	2,73,802
Cost for the year	9,22,006	4,85,506	2,73,802
Cumulative cost	9,22,006	14,07,512	16,81,314

Appendix VII

Accounting for Employee Share-based Payment Plans Administered Through a Trust

Illustration 1: Enterprise allots Shares to the ESOP Trust as and when the Employees Exercise Stock Options

At the beginning of year 1, an enterprise grants 300 stock options to each of its 1,000 employees, conditional upon the employees remaining in the employment of the enterprise for one year. The fair value of the stock options, at the date of grant, is ₹ 15 per option and the exercise price is ₹ 50 per share. The options can be exercised in one year after the date of vesting. The other relevant terms of the grant and assumptions are as below:

(a) The grant is administered by an ESOP trust appointed by the enterprise. According to the terms of appointment, the enterprise agrees to allot shares to the ESOP trust as and when the stock options are exercised by the employees.

(b) The number of employees expected to complete one year vesting period, at the beginning of the plan, is 900, i.e., 100 employees are expected to leave during the vesting period and, consequently, the options granted to them are expected to be forfeited.

(c) Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period.

(d) All 900 employees exercised their right to obtain shares vested in them in pursuance of the ESOP at the end of year 2.

(e) Apart from the shares allotted to the trust, the enterprise has 10,00,000 shares of ₹ 10 each outstanding at the end of year 1. The said shares were issued at a premium of ₹ 15 per share. The full amount of premium received on issue of shares is still standing to the credit of the Securities Premium Account. The enterprise has not made any change in the share capital upto the end of year 2, except that arising from transactions with the employees pursuant to the Employee Stock Option Plan.

Suggested Accounting Treatment

The accounting treatment, in this case, would be the same as explained in the case where the enterprise itself is administering the Employee Stock Option Plan (ESOP) although the enterprise issues shares to the ESOP Trust instead of issuing shares to the employees directly. The accounting treatment in this case is explained herein below.

Year 1

1. At the grant date, the enterprise estimates the fair value of the options expected to vest at the

end of the vesting period as below:

No. of options expected to vest

(1,000 – 100) employees x 300 options = 2,70,000 options

Fair value of options expected to vest

2,70,000 options x ₹ 15 = ₹ 40,50,000

2. At the end of the financial year, the enterprise examines its actual forfeitures and makes necessary adjustments, if any, to reflect expense for the number of options that actually vested. Considering that actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed one year vesting period, the enterprise recognises the fair value of options expected to vest (estimated at 1 above) towards the employee services received by passing the following entry:

Employee compensation expense A/c Dr. ₹ 40,50,000

To Stock Options Outstanding A/c ₹ 40,50,000

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding Account' is disclosed in the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus', as below:

Extracts from the Balance Sheet

Liabilities ***Share Capital***	***Amount (₹)***
Paid-up Capital:	
10,00,000 equity shares of ₹ 10 each	1,00,00,000
Stock Options Outstanding Account	40,50,000
Reserves and Surplus	
Securities Premium A/c (10,00,000 shares x ₹ 15)	1,50,00,000

Year 2

1. On exercise of the right to obtain shares by the employees, the enterprise allots shares to the ESOP Trust for issuance to the employees. The shares so issued are considered to have been issued on a consideration comprising the exercise price and the fair value of the options. In the present case, the exercise price is ₹ 50 per share and the fair value of the options is ₹ 15 per option. The enterprise, therefore, considers the shares to be issued at a price of ₹ 65 per share.

2. The amount to be recorded in the 'Share Capital Account' and the 'Securities Premium Account', upon issuance of the shares, is calculated as below:

Particulars	***Computations***
No. of employees exercising option	900
No. of shares issued on exercise @ 300 per employee	2,70,000
Exercise Price @ ₹ 50 per share	1,35,00,000
Fair value of options @ ₹ 15 per option	40,50,000
Total Consideration	1,75,50,000

Amount to be recorded in 'Share Capital A/c' @ ₹ 10 per share	27,00,000
Amount to be recorded in 'Securities Premium A/c' @ ₹ 55 per share	1,48,50,000
Total	1,75,50,000

3. The ESOP Trust receives exercise price from the employees exercising the options vested in them in pursuance of the Employee Stock Option Plan. The Trust passes on the exercise price so received to the enterprise for issuance of shares to the employees. The enterprise allots shares to the ESOP Trust for issuance to the employees exercising the options vested in them in pursuance of the Employee Stock Option Plan. To recognise the transaction, the following entry is passed:

Bank A/c Dr.	₹.1,35,00,000	
Stock Options Outstanding A/c Dr.	₹ 40,50,000	
To Share Capital A/c		₹ 27,00,000
To Securities Premium A/c		₹ 1,48,50,000

(Being shares allotted to the ESOP Trust for issuance to the employees against the options vested in them in pursuance of the Employee Stock Option Plan)

4. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities **Share Capital**	**Amount (₹)**
Paid-up Capital:	
12,70,000 equity shares of ₹ 10 each fully paid	1,27,00,000
(Of the above, 2,70,000 shares of ₹ 10 each have been issued to the employees pursuant to an Employee Share-based Payment Plan. The issue price of the share was ₹ 65 per share out of which ₹ 15 per share were received in the form of employee services over a period of one year).	
Reserves and Surplus	
Securities Premium A/c	2,98,50,000

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, stock options granted pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, stock options so granted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 2: Enterprise Provides Finance to the ESOP Trust for Subscription to Shares Issued by the Enterprise at the Beginning of the Plan

Continuing Illustration 1 above, suppose the enterprise provides finance, at the grant date, to the ESOP trust for subscription to the shares of the enterprise equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the trust subscribes to the shares offered by the enterprise at a cash price of ₹ 50 per share, at the beginning of the plan. The Trust would issue shares to the employees as and when they exercise the right vested in them in pursuance of the Employee Stock Option Plan (ESOP). The other facts of the case are the same as in Illustration 1.

Suggested Accounting Treatment

The computations of employee compensation expense, amount to be recognised in the Share Capital Account and the Securities Premium Account, etc., would be the same as that in Illustration 1 above.

Year 1

1. The enterprise passes the following entry to record provision of finance [₹ 1,35,00,000 (i.e., 2,70,000 shares x ₹ 50)] to the ESOP trust:

Amount recoverable from ESOP Trust A/c	Dr.	₹ 1,35,00,000	
To Bank A/c			₹ 1,35,00,000

(Being finance provided to the ESOP trust for subscription of shares)

2. The enterprise passes the following entry to record the allotment of 2,70,000 shares to the ESOP Trust at ₹ 65 per share [comprising the exercise price (₹ 50) and the fair value of options (₹ 15)]:

Bank A/c	Dr.	₹ 1,35,00,000	
Amount recoverable from ESOP Trust A/c	Dr.	₹ 40,50,000	
To Share Capital A/c			₹ 27,00,000
To Securities Premium A/c			₹ 1,48,50,000

(Being shares allotted to the ESOP Trust in respect of the Employee Stock Option Plan)

3. The enterprise passes the following entry to recognise the employee services received during the year:

Employee compensation expense A/c	Dr.	₹ 40,50,000	
To Stock Options Outstanding A/c			₹ 40,50,000

(Being compensation expense recognised in respect of the ESOP)

4. The Share Capital Account, the Securities Premium Account, credit balance in the 'Stock Options Outstanding Account' and debit balance in the 'Amount recoverable from ESOP Trust Account' are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities **Share Capital**	**Amount (₹)**	
Paid-up Capital:		
12,70,000 equity shares of ₹ 10 each	1,27,00,000	
Less: Amount recoverable from ESOP Trust	27,00,000	1,00,00,000
(face value of 2,70,000 share allotted to the Trust)		
Stock Options Outstanding Account	40,50,000	
Reserves and Surplus		
Securities Premium Account	2,98,50,000	
Less: Amount recoverable from ESOP Trust	1,48,50,000	1,50,00,000
(Premium on 2,70,000 share allotted to the Trust)		

5. Apart from other required disclosures, the enterprise gives a suitable note in the Notes to Accounts to explain the transaction and the nature of deduction of the 'Amount recoverable from ESOP Trust' made from the 'Share Capital' and the 'Securities Premium Account'.

Year 2

1. On exercise of the right to obtain shares, the ESOP trust issues shares to the respective employees after receiving the exercise price of ₹ 50 per share. The ESOP Trust passes on the exercise price received on issue of shares to the enterprise. The enterprise passes the following entry to record the receipt of the exercise price:

Bank A/c	Dr.	₹ 1,35,00,000	
To Amount recoverable from ESOP Trust A/c			₹ 1,35,00,000

(Being amount received from the ESOP Trust against finance provided to it at the beginning of the Employee Stock Option Plan)

2. The enterprise transfers the balance standing to the credit of the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

Stock Options Outstanding A/c	Dr.	₹ 40,50,000	
To Amount recoverable from ESOP Trust A/c			₹ 40,50,000

(Being consideration for shares issued to the employees received in the form of employee services adjusted against the relevant account)

3. The Share Capital Account and the Securities Premium Account are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	***Amount (₹.)***
Share Capital *Paid-up Capital*: 12,70,000 equity shares of ₹ 10 each fully paid (Of the above, 2,70,000 shares of ₹ 10 each have been issued to the employees (through ESOP Trust) pursuant to an Employee Share-based Payment Plan. The issue price of the share was ₹ 65 per share out of which ₹ 15 per share were received in the form of employee services over a period of one year).	1,27,00,000
Reserves and Surplus Securities Premium Account	2,98,50,000

Computation of Earnings Per Share

For the purpose of calculating Basic EPS, shares allotted to the ESOP Trust pursuant to the employee share-based payment plan would not be included in the shares outstanding till the employees have exercised their right to obtain shares, after fulfilling the requisite vesting conditions. Till such time, the shares so allotted would be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Illustration 3: Enterprise Provides Finance to the ESOP Trust to Purchase Shares from the Market at the beginning of the Plan

Continuing Illustration 2 above, suppose the enterprise does not issue fresh shares to the ESOP Trust. Instead, it provides finance, at the grant date, to the trust to purchase shares of the enterprise from the market, equivalent to the number of shares expected to vest. With the help of finance provided by the enterprise, the ESOP Trust purchases 2,70,000 shares from the market @ ₹ 52 per share at the beginning of the plan. The other facts remain the same as in Illustration 2 above.

Suggested Accounting Treatment

Year 1

1. The enterprise passes the following entry to record provision of finance [₹ 1,40,40,000 (i.e., 2,70,000 shares x ₹ 52)] to the ESOP trust:

Amount recoverable from ESOP Trust A/c	Dr.	₹ 1,40,40,000	
To Bank A/c			₹ 1,40,40,000

(Being finance provided to the ESOP trust for purchase of shares in respect of the ESOP)

2. The enterprise passes the following entry at the end of the year to recognise the employee services received during the year:

Employee compensation expense A/c	Dr.	₹ 40,50,000	
To Stock Options Outstanding A/c			₹ 40,50,000

(Being compensation expense recognised in respect of the ESOP)

3. Credit balance in the 'Stock Options Outstanding Account' is disclosed on the liability side of the balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'. Debit balance in the 'Amount recoverable from ESOP Trust Account' is disclosed on the asset side under a separate heading, between the 'Investments' and the 'Current Assets, Loans and Advances'. On this basis, the relevant extracts of the balance sheet appear as below:

Extracts from the Balance Sheet

Liabilities	**Amount (₹)**
Share Capital	
Paid-up Capital:	
10,00,000 equity shares of ₹ 10 each	1,00,00,000
Stock Options Outstanding Account	40,50,000
Reserves and Surplus	
Securities Premium Account	1,50,00,000
Assets	**Amount (₹)**
Investments —	
Amount recoverable from ESOP Trust	1,40,40,000
Current Assets, Loans and Advances —	

4. Apart from the other required disclosures, the enterprise gives a suitable note in the 'Notes to Accounts' to explain the transaction and the nature of the 'Amount recoverable from ESOP Trust'.

Year 2

1. On exercise of the right to obtain shares by the employees, the ESOP trust issues shares to the respective employees after receiving the exercise price. The exercise price so received is passed on to the enterprise.

The amount received, in this manner, is ₹ 1,35,00,000 (i.e., 900 employees x 300 options x ₹ 50). The enterprise passes the following entry to record the receipt of the exercise price:

Bank A/c	Dr.	₹ 1,35,00,000	
To Amount recoverable from ESOP Trust A/c			₹ 1,35,00,000

(Being amount received from the ESOP trust against the finance provided to it in respect of the Employee Stock Option Plan)

2. The enterprise transfers an amount equivalent to the difference between the cost of shares to the ESOP Trust and the exercise price from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account'. In the present case, there is a difference of ₹ 2 per share (i.e., ₹ 52 – ₹ 50) between the cost of shares and the exercise price. The number of shares issued to the employees is 2,70,000. The enterprise, accordingly, transfers an amount of ₹ 5,40,000 from the 'Stock Options Outstanding Account' to the 'Amount recoverable from ESOP Trust Account' by passing the following entry:

Stock Options Outstanding A/c	Dr.	₹ 5,40,000	
To Amount recoverable from ESOP Trust A/c			₹ 5,40,000

(Being the difference between the cost of shares to the ESOP Trust and the exercise price adjusted)

3. The balance of ₹ 35,10,000 (i.e., ₹ 40,50,000 – ₹ 5,40,000)

standing to the credit of the 'Stock Options Outstanding Account' is transferred to the 'General Reserve' by passing the following entry:

Stock Options Outstanding A/c	Dr.	₹ 35,10,000	
To General Reserve			₹ 35,10,000

(Being balance in the 'Stock Options Outstanding Account' transferred to the 'General Reserve', at the end of the Employee Stock Option Plan)

4. The Share Capital Account, the Securities Premium Account and the General Reserve are disclosed in the balance sheet as below:

Extracts from the Balance Sheet

Liabilities	Amount (₹)	
Share Capital		
Paid-up Capital:		
10,00,000 equity shares of ₹ 10 each fully paid	1,00,00,000	
Reserves and Surplus		
Securities Premium Account	1,50,00,000	
General Reserve	xx,xx,xxx	
Add: Amount transferred from the Stock		
Options Outstanding Account	35,10,000	yy,yy,yyy

5. The enterprise gives a suitable note in the 'Notes to Accounts' to explain the nature of the addition of ₹ 35,10,000 made in the 'General Reserve'.

Computation of Earnings Per Share

In this case, the enterprise does not issue any new shares either at the beginning of the Employee Stock Option Plan or on exercise of stock options by the employees. Instead, the ESOP Trust purchases the shares from the market at the beginning of the plan and the employees exercising options vested in them are granted shares out of the shares so purchased. The shares purchased by the Trust represent the shares that have already been issued by the enterprise and the same should continue to be included in the shares outstanding for the purpose of calculating Basic EPS as would have been done prior to the purchase of the shares by the Trust. Since the exercise of stock options granted under the plan does not result into any fresh issue of shares, the stock options granted would not be considered as dilutive potential equity shares for the purpose of calculating Diluted EPS.

Appendix VIII

Computation of Earnings Per Share

Illustration:

At the beginning of year 1, an enterprise grants 300 stock options to each of its 1,000 employees, conditional upon the employees remaining in the employment of the enterprise for two years. The fair value of the stock options, at the date of grant, is ₹ 10 per option and the exercise price is ₹ 50 per share. The other relevant terms of the grant and assumptions are as below:

(a) The number of employees expected to complete two years vesting period, at the beginning of the plan, is 900. 50 employees are expected to leave during the each of the year 1 and year 2 and, consequently, the options granted to them are expected to be forfeited.

(b) Actual forfeitures, during the vesting period, are equal to the expected forfeitures and 900 employees have actually completed two-years vesting period.

(c) The profit of the enterprise for the year 1 and year 2, before amortisation of compensation cost on account of ESOPs, is ₹ 25,00,000 and ₹ 28,00,000 respectively.

(d) The fair value of shares for these years was ₹ 57 and ₹.60 respectively.

(e) The enterprise has 5,00,000 shares of ₹ 10 each outstanding at the end of year 1 and year 2.

Compute the Basic and Diluted EPS, ignoring tax impacts, for the year 1 and year 2.

Suggested Computations

(a) The stock options granted to employees are not included in the shares outstanding till the employees have exercised their right to obtain shares or stock options, after fulfilling the requisite vesting conditions. Till such time, the stock options so granted are considered as dilutive potential equity shares for the purpose of calculating Diluted EPS. At the end of each year, computations of diluted EPS are based on the actual number of options granted and not yet forfeited.

(b) For calculating diluted EPS, no adjustment is made to the net profit attributable to equity shareholders as there are no expense or income that would result from conversion of ESOPs to the equity shares.

(c) For calculating diluted EPS, the enterprise assumes the exercise of dilutive options. The assumed proceeds from these issues are considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value are treated as an issue of equity shares for no consideration

(d) As per paragraph 47 of this Guidance Note, the assumed proceeds to be included for computation, mentioned at (c) above, include (i) the exercise price; and (ii) the unamortized compensation cost related to these ESOPs, attributable to future services.

(e) The enterprise calculates the basic and diluted EPS as below:

Particulars	**Year 1**	**Year 2**
Net profit before amortisation of ESOP		
cost	₹ 25,00,000	₹ 28,00,000
Less: Amortisation of ESOP cost	(₹ 13,50,000)	(₹ 13,50,000)
[(900 employees × 300 options × ₹ 10)/2]		
Net profit attributable to equity shareholders	₹ 11,50,000	₹ 14,50,000
Number of shares outstanding	5,00,000	5,00,000

Basic EPS	₹ 2.30	₹ 2.90
Number of options outstanding (Options granted less actual forfeitures)	2,85,000	2,70,000
[1,000 employees [2,85,000× 300 options – options – (50 employees (50 employees × 300 options)] × 300 options)]		
Unamortised compensation cost per option	₹ 5 [₹ 10 – ₹ 10/2]	₹ 0
Number of dilutive potential equity shares [2,85,000 – [2,70,000 –({(2,85,000 * 50) (2,70,000 + (2,85,000 * 50)/60)]* 5)}/57)]	10,000	45,000
No. of equity shares used to compute diluted earnings per share	5,10,000	5,45,000
Diluted EPS	₹ 2.255	₹ 2.66

Appendix IX

Illustrative Disclosures

An example has been given in this appendix to illustrate the disclosure requirements in paragraphs 49 to 52 of the text of the Guidance Note. The students are advised to refer this appendix from the compendium of Guidance Notes.

GN(A) 22 (Issued 2006)

Guidance Note on Accounting for Credit Available in respect of Minimum Alternative Tax under the Income-tax Act, 1961

(The following is the text of the Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax Under the Income-tax Act,1961, issued by the Council of the Institute of Chartered Accountants of India.)

Introduction

1. The Finance Act, 1997, introduced section 115JAA in the Income-tax Act, 1961 (hereinafter referred to as the 'Act') providing for tax credit in respect of MAT paid under section 115JA (hereinafter referred to as 'MAT credit') which could be carried forward for set-off for five succeeding years in accordance with the provisions of the Act. Section 115JA was inserted by the Finance Act, 1996, w.e.f. 1.4.1997. The said section provided for payment of Minimum Alternative Tax (hereinafter referred to as 'MAT') by certain companies, where the total income, as computed under the Income-tax Act, 1961, in respect of any previous year relevant to the assessment year commencing on or after 1st day of April, 1997, but before the 1st day of April, 2001, was less than 30% of its book profit. In such a case, the total income of the company chargeable to tax for the relevant previous year was deemed to be an amount equal to thirty per cent of its book profit.

2. The Finance Act, 2000, w.e.f. 1.4.2001, introduced section 115JB according to which a company is liable to pay MAT under the provisions of the said section in respect of any previous year relevant to the assessment year commencing on or after the 1st day of April, 2001. The MAT under this section is

payable where the normal income-tax payable by such company in the previous year is less than 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit which is deemed to be the total income of the company. Such company is liable to pay income-tax at the rate of 7.5 per cent (10 per cent proposed by the Finance Bill, 2006) of its book profit.

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07.

3. The salient features of MAT credit under section 115JAA as applicable, in respect of tax paid under sections 115JA and 115JB, are as below:

(a) A company, which has paid MAT, would be allowed credit in respect thereof.

(b) The amount of MAT credit would be equal to the excess of MAT over normal income-tax for the assessment year for which MAT is paid.

(c) No interest is allowable on such credit.

(d) The MAT credit so determined can be carried forward for set-off for five succeeding assessment years from the year in which MAT credit becomes allowable. The Finance Bill, 2006, has proposed that credit in respect of MAT paid under section 115JB can be carried forward upto seven succeeding assessment years (hereinafter referred to as the 'specified period').

(e) The amount of MAT credit can be set-off only in the year in which the company is liable to pay tax as per the normal provisions of the Act and such tax is in excess of MAT for that year.

(f) The amount of set-off would be to the extent of excess of normal income-tax over the amount of MAT calculated as if section 115JB had been applied for that assessment year for which the set-off is being allowed.

Accounting Treatment

Whether MAT credit is a deferred tax asset

4. An issue has been raised whether the MAT credit can be considered as a deferred tax asset within the meaning of Accounting Standard (AS) 22, Accounting for Taxes on Income, issued by the Institute of Chartered Accountants of India. In this context, the following definitions given in AS 22 are noted:

"Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."

"Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving."

"Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined."

5. From the above, it is noted that payment of MAT, does not by itself, result in any timing difference since it does not give rise to any difference between the accounting income and the taxable income which are arrived at before adjusting the tax expense, namely, MAT. In other words, under AS 22, deferred tax asset and deferred tax liability arise on account of differences in the items of income and expenses credited or charged in the profit and loss account as compared to the items of income that are taxed or items of expense that are allowed as deduction, for the purposes of the Act. Thus, deferred tax assets and deferred tax liabilities do not arise on account of the amount of the tax expense itself. In view of this, it is not appropriate to consider MAT credit as a deferred tax asset for the purposes of AS 22.

Whether MAT credit can be considered as an 'asset'

6. Although MAT credit is not a deferred tax asset under AS 22 as discussed above, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specified period. A question, therefore, arises whether the MAT credit can be considered as an 'asset' and in case it can be considered as an asset whether it should be so recognised in the financial statements.

7. The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term 'asset' as follows:

"An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

8. MAT paid in a year in respect of which the credit is allowed during the specified period under the Act is a resource controlled by the company as a result of past event, namely, the payment of MAT. MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period.

Accordingly, MAT credit is an 'asset'.

9. According to the Framework, once an item meets the definition of the term 'asset', it has to meet the criteria for recognition of an asset so that it may be recognised as such in the financial statements. Paragraph 88 of the Framework provides the following criteria for recognition of an asset:

"88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably."

10. In order to decide when it is 'probable' that the future economic benefits associated with the asset will flow to the enterprise, paragraph 84 of the Framework, *inter alia*, provides as below:

"84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared."

11. The concept of probability as contemplated in paragraph 84 of the Framework relates to both items of assets and liabilities and, therefore, the degree of uncertainty for recognition of assets and liabilities may vary keeping in view the consideration of 'prudence'. Accordingly, while for recognition of a liability the degree of uncertainty to be considered 'probable' can be 'more likely than not' (as in paragraph 22 of Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets') for recognition of an asset, in appropriate conditions, the degree may have to be higher than that. Thus, for the purpose of consideration of the probability of expected future economic benefits in respect of MAT credit, the fact that a company is paying MAT and not the normal income tax, provides a *prima facie* evidence that normal income tax liability may not arise within the specified period to avail MAT credit. In view of this, MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. Such evidence may exist, for example, where a company has, in the current year, a deferred tax liability because its depreciation for the income-tax purposes is higher than the depreciation for accounting purposes, but from the next year onwards, the depreciation for accounting purposes would be higher than the depreciation for income-tax purposes, thereby resulting in the reversal of the deferred tax liability to an extent that the company becomes liable to pay normal income tax.

12. Where MAT credit is recognised as an asset in accordance with paragraph 11 above, the same should be reviewed at each balance sheet date. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period.

Presentation of MAT credit in the financial statements

Balance Sheet

13. Where a company recognises MAT credit as an asset on the basis of the considerations specified in paragraph 11 above, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

14. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 above.

Profit and Loss Account

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 24 (Issued 2006)

Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

(The following is the text of the Guidance Note on Measurement of Income-tax Expense for Interim Financial Reporting in the context of AS 25, issued by the Council of the Institute of Chartered Accountants of India.)

1. Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.

2. The general principles for recognition and measurement have been laid down in AS 25 as below:

"27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

3. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

"29.....

(c) income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

4. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:

"8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period."

5. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:

(i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

(ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:

(a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

(b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

(iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.

(iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

6. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

7. Appendix B contains examples of computing weighted average annual effective tax rate.

APPENDIX A

EXTRACTS FROM APPENDIX 3 TO ACCOUNTING STANDARD (AS) 25, INTERIM FINANCIAL REPORTING

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns ₹ 150 lakhs pre-tax profit in the first quarter but expects to incur losses of ₹ 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in ₹ lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns ₹ 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in ₹ lakhs)

	Quarter Ending 31 Dec. Year 1	Quarter Ending 31 Mar. Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep. Year 2	Year Ending 30 Sep. Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carry forwards

15. A deferred tax asset should be recognised in respect of carry forward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carry forward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of ₹ 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns ₹ 100 lakhs in the first quarter of the current year and expects to earn ₹ 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on ₹ 400 lakhs of earnings for the current year would be ₹ 120 lakhs {(₹ 400 lakhs - ₹ 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(₹ 120 lakhs/₹ 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in ₹ lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	30.00	30.	30.00	30.00	120.00

Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: *When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.*

	QUARTER I ₹	QUARTER II ₹	QUARTER III ₹	QUARTER IV ₹	**Total** ₹
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off there against. Therefore, it will not have any tax effect on future periods.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)
Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year (50x30/100)					15
Weighted Average Annual Effective Tax Rate (current tax)					$\frac{30}{175}$ x100=17.14%

Weighted Average Annual Effective Tax Rate (deferred tax)_					$\frac{15}{175}$ x 100 = 8.57%
Tax expense for the interim period Current tax Deferred tax Total	 (4.29) (2.14) (6.43)	 30 15 45	 (4.29) (2.14) (6.43)	 8.57 4.29 12.86	 29.99 15.01 45.00

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 2: *When deferred tax asset was recognised for carried forward losses from earlier accounting periods.*

	QUARTER I ₹	QUARTER II ₹	QUARTER III ₹	QUARTER IV ₹	**Total** ₹
Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year)	(25)	175	(25)	50	175
Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off there against. This will result in reversal of the deferred tax asset in the current year.					(25)
Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year.					(50)

Estimated taxable income on which tax payable.					100
Applicable tax rate (say)					30%
Estimated current tax expense for the year.					30
Estimated deferred tax expense for the year: (i) Deferred tax liability on account of timing difference in depreciation (50x30/100) 15 (ii) Reversal of deferred tax asset (25x30/100) 7.5					22.5
Weighted Average Annual Effective Tax Rate (Current tax)					$\frac{30}{175}$ x100=17.14%
Weighted Average Annual Effective Tax Rate (Deferred tax)					$\frac{22.5}{175}$ x100=12.86%
Tax expense for the interim period					
Current tax	(4.29)	30.0	(4.29)	8.57	29.99
Deferred tax	(3.21)	22.5	(3.21)	6.43	22.51
Total	(7.50)	52.5	(7.50)	15.00	52.50

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: *When progressive rates of tax are applicable*

Under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

Estimated annual income ₹ 1 lakh

Assumed Tax Rates:

On first ₹ 40,000 30%

On the balance income 40%

Tax expense: 30% of ₹ 40,000 + 40% of ₹ 60,000 = ₹ 36,000

Weighted average annual effective tax rate = $\frac{36,000}{1,00,000}$ x 100 = 36%

Supposing the estimated income of each quarter is ₹ 25,000, the tax expense of ₹ 9,000 (36% of ₹ 25,000) would be recognised in each of the quarterly financial reports.

Example 4: *When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para5(iii))*

Estimated annual income ₹ 1 lakh

(inclusive of Estimated Capital Gains (earned in Quarter II) ₹ 20,000

Assumed Tax Rates:

On Capital Gains 10%

On other income:

First ₹ 40,000 30%

Balance income 40%

Assuming there is no difference between the estimated taxable income and the estimated accounting income,

Tax Expense:

On Capital Gains portion of annual income:

10% of ₹ 20,000 ₹ 2,000

On other income: 30% of ₹ 40,000 + 40% of ₹ 40,000 ₹ 28,000

Total: ₹ 30,000

Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual income: $\frac{2,000}{20,000}$ x 100 = 10%

On other income: $\frac{28,000}{80,000}$ x 100 = 35%

Supposing the estimated income of each quarter is ₹ 25,000, when income of ₹ 25,000 for 2nd Quarter includes capital gains of ₹ 20,000, the tax expense for each quarter will be calculated as below:

		Income	Tax Expense		
Quarter I:		₹ 25,000	35% of ₹ 25,000 =	₹ 8,750	
Quarter II:	Capital Gains:	₹ 20,000	10% of ₹ 20,000 =	₹ 2,000	
	Other:	₹ 5,000	35% of ₹ 5,000 =	₹ 1,750	₹ 12,500
Quarter III:		₹ 25,000	35% of ₹ 25,000 =		₹ 8,750
Quarter IV:		₹ 25,000	35% of ₹ 25,000 =		₹ 8,750
Total tax expense for the year					₹ 30,000

GN(A) 28 (Issued 2008)

Guidance Note on Applicability of AS 25 to Interim Financial Results[1]

(The following is the text of the 'Guidance Note on Applicability of AS 25 to Interim Financial Results', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 27 - 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether Accounting Standard (AS) 25, *Interim Financial Reporting*, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.
2. Accounting Standard (AS) 25, *Interim Financial Reporting*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. If any enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard (applicability paragraph).
3. AS 25 further provides as follows:

"1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator."

"4. The following terms are used in this Statement with the meanings specified:

> ***……………***
>
> ***<u>Interim financial report</u> means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Statement) for an interim period."***

Recommendation

4. The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as

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[1] This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results (Re. AS 25)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by ICAI, ASI 27 has not been so incorporated as it was felt that it was not relevant to the requirements of the Companies Act, 1956. The Council of the ICAI, accordingly, has decided to withdraw ASI 27 and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

GN(A) 29 (Issued 2008)

Guidance Note on Turnover in Case of Contractors[1]

(The following is the text of the 'Guidance Note on Turnover in case of Contractors', issued by the Council of the Institute of Chartered Accountants of India. Pursuant to the issuance of this Guidance Note, Accounting Standards Interpretation (ASI) 29 – 'Turnover in case of Contractors (Re. AS 7)', stands withdrawn.)

Introduction

1. This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, *Construction Contracts* (revised 2002), can be considered as 'turnover'.
2. AS 7 (revised 2002) deals, *inter alia*, with revenue recognition in respect of construction contracts in the financial statements of contractors. It requires recognition of revenue by reference to the stage of completion of a contract (referred to as 'percentage of completion method'). This method results in reporting of revenue which can be attributed to the proportion of work completed. Under this method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting period in which the work is performed.
3. The paragraph dealing with the 'Objective' of AS 7 (revised 2002) provides as follows:

"Objective

The objective of this Statement is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Statement uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria."

From the above, it may be noted that AS 7 (revised 2002) deals, *inter alia*, with the allocation of contract revenue to the accounting periods in which construction work is performed.

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[1] This Guidance Note was earlier issued as Accounting Standards Interpretation (ASI) 29, 'Turnover in case of Contractors (Re. AS 7)' by the Institute of Chartered Accountants of India (ICAI). While the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, have incorporated the 'Consensus' part of various ASIs issued by the ICAI, ASI 29 has not been so incorporated as it was felt that it is primarily clarificatory in nature. The Council of the ICAI, has accordingly, decided to withdraw ASI 29, and issue the same as a Guidance Note as it provides appropriate guidance on the subject.

4. Further, paragraphs 21 and 31 of AS 7 (revised 2002) provide as follows:

"21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

"31. When the outcome of a construction contract cannot be estimated reliably:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35."

From the above, it may be noted that the recognition of revenue as per AS 7 (revised 2002) may be inclusive of profit (as per paragraph 21 reproduced above) or exclusive of profit (as per paragraph 31 reproduced above) depending on whether the outcome of the construction contract can be estimated reliably or not. When the outcome of the construction contract can be estimated reliably, the revenue is recognised inclusive of profit and when the same cannot be estimated reliably, it is recognised exclusive of profit. However, in either case it is considered as revenue as per AS 7 (revised 2002).

5. 'Revenue' is a wider term. For example, within the meaning of Accounting Standard (AS) 9, *Revenue Recognition*, the term 'revenue' includes revenue from sales transactions, rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. The term 'turnover' is used in relation to the source of revenue that arises from the principal revenue generating activity of an enterprise. In case of a contractor, the construction activity is its principal revenue generating activity. Hence, the revenue recognised in the statement of profit and loss of a contractor in accordance with the principles laid down in AS 7 (revised 2002), by whatever nomenclature described in the financial statements, is considered as 'turnover'.

Recommendation

6. The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

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Guidance Note on Accounting for Derivative Contracts

Introduction

1. In the year 2007, the Institute of Chartered Accountants of India (ICAI), issued Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31*, Financial Instruments: Presentation.* Both of these Accounting Standards were to come into effect in respect of accounting periods commencing on or after April 1, 2009 and were to be recommendatory in nature for an initial period of two years. These were to become mandatory in respect of accounting periods commencing on or after April 1, 2011. Further, it was clarified, that from the date of AS 30

becoming recommendatory in nature, the following Guidance Notes on Accounting, issued by the ICAI, stood withdrawn:

(i) Guidance Note on Guarantees & Counter Guarantees given by the Companies

(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds

(iii) Guidance Note on Accounting for Securitisation

(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

2. In March 2008, the ICAI issued an announcement that in case of derivatives, if an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in Accounting Standard (AS) 1*, Disclosure of Accounting Policies*, the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market. This announcement was applicable to financial statements for the period ending March 31, 2008, or thereafter. In case of forward contracts to which Accounting Standard (AS) 11*, The Effects of Changes in Foreign Exchange Rates (revised 2003)* applies the entity needs to fully comply with the requirements of AS 11.

3. Subsequently, in the year 2008, Accounting Standard (AS) 32, *Financial Instruments: Disclosures,* was issued by the ICAI, which was also recommendatory initially and was to become mandatory in respect of accounting periods commencing on or after April 1, 2011.

4. Owing to global financial crisis which raised issues regarding accounting treatment of financial instruments, various accounting standards setting bodies including the ICAI examined these aspects. Later, the ICAI withdrew the recommendatory as well as mandatory status of AS 30, AS 31 and AS 32 in March 2011 by means of an announcement. The announcement clarified that considering that International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, issued by the International Accounting Standards Board (IASB), on which AS 30 is based, was under revision by the IASB. AS 30 was not expected to be continued in its present form, i.e., was expected to be revised. Further, the status of AS 30, AS 31 and AS 32 was clarified as below:

(i) To the extent of accounting treatments covered by any of the existing notified Accounting Standards (e.g. AS 11, AS 13 etc.), the existing Accounting Standards would continue to prevail over AS 30, AS 31 and AS 32.

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (e.g. Loan impairment, investment classification or accounting for securitisations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30, AS 31, AS 32.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30, AS 31 and AS 32 subject to (i) and (ii) above.

5. Accordingly, currently, the relevant source of guidance for accounting of foreign currency forward exchange contracts is AS 11, which is notified under the Companies (Accounting Standards) Rules, 2006. AS 11 lays down accounting principles for foreign currency transactions and foreign exchange forward contracts and in substance similar contracts. However, it does not cover all types of foreign exchange forward contracts since contracts used to hedge highly probable forecast transactions and firm commitments are outside the scope of AS 11.

6. This Guidance Note will apply to all entities that do not apply Indian Accounting Standards (Ind AS).

Objective

7. The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities.

Scope

8. This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:

(i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.

(ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.

9. Entities such as banking, non-banking finance companies ('NBFCs'), housing finance companies and insurance entities are required to follow the accounting treatment for derivative contracts, if any, prescribed by the concerned regulators such as the Reserve Bank of India (RBI) in case of banking entities and the NBFCs, National Housing Bank (NHB) in case of housing finance companies and Insurance Regulatory and Development Authority (IRDA) in case of insurance entities. In case the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained herein should be followed.

10. This Guidance Note also provides guidance on accounting of assets covered by Accounting Standard (AS) 2, *Valuation of Inventories*, Accounting Standard (AS) 10, *Accounting for Fixed Assets*, Accounting Standard (AS) 13, *Accounting for Investments*, etc., which are designated as hedged items, since such notified Accounting Standards are silent on hedge accounting using derivative instruments for items covered by these Standards. In contrast, AS 11 provides guidance specific to foreign currency forward contracts. Accordingly, guidance for accounting for derivatives and hedging relationships which pertain to hedged items covered under such notified Accounting Standards, e.g., commodities stock, fixed assets, investments etc., is provided in this Guidance Note. However, this Guidance Note does not provide guidance on accounting for items and transactions covered in AS 11, which is a notified Standard. Similarly, accounting for embedded derivative contracts is not part of the scope of this Guidance Note since there are potential conflicts with the requirements of certain other notified Accounting Standards such as AS 2, AS 13 etc. Further, this Guidance Note does not deal with macro-hedging and accounting for non-derivative financial assets/liabilities which are designated as hedging instruments since its objective is to provide guidance on accounting for derivative contracts only and not hedge accounting in its entirety.

11. This Guidance Note, thus, applies to following derivative contracts whether or not used as hedging instruments:

(i) Foreign exchange forward contracts (or other financial instruments that are in substance forward contracts) that are hedges of highly probable forecast transactions and firm commitments (therefore outside the scope of AS 11);

(ii) Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps if not in the scope of AS 11;

(iii) Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts; and

(iv) Commodity derivative contracts;

This list is meant to be illustrative only and is not exhaustive.

12. Examples of contracts covered within the scope of AS 11 and thus not covered within the scope of this Guidance Note include:

- Foreign currency forward or future contract entered into to hedge the payment of a monetary asset or a monetary liability recognised on balance sheet, e.g., a debtor, creditor, loan, borrowing etc.
- A currency swap contract (principal only; no interest rate element) that hedges the repayment of the principal of a foreign currency loan.

This list is meant to be illustrative only and is not exhaustive.

Definitions

13. For the purpose of this Guidance Note, the following terms are used with the meanings specified as below:

Derivative: A derivative is a financial instrument or other contract with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the "underlying");
- it requires no initial net investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- it is settled at a future date.

Firm Commitment: A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified future date or dates.

Forecast transaction: A forecast transaction is an uncommitted but anticipated future transaction.

Hedging Instrument: A hedging instrument is a designated derivative whose fair value or cash flows are expected to offset changes in the fair value or cash flows, of a designated hedged item. For the purposes of applying hedging in consolidated financial statements, the counterparty of a derivative instrument needs to be outside the consolidated group.

Hedged Item: A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. A hedged item could also be a portfolio or group of identified assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations.

Hedge Effectiveness: Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

***Hedge Ratio*:** The ratio between the hedging instrument(s) and the hedged item(s) that is maintained during the course of a hedging relationship.

The other terms which are used in the Guidance Note and are not defined above would be deemed to have the same definitions as those contained in the Framework for Preparation and Presentation of Financial Statements and Accounting Standards issued by the ICAI.

Key Accounting Principles

14. The accounting for derivatives covered by this Guidance Note is based on the following key principles:

(i) All derivative contracts should be recognised on the balance sheet and measured at fair value.

(ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.

(iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.

(iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.

(v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

Synthetic Accounting not permitted

15. This Guidance Note does not permit synthetic accounting, i.e., accounting of combining a derivative and the underlying together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

Recognition of derivatives on the balance sheet at fair value

16. This Guidance Note requires that all derivatives are recognised on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation.

17. Fair value in the context of derivative contracts represents the 'exit price' i.e. the price that would be paid to transfer a liability or the price that would be received when transferring an asset to a knowledgeable, willing counterparty. The fair value would also incorporate the effect of credit risk

associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.

Hedge Accounting

Designation of a derivative contract as a hedging instrument

18. An entity is permitted but not required to designate a derivative contract as a hedging instrument. Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:

(i) identify its risk management objective;

(ii) demonstrate how the derivative contract helps meet that risk management objective;

(iii) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);

(iv) document this assessment (of points (i), (ii), (v), (vi) and (vii) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;

(v) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring;

(vi) conclude that the risk that is being hedged could impact the statement of profit and loss; and

(vii) adequately disclose its accounting policies, risk management objectives and hedging activities (as required by this Guidance Note) in its financial statements.

19. In India, for a large number of derivative contracts that are undertaken in the Over the Counter (OTC) market, authorised dealers (generally banks) are required by the concerned regulator (e.g. the Reserve Bank of India (RBI)) to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. The permissibility of a contract under RBI regulations, whilst persuasive, is not a sufficient condition to assert that it qualifies for hedge accounting under this Guidance Note. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

20. In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognised immediately in the statement of profit and loss.

21. It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably. Examples of such non-financial components include exchange (for instance London Metal Exchange) traded prices components of metal inventory and crude oil components of aviation turbine fuel.

Need for hedge accounting

22. Hedge accounting may be required due to accounting mismatches in:

- *Measurement* – some financial instruments (non-derivative) are not measured at fair value with changes being recognised in the statement of profit and loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.

- *Recognition* – unsettled or forecast transactions that may be hedged are not recognised on the balance sheet or are included in the statement of profit and loss only in a future accounting period, whereas all derivatives are recognised at inception.

23. An example of measurement mismatch is the hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading. Another example of a measurement mismatch could be a derivative undertaken to hedge the price risk associated with recognised inventory.

24. Recognition mismatches include the hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.

25. In order that the statement of profit and loss reflects the effect of the hedge properly, it is necessary to match the recognition of gains and losses on the hedging instrument and those on the hedged item. Matching can be achieved in principle by delaying the recording of certain gains and losses on the hedging instrument or by accelerating the recording of certain gains and losses on the hedged item in the statement of profit and loss. Both of these techniques are used while applying hedge accounting, depending on the nature of the hedging relationship.

Types of hedge accounting

26. This Guidance Note recognises the following three types of hedging;

- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
- the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- the hedge of a net investment in a foreign operation.

Fair value hedge accounting model

27. A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the statement of profit and loss. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect the statement of profit and loss.

28. When applying fair value hedge accounting, the hedging instrument is measured at fair value with changes in fair value recognised in the statement of profit and loss. The hedged item is remeasured to fair value in respect of the hedged risk even if normally it is measured at cost, e.g., a fixed rate borrowing. Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the statement of profit and loss even if normally such a change may not be recognised, e.g., for inventory being hedged for fair value changes.

29. The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the statement of profit and loss except for the impact of ineffectiveness.

30. An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

31. The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as Accounting Standard (AS) 28*, Impairment of Assets,* Accounting Standard (AS) 2*, Valuation of Inventories,* Accounting Standard (AS) 13*, Accounting for Investments* etc.

Cash flow hedge accounting model

32. A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period.

33. A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction or a firm commitment in respect of foreign currency and (ii) could affect the statement of profit and loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.

34. Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedged item are not recognised therein.

35. In order to match the gains and losses of the hedged item and the hedging instrument in the statement of profit and loss, the changes in fair value of the hedging instrument recognised in equity must be recycled from equity and recognised in the statement of profit and loss at the same time that the impact from the hedged item is recognised (recycled) in the statement of profit and loss. The manner in which this is done depends on the nature of the hedged item:

- if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are recycled from equity as and when the asset acquired or liability incurred affects the statement of profit and loss, e.g., when interest income or expense is recognised.
- if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, either of the following two approaches may be applied:
- the gains or losses are recycled from equity as and when the impact of asset acquired or liability incurred affects or is recognised in the statement of profit and loss, e.g., as depreciation or cost of sales is recognised.
- the gains or losses are recycled from equity and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the "basis adjustment").
- in all other cases the gains or losses are recycled from equity as and when the hedged forecast transaction affects statement of profit and loss.

Note that in the first two bullets above, any gain or loss (or portions thereof) that is not expected to be recovered in future periods are recycled from equity as soon as an entity becomes aware of the fact that those amounts are not expected to be recovered.

36. An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate

swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the statement of profit and loss over the life of the bond.

37. The choice of the basis adjustment approach is only relevant for hedges of forecast purchases of non-financial assets such as inventory or property, plant and equipment. This approach is permitted but not required and must be applied consistently as an accounting policy choice to all cash flow hedges that result in the acquisition of a non-financial asset or non-financial liability. Any basis adjustment or accumulated balance in the hedging reserve will require to be tested at least at every reporting date for impairment. For the purposes of this impairment assessment, the basis adjustment / relevant portion of the hedging reserve may be combined with the carrying amount of the hedged item and compared to its current realisable value.

Net investment hedging

38. An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.

39. Principles relating to the hedge of a net investment in a foreign operation are:

- foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation's net assets for purposes of consolidation;
- gains and losses on foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective;
- the ineffective portion of the gains and losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the statement of profit and loss immediately;
- any net deferred foreign currency gains and losses, i.e., arising from both the net investment and the hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.

40. This Guidance Note does not override the principles of AS 11. However, it introduces the hedge accounting criteria for hedging of net investments.

41. When the net investment is disposed off, the cumulative amount in the foreign currency translation reserve in equity is transferred to the statement of profit and loss as an adjustment to the profit or loss on disposal of the investment. Therefore, it is necessary for an entity to keep track of the amount recognised directly in equity separately in respect of each foreign operation, in order to identify the amounts to be transferred to the statement of profit and loss on disposal.

Formal documentation at inception

42. At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:

- the entity's risk management objective and strategy for undertaking the hedge;
- the nature of the risk being hedged;
- clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
- demonstrate how the derivative contract helps meet that risk management objective;

- indentify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
- demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
- conclude that the risk that is being hedged could impact the statement of profit and loss.

43. This Guidance Note does not mandate a specific format for the documentation and in practice hedge documentation may vary in terms of lay-out, technology used etc. Various formats may be acceptable as long as the documentation includes the contents identified above.

44. A hedging relationship is effective if it meets all of the following requirements:

(i) There is an economic relationship between the hedged item and the hedging instrument.

(ii) The effect of credit risk does not dominate the value changes that result from that economic relationship.

(iii) The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

Hedge effectiveness testing and measurement of ineffectiveness

45. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and

(b) separating the interest element and the spot price of a forward contract.

46. An entity may consider the costs associated with a hedging instrument e.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the statement of profit and loss.

47. This Guidance Note does not prescribe one single method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.

48. Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Guidance Note does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity's risk management objectives and measures for assessing if these objectives are met.

49 When designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.

50. A hedging relationship will meet the hedge effectiveness requirements if:

(i) there is an economic relationship between the hedged item and the hedging instrument.

(ii) the effect of credit risk does not dominate the value changes that result from the economic relationship.

(iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:

- the hedged item that the entity actually hedges; and
- the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and

(iv) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

51. An entity will assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity should perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

52. If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.

53. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.

54. This Guidance Note does not also prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness.

55. Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.

56. When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

57. In certain situations, ineffectiveness is required to be recognised. These include

- in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring;
- in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and

- in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

The recognition of ineffectiveness does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

Termination of hedge accounting / reclassification of hedge reserves

58. An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.

59. If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively. Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges) is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

60. In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring, (but still probable of occurring) then hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings (as specified in paragraph 35 of this Guidance Note). 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring.

61. In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss. 'Probable' for the purpose of this assessment is based on whether the forecasted transaction is 'more likely than not' (or greater than 50% probability) of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not. This Guidance Note does not provide a bright line test in this context but recognises that judgment is required and an entity should disclose the manner in which such determinations are made in its financial statements.

Presentation in the financial statements

62. Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognised assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bi-furcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.

63. This Guidance Note does not permit any netting off of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

Disclosures in financial statements

64. An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks.

65 An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity.

66. The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:

- how specific financial risks are identified, monitored and measured;
- what specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
- details of the extent of transactions that are hedged.

67. An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:

- a description of the hedge;
- a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;
- the nature of the risks being hedged;
- for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Guidance Note does not specify the future time bands for which the disclosures should be made. Entities should decide on appropriate groupings based on the characteristics of the forecast transactions;
- if a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedging reserve: -
  - — the amount recognised in hedge reserve during the period.
  - — the amount recycled from the hedge reserve and reported in statement of profit and loss.
  - — the amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction.
- a breakup of the balance in the hedge reserve between realised and unrealised components and a reconciliation of the opening balance to the closing balance for each reporting period.

68. Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix I to the Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.

69. The Appendix II to this Guidance Note contains examples illustrating the principles contained in this Guidance Note.

Transitional provisions

70. This Guidance Note applies to all derivative contracts covered by it and are outstanding on the date this Guidance Note becomes effective. Any cumulative impact (net of taxes) should be recognised in reserves as a transition adjustment and disclosed separately. An entity is not permitted to follow hedge accounting as recommended in this Guidance Note retrospectively.

Effective Date

71. This Guidance Note becomes applicable for accounting periods beginning on or after 1st April, 2016; its earlier application, is encouraged. From the date this Guidance Note comes into effect the following Announcements issued by the Council of the ICAI stand withdrawn:

(i) Applicability of Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.

(ii) Disclosures regarding Derivative Instruments published in 'The Chartered Accountant', December 2005 (pp 927).

(iii) Accounting for Derivatives published in 'The Chartered Accountant', May 2008 (pp.1945).

(iv) Application of AS 30, *Financial Instruments: Recognition and Measurement* published in 'The Chartered Accountant', April 2011 (pp. 1575) to the extent of the guidance covered for accounting for derivatives within the scope of this Guidance Note.

Appendix I

Format for Disclosure of Foreign Currency Exposures

Exposures in Foreign Currency:

I. Assets	**Foreign Currency**	**Current Year**			**Previous Year**		
		Exchange Rate	**Amount in Foreign currency**	**Amount in ₹**	**Exchange Rate**	**Amount in Foreign currency**	**Amount in ₹**
Receivables (trade & other)							
Other Monetary assets (e.g. ICDs/Loans given in FC)							
Total Receivables (A)							

Hedges by derivative contracts (B)							
Unhedged receivables (C=A-B)							
II. Liabilities	**Foreign Currency**	**Current Year**			**Previous Year**		
		Exchange Rate	**Amount in Foreign currency**	**Amount in ₹**	**Exchange Rate**	**Amount in Foreign currency**	**Amount in ₹**
Payables (trade & other)							
Borrowings (ECB and Others)							
Total Payables (D)							
Hedges by derivative contracts (E)							
Unhedged Payables F=D-E)							
III. Contingent Liabilities and Commitments	**Foreign Currency**	**Current Year**			**Previous Year**		
		Exchange Rate	**Amount in Foreign currency**	**Amount in ₹**	**Exchange Rate**	**Amount in Foreign currency**	**Amount in ₹**
Contingent Liabilities							
Commitments							
Total (G)							
Hedges by derivative contracts (H)							
Unhedged Payables (I=G-H)							
Total unhedged FC Exposures (J=C+F+I)							

Explanatory notes:

Note 1: Exposures in Assets and Liabilities to be presented currency wise.

Note 2: Exposure in any foreign currency(s) which are not material may be aggregated. However, any currency in which exposure is more than 10% of the total exposure should be reported separately; at least 75% of total exposure should be reported currency wise.

Note 3: Additional disclosures of any foreign currency exposure in an asset not hedged by an entity on the ground that the same is covered by a corresponding foreign currency exposure in a liability and vice versa, to the extent having same maturity date and the amount (known as 'natural hedge') may be made in the notes.

Appendix II

Illustrative examples of application of Guidance Note

1. Application of cash flow hedge

ABC Ltd. is an exporter of goods. In the month of July 2013, it receives the order for supply of goods to US customers in the month of January 2014 and as per the payment cycle with the customers, it expects to realise USD 100,000 in April 2014.

ABC Ltd has decided to fully hedge the sales from foreign currency risk. Immediately after getting the order, to hedge the firm commitment in foreign currency it enters into a derivative transaction with XYZ Bank, for future sale of USD 100,000 in the month of April 2014 @ ₹ 65 per USD (Spot Rate was ₹ 64.50 per USD).

For this purpose, it is assumed that the company has entered into a cash flow hedge, which is generally the case for hedging foreign currency risk.

Further, it is assumed that:

- At the time of booking of sale in January 2014, the USD rate was ₹ 61, and forward rate for delivery on April 30, 2014 was ₹ 61.20.
- On the reporting date on March 31, 2014, the USD rate was ₹ 60.50, and forward rate for delivery on April 30, 2014 was ₹ 60.60.
- At the time of realisation USD rate was ₹ 60/- on April 30, 2014.

The above transaction should be accounted in the following manner (impact of discounting of MTM of the hedging instrument has been ignored in this simplified illustration).

	ABC Limited entered to sell a forward exchange contract for USD 100,000 having ten months maturity on April 30, 2014		
	Forward Exchange Rate Spot Rate as at July 01, 2013 No entry in the books	65.00 64.50	
Upto January 31, 2014	ABC Limited accounts the MTM effect in the books Forward Contract Rate Entered Forward Contract Available in the market with similar maturity	 65.00 61.20	
	Forward Contract Receivable To Cash Flow Hedge Reserve	3,80,000	 3,80,000
January 31, 2014	ABC Limited recognises the revenue by booking an invoice for USD 100,000, having credited period of 90 days (i.e. due date – April 30, 2014) Spot rate as at January 31, 2014 Forward Contract Available in the Market with similar maturity	 61.00 61.20	

	Recognisation of Revenue Accounts Receivable To Revenue	61,00,000	 61,00,000
	Recognisation of Hedging gain Cash Flow hedge reserve To Statement of Profit & Loss	3,80,000	 3,80,000
March 31, 2014	Spot Rate Forward Contract Available in the Market with similar maturity	60.50 60.60	
	Restatement of Accounts Receivable Forex Gain/Loss (P&L) To Accounts Receivable	50,000	 50,000
	MTM Effect of Forward Cover Forward Contract Receivable To Forex Gain/Loss (P&L)	60,000	 60,000
April 30, 2014	Spot rate **Realisation of Accounts Receivable** Bank Forex Gain/Loss (P&L) To Accounts Receivable	60.00 60,00,000 50,000	 60,50,000
	Maturity of Forward Contract Bank To Forward Contract Receivable To Forex Gain/Loss (P&L)	5,00,000	 4,40,000 60,000

2. Cash flow hedge of the repayment of a loan

Company X is an Indian company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X borrows from a bank USD 1 million six month debt carrying a floating interest rate of three month LIBOR plus 50 basis points. As per the Company's risk management policies, it enters into a Cross Currency Interest Rate Swap (CCIRS) with a bank to swap the above floating interest bearing USD debt into a fixed interest bearing INR debt.

Since the CCIRS does not fall within the scope of AS 11 and has been entered into to hedge the exposure of currency and interest rate risk arising from the debt instrument, it would be within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

(i) Translate the USD loan at closing rate and record the foreign exchange gain/ loss in the statement of profit and loss.

(ii) Record a derivative asset/ liability based on the fair value (Mark To Market 'MTM' value) of the CCIRS with a corresponding credit/debit in Cash Flow Hedging Reserve.

(iii) Record the net interest expense in statement of profit and loss, i.e., the USD floating interest expense adjusted for the settlement of the interest rate swap for the period.

(iv) Reclassify from the Cash Flow Hedging Reserve to statement of profit and loss the amount by which the hedged item, i.e., the debt has impacted the statement of profit and loss. (In this case, the amount of translation foreign exchange gain/ loss that has been recorded for the loan).

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Loan – Translated at the closing USD – INR conversion rate.
- Derivative asset/ liability – MTM of the CCIRS.
- Cash Flow Hedging Reserve - MTM of the CCIRS less amount reclassified to the statement of profit and loss.

3a. Commodity contract – cash flow hedge of a forecasted sale with an exchange traded future

Company Z is a producer and wholesaler of copper with annual reporting period ending on March 31 each year. On January 1, 2014, Company Z forecasts sales of 100 tonnes of copper expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of copper prices, Company Z enters into a 'sell' futures contract on the Commodity Exchange to sell 100 tonnes of copper (same grade) with maturity of September 30, 2014. As per its risk management policies, Company Z designates this futures contract as a cash flow hedge of highly probable forecasted sales of 100 tonnes of copper inventory in September 2014.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014

Record a derivative asset/ liability based on the fair value (MTM) of the commodity future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the commodity future contract.
- Cash Flow Hedging Reserve - MTM of the commodity future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014, along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which potentially records the sales at the hedged price.

3b. Commodity contract – fair value hedge of forecasted sales with an exchange traded future

Continuing the above example, consider that Company Z designates the commodity futures contract as a fair value hedge of a portion of its inventory, i.e., 100 tonnes of copper. The Company documents it as a hedge of the exposure to changes in fair value of the inventory due to commodity price risk. As at March 31, 2014, the price of copper increases thereby resulting in an increase in the fair value of inventory and MTM loss on the derivative.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in fair values due to price risk, it would fall within the scope of this Guidance Note.

According to this Guidance Note, Company Z will record the following on March 31, 2014:

(i) Record a derivative liability based on the fair value (MTM) of the commodity future contract with a corresponding debit to the statement of profit and loss.

(ii) Record an increase in inventories for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 2, *Valuation of Inventories,* requires inventories to be carried at the lower of cost and net realisable value. Hence, this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of inventories under AS 2.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/liability – MTM of the commodity future contract.
- Inventory – valued as per AS 2 at cost.
- Inventory hedge accounting adjustment – basis adjustment to record change in fair value.

When sales of the hedged inventory occur in the future, the hedging related fair value adjustment to inventory will be released to the statement of profit and loss and can be classified as part of 'cost of goods sold'.

4. Hedging a portion of a non-financial item – Commodity future

Company X is a producer and wholesaler of steel with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of 200 tonnes of steel expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of expected cash flows from forecasted sales of steel, as per its risk management policies, Company X enters into a 'sell' futures contract on the commodity exchange for 200 tonnes of iron ore which is one of the significant components of the steel making process and significantly impacts the price of steel.

Since the commodity future does not fall within the scope of AS 11 and has been entered into to hedge the exposure of variability in cash flows arising from price risk, this would fall under the scope of this Guidance Note. This will not result into a perfect hedge since the hedged commodity, i.e., steel and the hedging instrument used, i.e., iron ore futures, are not perfectly correlated. The Guidance Note permits such designation if it is as per the company's risk management policies and strategy.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/ liability based on the fair value (MTM) of the iron ore future contract with a corresponding credit/ debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the iron ore future contract.
- Cash Flow Hedging Reserve - MTM of the iron ore future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 2014 along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss.

5. Exchange traded contract – Fair value hedge of investment portfolio

Company Z holds a closed portfolio of equity shares classified as long term investments under AS 13. As per its risk management policies, Company Z hedges its exposure to variability of expected fair value of the investments by entering into equity futures contract on a recognised stock exchange.

Since this derivative is outside the scope of AS 11 and is entered into to hedge a specific exposure, this would fall within the scope of this Guidance Note.

Under this Guidance Note, Company Z will record the following on March 31, 2014:

(i) Record a derivative liability/derivative asset based on the fair value (MTM) of the equity futures contract with a corresponding debit to the statement of profit and loss.

(ii) Record an increase/decrease in long term investments for the change in fair value as a hedge accounting adjustment through statement of profit and loss. Accounting Standard (AS) 13, *Valuation of Investments,* requires long term investments to be carried at cost. Hence this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of investments under AS 13.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the equity futures contract.
- Long term investments – valued as per AS 13 at cost.
- Investment hedge accounting adjustment – adjustment to record change in fair value.

6. Cash flow hedge accounting – forecasted sale with a forward contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014, Company X enters into a sell USD – buy INR forward contract which matures on September 30, 2014.

Since the forward contract is taken to hedge highly probable forecasted sales transaction, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following on March 31, 2014:

Record a derivative asset/liability based on the fair value (MTM) of the foreign currency forward contract with a corresponding credit/debit to Cash Flow Hedging Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency forward contract.
- Cash Flow Hedging Reserve – MTM of the foreign currency forward contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen in September 30, 2014 along with the maturity of the foreign currency forward contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

7. Cash flow hedge accounting - forecasted sale with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014 Company X enters into a sell USD – buy INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result, the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

Since the option contract is taken to hedge highly probable forecasted sales transactions, it does not fall within the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/ debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency option contract.
- Cash Flow Hedging Reserve - MTM of the foreign currency option contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedging Reserve will be reclassified to the statement of profit and loss when the sales are booked in the statement of profit and loss. In this case, this will happen on September 30, 2014, along with the maturity of the foreign currency option contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

8. Cash flow hedge accounting – hedging the repayment of foreign currency debt with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X has USD 1 million of foreign currency debt that it needs to repay on September 30, 2014. As per its risk management policies, in order to hedge the variability in cash flows arising from the repayment of this debt in foreign currency, on January 1, 2014 Company X enters into a buy USD – sell INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an 'At the Money' strike price option). As a result the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the 'cost of hedging'.

The option contract is outside the scope of AS 11 and hence is within the scope of this Guidance Note.

According to this Guidance Note, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/debit to Cash Flow Hedging Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

In addition,

- Company X will also reclassify from the Cash Flow Hedge Reserve, a proportionate amount of the option premium paid as a 'cost of hedging' type adjustment into the statement of profit or loss; and
- To the extent that there is intrinsic value in the option contract that offsets the translation gain/loss on the foreign currency debt, Company will additionally reclassify such amounts to the statement of profit or loss.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/ liability – MTM of the foreign currency option contract.
- Cash Flow Hedging Reserve - MTM of the foreign currency option contract adjusted for the 'cost of hedging' reclassification and the intrinsic value reclassification, if any.

On September 30, 2014, in addition to the above treatment, the debt will be repaid at the spot rate, the option settled or expires worthless (as the case may be) and any balance in the cash flow hedge reserve will be reclassified to the statement of profit and loss for the period ended on that date.

GN (A) 34 (Issued May 15, 2015)

Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities

(The Council of the Institute of Chartered Accountants of India (ICAI) has issued this **Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities** which comes into effect from the date of its issuance.)

Introduction

1. Section 135 of the Companies Act, 2013 (the Act), requires the Board of Directors of every company having a net worth of Rupees 500 crore or more, or turnover of Rupees 1,000 crore or more or a net profit of Rupees 5 crore or more, during any financial year, to ensure that the company spends in every financial year atleast 2% of the average net profits of the company made during the three immediately preceding financial years on Corporate Social Responsibility (CSR) in pursuance of its policy in this regard. The Act requires such companies to constitute a Corporate Social Responsibility Committee which shall formulate and recommend to the Board a Corporate Social Responsibility Policy which shall indicate the CSR activities to be undertaken by the company as specified in Schedule VII to the Act.

Objective

2. The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure of expenditure on activities relating to corporate social responsibility.

Scope

3. What constitutes CSR activities is specified in Schedule VII to the Act. Reference is also invited to the circular issued by the Ministry of Corporate Affairs (MCA) No. 21/2014 and Notification dated October 24, 2014. Accordingly, the Guidance Note does not deal with identification of activities that

constitute CSR activities but only provides guidance on accounting for expenditure on CSR activities in line with the requirements of the generally accepted accounting principles including the applicable Accounting Standards.

Definitions

4. For the purpose of this Guidance Note, the definitions mentioned at sl. nos. (a) to (f) are reproduced from the Companies Act, 2013, and the Companies (Corporate Social Responsibility Policy) Rules, 2014 and in the event of any change in the Act or the Rules made thereunder, these definitions shall stand automatically revised/modified to that extent:

(a) *Any financial year:* "Any financial year" referred under sub-section (1) of Section 135 of the Act read with Rule 3(2) of Companies CSR Rule, 2014, implies 'any of the three preceding financial years'. (Clarification vide MCA General Circular No. 21/2014)

(b) *Average Net Profit*: "Average Net Profit" is the amount as calculated in accordance with the provisions of Section 198 of the Companies Act, 2013.

(c) *Financial Year:* "Financial Year", in relation to any company or body corporate, means the period ending on the 31st day of March every year, and where it has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up:

Provided that on an application made by a company or body corporate, which is a holding company or a subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the Tribunal may, if it is satisfied, allow any period as its financial year, whether or not that period is a year:

Provided further that a company or body corporate, existing on the commencement of this Act, shall, within a period of two years from such commencement, align its financial year as per the provisions of this clause;

(d) *Net Profit:* "Net Profit" means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely:-

(i) any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and

(ii) any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act:

Provided that net profit in respect of a financial year for which the relevant financial statements were prepared in accordance with the provisions of the Companies Act, 1956, (1 of 1956) shall not be required to be re-calculated in accordance with the provisions of the Act:

Provided further that in case of a foreign company covered under these rules, net profit means the net profit of such company as per profit and loss account prepared in terms of clause (a) of sub-section (1) of section 381 read with section 198 of the Act.

(e) *Net worth*: "Net worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation;

(f) *Turnover*: "Turnover" means the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year;

(g) *Spend :* The term 'spend' in accounting parlance generally means the liabilities incurred during the relevant accounting period.

5. Rule 4 of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that the CSR activities that shall be undertaken by the companies for the purpose of Section 135 of the Act shall exclude activities undertaken in pursuance of its 'normal course of business'. The Rules also specify that CSR projects or programmes or activities that benefit only the employees of the company and their families shall not be considered as CSR activities in accordance with the requirements of the Act. Such programmes or projects or activities, that are carried out as a pre-condition for setting up a business, or as part of a contractual obligation undertaken by the company or in accordance with any other Act, or as a part of the requirement in this regard by the relevant authorities cannot be considered as a CSR activity within the meaning of the Act. Similarly, the requirements under relevant regulations or otherwise prescribed by the concerned regulators as a necessary part of running of the business, would be considered to be the activities undertaken in the 'normal course of business' of the company and, therefore, would not be considered CSR activities.

Recognition and Measurement of CSR Expenditure in Financial Statements

Whether Provision for Unspent Amount required to be created?

6. Section 135 (5) of the Companies Act, 2013, requires that the Board of every eligible company, "shall ensure that the company spends, in every financial year, at least 2% of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy". A proviso to this Section states that "if the company fails to spend such amount, the Board shall, in its report … specify the reasons for not spending the amount".

7. Further, Rule 8(1) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, prescribes that the Board Report of a company under these Rules shall include an Annual Report on CSR, containing particulars specified in the Annexure to the said Rules, which provide a format in this regard.

8. The above provisions of the Act clearly lay down that the expenditure on CSR activities is to be disclosed only in the Board's Report in accordance with the Rules made thereunder. In view of this, no provision for the amount which is not spent, i.e., any shortfall in the amount that was expected to be spent as per the provisions of the Act on CSR activities and the amount actually spent at the end of a reporting period, may be made in the financial statements. The proviso to section 135 (5) of the Act, makes it clear that if the specified amount is not spent by the company during the year, the Directors' Report should disclose the reasons for not spending the amount. However, if a company has already undertaken certain CSR activity for which a liability has been incurred by entering into a contractual obligation, then in accordance with the generally accepted principles of accounting, a provision for the amount representing the extent to which the CSR activity was completed during the year, needs to be recognised in the financial statements.

9. Where a company spends more than that required under law, a question arises as to whether the excess amount 'spent' can be carried forward to be adjusted against amounts to be spent on CSR activities in future period. Since '2% of average net profits of immediately preceding three years' is the minimum amount which is required to be spent under section 135 (5) of the Act, the excess amount cannot be carried forward for set off against the CSR expenditure required to be spent in future.

Other Considerations in Recognition and Measurement

10. A company may decide to undertake its CSR activities approved by the CSR Committee with a view to discharge its CSR obligation as arising under section 135 of the Act in the following three ways:

(a) making a contribution to the funds as specified in Schedule VII to the Act; or

(b) through a registered trust or a registered society or a company established under section 8 of the Act (or section 25 of the Companies Act, 1956) by the company, either singly or along with its holding or subsidiary or associate company or along with any other company or holding or subsidiary or associate company of such other company, or otherwise; or

(c) in any other way in accordance with the Companies (Corporate Social Responsibility Policy) Rules, 2014, e.g. on its own

11. In case a contribution is made to a fund specified in Schedule VII to the Act, the same would be treated as an expense for the year and charged to the statement of profit and loss. In case the amount is spent in the manner as specified in paragraph10 (b) above the same will also be treated as expense for the year by charging off to the statement of profit and loss. The accounting for expenditure incurred by the company otherwise e.g. on its own would be accounted for in accordance with the principles of accounting as explained hereinafter.

CSR activities carried out by the company covered under paragraph 10 (c)

12. In cases, where an expenditure of revenue nature is incurred on any of the activities mentioned in Schedule VII to the Act by the company on its own, the same should be charged as an expense to the statement of profit and loss. In case the expenditure incurred by the company is of such nature which may give rise to an 'asset', a question may arise as to whether such an 'asset' should be recognised by the company in its balance sheet. In this context, it would be relevant to note the definition of the term 'asset' as per the Framework for Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. As per the Framework, an 'asset' is a "resource controlled by an enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise". Hence, in cases where the control of the 'asset' is transferred by the company, e.g., a school building is transferred to a Gram Panchayat for running and maintaining the school, it should not be recognised as 'asset' in its books and such expenditure would need to be charged to the statement of profit and loss as and when incurred. In other cases, where the company retains the control of the 'asset' then it would need to be examined whether any future economic benefits accrue to the company. Invariably future economic benefits from a 'CSR asset' would not flow to the company as any surplus from CSR cannot be included by the company in business profits in view of Rule 6(2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014.

13. In some cases, a company may supply goods manufactured by it or render services as CSR activities. In such cases, the expenditure incurred should be recognised when the control on the goods manufactured by it is transferred or the allowable services are rendered by the employees. The goods manufactured by the company should be valued in accordance with the principles prescribed in Accounting Standard (AS) 2, *Valuation of Inventories.* The services rendered should be measured at cost. Indirect taxes (like excise duty, service tax, VAT or other applicable taxes) on the goods and services so contributed will also form part of the CSR expenditure.

14. Where a company receives a grant from others for carrying out CSR activities, the CSR expenditure should be measured net of the grant.

Recognition of Income Earned from CSR Projects/ Programmes or During the Course of Conduct of CSR Activities

15. Rule 6 (2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that "the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company". The term 'surplus' ordinarily means excess of income over expenditure pertaining to an entity or an activity. Thus, in respect of a CSR project or programme or activity, it needs to be determined whether any surplus is arising therefrom. A question would arise as to whether such surplus should be recognised in the statement of profit and loss of the company. It may be noted that paragraph 5 of Accounting Standard (AS) 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies,* inter alia, requires that all items of income which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise. As to whether the surplus from CSR activities can be considered as 'income', the *Framework for Preparation and Presentation of Financial Statements* issued by the Institute of Chartered Accountants of India, defines 'income' as "increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants". Since the surplus arising from CSR activities is not arising from a transaction with the owners, it would be considered as 'income' for accounting purposes. In view of the aforesaid requirement any surplus arising out of CSR project or programme or activities shall be recognised in the statement of profit and loss and since this surplus cannot be a part of business profits of the company, the same should immediately be recognised as liability for CSR expenditure in the balance sheet and recognised as a charge to the statement of profit and loss. Accordingly, such surplus would not form part of the minimum '2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its Corporate Social Responsibility Policy'.

16. Item 5 (A)(k) of the General Instructions for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013, requires that in case of companies covered under Section 135, the amount of expenditure incurred on 'Corporate Social Responsibility Activities' shall be disclosed by way of a note to the statement of profit and loss. From the perspective of better financial reporting and still be in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with paragraphs 10-14 above should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.

17. The notes to accounts relating to CSR expenditure should also contain the following:

(a) Gross amount required to be spent by the company during the year.

(b) Amount spent during the year on:

		In cash	Yet to be paid in cash	Total
(i)	Construction/acquisition of any asset			
(ii)	On purposes other than (i) above			

The above disclosure, to the extent relevant, may also be made in the notes to the cash flow statement, where applicable.

(c) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per Accounting Standard (AS) 18, *Related Party Disclosures*.

(d) Where a provision is made in accordance with paragraph 8 above the same should be presented as per the requirements of Schedule III to the Companies Act, 2013. Further, movements in the provision during the year should be shown separately.

Appendix 1

Section 135 of the Companies Act, 2013-Corporate Social Responsibility

(1) Every company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during any financial year shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors, out of which at least one director shall be an independent director.

(2) The Board's report under sub-section (3) of Section 134 shall disclose the composition of the Corporate Social Responsibility Committee.

(3) The Corporate Social Responsibility Committee shall,

(a) formulate and recommend to the Board, a Corporate Social Responsibility Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;

(b) recommend the amount of expenditure to be incurred on the activities referred to in clause (a); and

(c) monitor the Corporate Social Responsibility Policy of the company from time to time.

(4) The Board of every company referred to in sub-section (1) shall,

(a) after taking into account the recommendations made by the Corporate Social Responsibility Committee, approve the Corporate Social Responsibility Policy for the company and disclose contents of such Policy in its report and also place it on the company's website, if any, in such manner as may be prescribed; and

(b) ensure that the activities as are included in Corporate Social Responsibility Policy of the company are undertaken by the company.

(5) The Board of every company referred to in sub-section (1), shall ensure that the company spends, in every financial year, at least two per cent. of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy:

Provided that the company shall give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities:

Provided further that if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of Section 134, specify the reasons for not spending the amount.

Explanation.—For the purposes of this section "average net profit" shall be calculated in accordance with the provisions of Section 198.

Appendix 2

Section 198 of the Companies Act , 2013 – Calculation of Profits

(1) In computing the net profits of a company in any financial year for the purpose of section 197,—

(*a*) credit shall be given for the sums specified in sub-section (*2*), and credit shall not be given for those specified in sub-section (*3*); and (*b*) the sums specified in sub-section (*4*) shall be deducted, and those specified in sub-section (*5*) shall not be deducted.

(2) In making the computation aforesaid, credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

(3) In making the computation aforesaid, credit shall not be given for the following sums, namely:—

(*a*) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company;

(*b*) profits on sales by the company of forfeited shares;

(*c*) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof;

(*d*) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets:

Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value;

(*e*) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

(*4*) In making the computation aforesaid, the following sums shall be deducted, namely:—

(*a*) all the usual working charges;

(b) directors' remuneration;

(c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis;

(d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;

(e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;

(*f*) interest on debentures issued by the company;

(*g*) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;

(*h*) interest on unsecured loans and advances;

(*i*) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;

(*j*) outgoings inclusive of contributions made under section 181;

(*k*) depreciation to the extent specified in section 123;

(*l*) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained;

(*m*) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;

(*n*) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (*m*);

(*o*) debts considered bad and written off or adjusted during the year of account.

(*5*) In making the computation aforesaid, the following sums shall not be deducted, namely:—

(*a*) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (*d*) and (*e*) of sub-section (*4*);

(*b*) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (*m*) of sub-section (*4*);

(*c*) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value;

(*d*) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

Appendix 3

Schedule VII to the Companies Act, 2013

(See sections 135)

Activities which may be included by companies in their Corporate Social Responsibility Policies Activities relating to:—

(i) eradicating hunger, poverty and malnutrition, promoting health care including preventive health care and sanitation[2] including contribution to the Swach Bharat Kosh set-up by the Central Government for the promotion of sanitation and making available safe drinking water;

(ii) promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects;

(iii) promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups;

(iv) ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water[3] including contribution to the Clean Ganga Fund set-up by the Central Government for rejuvenation of river Ganga;

(v) protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts;

(vi) measures for the benefit of armed forces veteran, war widows and their dependents;

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[2] Inserted vide Notification G.S.R. 741 (E) dated 24.10.2014

[3] Inserted vide Notification G.S.R. 741 (E) dated 24.10.2014

(vii) training to promote rural sports nationally recognised sports, Paralympic sports and Olympic sports;

(viii) contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women;

(ix) contributions or funds provided to technology incubators located within academic institutions which are approved by the Central Government;

(x) rural development projects;

(xi) [4]slum area development

Explanation.—For the purposes of this item, the term ‘slum area’ shall mean any area declared as such by the Central Government or any State Government or any other competent authority under any law for the time being in force.

Appendix 4

Rules for CSR under Section 135 of Chapter IX (after incorporating Amendments upto May, 2015)

New Delhi, dated 27th February, 2014

G.S.R. 129 (E).- In exercise of the powers conferred under section 135 and sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby makes the following rules, namely: -

1. **Short title and commencement. –**

    (1) These rules may be called the Companies (Corporate Social Responsibility Policy) Rules, 2014;

    (2) They shall come into force on the 1st day of April, 2014.

2. **Definitions.-**

(1) In these rules, unless the context otherwise requires;

    (a) "Act" means the Companies Act, 2013;

    (b) "Annexure" means the Annexure appended to these rules;

    (c) "Corporate Social Responsibility (CSR)" means and includes but is not limited to:-

        (i) Projects or programs relating to activities specified in Schedule VII to the Act; or

        (ii) Projects or programs relating to activities undertaken by the board of directors of a company (Board) in pursuance of recommendations of the CSR Committee of the Board as per declared CSR Policy of the company subject to the condition that such policy will cover subjects enumerated in Schedule VII of the Act.

    (d) "CSR Committee" means the Corporate Social Responsibility Committee of the Board referred to in section 135 of the Act;

[4] Inserted vide Notification G.S.R 568 (E) dated 06.08.2014

(e) "CSR Policy" relates to the activities to be undertaken by the company as specified in Schedule VII to the Act and the expenditure thereon, excluding activities undertaken in pursuance of normal course of business of a company;

(f) "Net profit" means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely :-

(i) any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and

(ii) any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act:

Provided that net profit in respect of a financial year for which the relevant financial statements were prepared in accordance with the provisions of the Companies Act, 1956, (1 of 1956) shall not be required to be re-calculated in accordance with the provisions of the Act:

Provided further that in case of a foreign company covered under these rules, net profit means the net profit of such company as per profit and loss account prepared in terms of clause (a) of sub-section (l) of section 381 read with section 198 of the Act.

(2) Words and expressions used and not defined in these rules but defined in the Act shall have the same meanings respectively assigned to them in the Act.

3. Corporate Social Responsibility. -

(1) Every company including its holding or subsidiary, and a foreign company defined under clause (42) of section 2 of the Act having its branch office or project office in India, which fulfills the criteria specified in sub-section (l) of section 135 of the Act shall comply with the provisions of section 135 of the Act and these rules:

Provided that net worth, turnover or net profit of a foreign company of the Act shall be computed in accordance with balance sheet and profit and loss account of such company prepared in accordance with the provisions of clause (a) of sub-section (1) of section 381 and section 198 of the Act.

(2) Every company which ceases to be a company covered under sub-section (1) of section 135 of the Act for three consecutive financial years shall not be required to -

(a) constitute a CSR Committee; and

(b) comply with the provisions contained in sub-section (2) to (5) of the said section, till such time it meets the criteria specified in sub-section (1) of section 135

4. CSR Activities.-

(1) The CSR activities shall be undertaken by the company, as per its stated CSR Policy, as projects or programs or activities (either new or ongoing), excluding activities undertaken in pursuance of its normal course of business.

(2) The Board of a company may decide to undertake its CSR activities approved by the CSR Committee, through a registered trust or a registered society or a company established under Section 8 of the Act by the company, either singly or alongwith its holding or subsidiary or associate company, or alongwith any other company or holding or subsidiary or associate company of such other company, or otherwise:[5]

[5] Substituted vide Amendment in Rules, G.S.R. 43 (E), dated 19.01.2015

Provided that-

(i) if such trust, society or company is not established by the company either singly or alongwith its holding or subsidiary or associate company, or alongwith any other company or holding or subsidiary or associate company of such other company[6], it shall have an established track record of three years in undertaking similar programs or projects.

(ii) the company has specified the project or programs to be undertaken through these entities, the modalities of utilization of funds on such projects and programs and the monitoring and reporting mechanism.

(3) A company may also collaborate with other companies for undertaking projects or programs or CSR activities in such a manner that the CSR Committees of respective companies are in a position to report separately on such projects or programs in accordance with these rules.

(4) Subject to provisions of sub-section (5) of section 135 of the Act, the CSR projects or programs or activities undertaken in India only shall amount to CSR expenditure.

(5) The CSR projects or programs or activities that benefit only the employees of the company and their families shall not be considered as CSR activities in accordance with section 135 of the Act.

(6) Companies may build CSR capacities of their own personnel as well as those of their Implementing agencies through Institutions with established track records of at least three financial years but such expenditure [7]including expenditure on administrative overheads, shall not exceed five percent of total CSR expenditure of the company in one financial year.

(7) Contribution of any amount directly or indirectly to any political party under section 182 of the Act, shall not be considered as CSR activity.

5. CSR Committees.-

1. The companies mentioned in the rule 3 shall constitute CSR Committee as under:-

   (i) an unlisted public company or a private company covered under sub-section (1) of section 135 which is not required to appoint an independent director pursuant to subsection (4) of section 149 of the Act, shall have its CSR Committee without such director;

   (ii) a private company having only two directors on its Board shall constitute its CSR Committee with two such directors;

   (iii) with respect to a foreign company covered under these rules, the CSR Committee shall comprise of at least two persons of which one person shall be as specified under clause (d) of sub-section (1) of section 380 of the Act and another person shall be nominated by the foreign company.

(2) The CSR Committee shall institute a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.

6. CSR Policy.-

(1) The CSR Policy of the company shall, inter-alia, include the following, namely -

   (a) a list of CSR projects or programs which a company plans to undertake falling within the purview of the Schedule VII of the Act, specifying modalities of execution of such project or programs and implementation schedules for the same; and

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[6] Substituted vide Amendment in Rules, G.S.R. 43 (E), dated 19.01.2015

[7] Inserted vide Amendment in Rules, G.S.R. 644 (E), dated 12.09.2014

(b) monitoring process of such projects or programs:

Provided that the CSR activities does not include the activities undertaken in pursuance of normal course of business of a company.

Provided further that the Board of Directors shall ensure that activities included by a company in its Corporate Social Responsibility Policy are related to the activities included in Schedule VII of the Act.

(2) The CSR Policy of the company shall specify that the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company.

7. CSR Expenditure- CSR expenditure shall include all expenditure including contribution to corpus, for projects or programs relating to CSR activities approved by the Board on the recommendation of its CSR Committee, but does not include any expenditure on an item not in conformity or not in line with activities which fall within the purview of Schedule VII of the Act.

8. CSR Reporting-

(1) The Board's Report of a company covered under these rules pertaining to a financial year commencing on or after the 1st day of April, 2014 shall include an annual report on CSR containing particulars specified in Annexure.

(2) In case of a foreign company, the balance sheet filed under sub-clause (b) of sub-section (1) of section 381 shall contain an Annexure regarding report on CSR.

9. Display of CSR activities on its website -

The Board of Directors of the company shall, after taking into account the recommendations of CSR Committee, approve the CSR Policy for the company and disclose contents of such policy in its report and the same shall be displayed on the company's website, if any, as per the particulars specified in the Annexure.

ANNEXURE

FORMAT FOR THE ANNUAL REPORT ON CSR ACTIVITIES TO BE INCLUDED IN THE BOARD'S REPORT

1. A brief outline of the company's CSR policy, including overview of projects or programs proposed to be undertaken and a reference to the web-link to the CSR policy and projects or programs.
2. The Composition of the CSR Committee.
3. Average net profit of the company for last three financial years.
4. Prescribed CSR Expenditure (two per cent. Of the amount as in item 3 above)
5. Details of CSR spent during the financial year.
   (a) Total amount to be spent for the financial year;
   (b) Amount unspent, if any;

(c) Manner in which the amount spent during the financial year is detailed below.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
S. No.	CSR Project or activity identified	Sector in which the Project is covered	Projects or programs (1) Local area or other (2) Specify the State and district where projects or programs was undertaken	Amount outlay (budget) project or programs wise	Amount spent on the projects or programs **Sub -heads:** (1) Direct expenditure on projects or programs. 2.Overheads:	Cumulative expenditure upto to the reporting period	Amount spent: Direct or through implementing agency
1							
2							
3							
	TOTAL						

*Give details of implementing agency:

6. In case the company has failed to spend the two per cent of the average net profit of the last three financial years or any part thereof, the company shall provide the reasons for not spending the amount in its Board report.

7. A responsibility statement of the CSR Committee that the implementation and monitoring of CSR Policy, is in compliance with CSR objectives and Policy of the company.

Sd/- (Chief Executive Officer or Managing Director or Director)	Sd/- (Chairman CSR Committee)	Sd/- (Person specified under clause (d) of sub-section (1) of section 380 of the Act) (wherever applicable)

GN(A) 35 : Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013

Background

1. Schedule II to the Companies Act, 2013, specifies useful lives for the purpose of computation of depreciation. The said Schedule II was further amended by the Ministry of Corporate Affairs (MCA) through its notifications G.S.R. 237(E) dated March 31, 2014 and G.S.R. 627(E) dated August 29, 2014, respectively. As compared to Schedule XIV to the Companies Act, 1956, Schedule II, instead of specifying rates of depreciation for various assets, specifies that depreciation should be provided on the basis of useful life of an asset. While Schedule XIV was prescriptive in nature as it specified the minimum rate of depreciation, Schedule II provides indicative useful lives for various assets. As a consequence, the companies are in a position to charge depreciation based on the useful life of an asset supported by technical advice, even though such lives are higher or lower than those specified in the said schedule. In view of this, depreciation charged as per the useful life is true commercial depreciation bringing the financial statements prepared accordingly closer to those prepared in accordance with international standards.

2. In this Guidance Note wherever the term 'Schedule II' is used it refers to Schedule II to the Companies Act, 2013, and wherever term 'Schedule XIV' is used it refers to Schedule XIV to the Companies Act, 1956, unless specified otherwise.

3. Overview of some of the key changes in Schedule II as compared to Schedule XIV are as follows:

- ➢ Useful life is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity. Schedule XIV did not include such requirement.
- ➢ Schedule II prescribes indicative useful lives of various assets instead of Straight Line Method (SLM)/ Written Down Value (WDV) rates for calculating depreciation.
- ➢ Depreciation is systematic allocation of the depreciable amount of an asset over its useful life.
- ➢ The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.
- ➢ Companies are allowed to follow different useful life/residual value if an appropriate justification is given supported by technical advice.
- ➢ Useful lives of significant parts of an asset to be determined separately.
- ➢ No separate rate for double/ triple shift; depreciation to be increased based on the double shift/triple shift use of the assets.
- ➢ Useful lives of fixed assets prescribed under schedule II to the Act are different from those envisaged under Schedule XIV.
- ➢ No reference to depreciation on low value assets.

Objective

4. This Guidance Note is issued with the objective to provide guidance on certain significant issues that may arise from the practical application of Schedule II with a view to establish consistent practice with regard to the accounting for depreciation.

Scope

5. This Guidance Note includes relevant provisions of Schedule II and provides guidance on implementing the requirements of Schedule II.

Shift from Rate-based requirements to Useful Life

6. Paragraph 1 of Part A of Schedule II defines 'useful life' of an asset as:

> "The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity."

7. Paragraph 3(i) of Part A of Schedule II, as amended, states as follows:

"3. **Without prejudice** to the foregoing provisions of paragraph 1 (of Schedule II),—

(i) The useful life of an asset shall not ordinarily be different from the useful life specified in Part C and the residual value of an asset shall not be more than five percent of the original cost of the asset.

Provided that where a company adopts a useful life different from what is specified in Part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice."

8. In view of the above, paragraph 3 of Part A of Schedule II should be read along with paragraph 1 of Part A of Schedule II which defines useful life.

9. It may be noted that paragraph 3 of Schedule II initially provided that the useful life of an asset shall not be longer than the useful life prescribed in Part C. With a view to clarify that the useful lives as prescribed in Part C to Schedule II are indicative, Schedule II was amended by the MCA vide its notification G.S.R. 627(E) dated August 29, 2014, where the expression '**shall not be longer than'** was changed to **'shall not ordinarily be different'.**

10. Under Schedule XIV which specified rates of depreciation rather than useful lives, the Ministry of Industry, Department of Company Affairs, vide its circular No. 1/17/87-CL.V dated March 7, 1989, clarified that the rates as contained in Schedule XIV should be viewed as the **minimum rates**, and, depreciation at rates lower than those specified in Schedule XIV should not be adopted by the companies. However, on bonafide technical evaluation, higher rate may be applied by a company.

11. Paragraph 13 of Accounting Standard (AS) 6, *Depreciation Accounting,* notified under the Companies (Accounting Standards) Rules, 2006, also contains clarification similar to the aforesaid circular, inter alia, providing that "where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute." As Schedule II permits useful lives different from that specified in Part C of Schedule II, the useful lives specified therein are indicative only and therefore paragraph 13 of AS 6 now permits useful life longer than that specified in statute.

12. Paragraphs 8 and 22 of AS 6 state as follows:

> "8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis."

"22. The useful life of a depreciable asset should be estimated after considering the following factors:

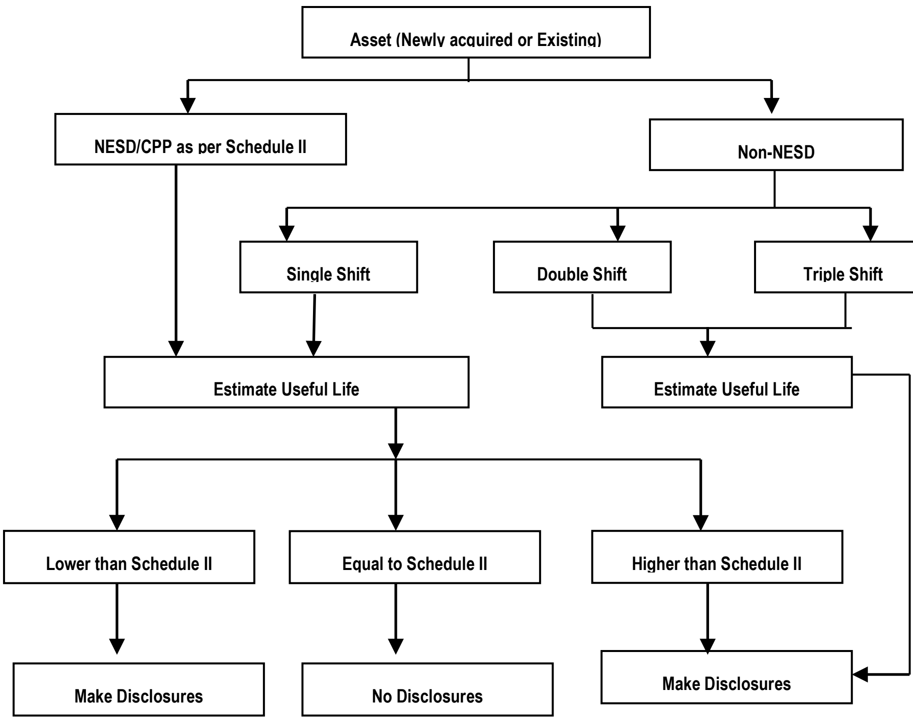
(i) expected physical wear and tear;

(ii) obsolescence;

(iii) legal or other limits on the use of the asset."

13. In view of the above, the useful lives as given under Part 'C' of Schedule II for various types of assets are indicative only and are not minimum or maximum. Where the useful lives of various specific assets are the same as those under Schedule II, the company should use these useful lives. In case the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former should be applied by the company for providing depreciation. The disclosures in this regard should be made as described later in this Guidance Note. The process of determination of useful life is explained in the chart below. A company has to determine the useful life at the beginning of the year for all fixed assets, existing as at the end of the immediately preceding period and for newly acquired assets, as and when acquired. All fixed assets existing at the beginning of the year should be classified into assets for which no extra shift depreciation is applicable which would include continuous process plant (CPP) and assets for which extra shift depreciation applies. Of the assets for which extra shift depreciation applies, assets which are going to be used on single shift, double shift or triple shift are segregated. This segregation is required as the extra shift depreciation is applicable only to those assets whose useful life is determined on single shift basis. After segregation, the remaining useful life of the asset is estimated. A company recognises depreciation expense based on the useful life estimated by the management. Where the useful life estimated by the management is different from that specified by Schedule II, the same is disclosed in notes.

Determination of Useful Life



14. As per paragraph 23 of AS 6, the useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life. Further, paragraph 21 of Accounting Standard (AS) 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies,* notified under the Companies (Accounting Standards) Rules, 2006, provides 'an estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.' Therefore, a company is required to assess whether there have been any changes in the measure of wearing out, consumption or other loss of value of the asset during the year and in future. Where there have been such changes, the company is required to re-estimate the useful life of the asset.

Illustration 1

Facts: A Limited is a company incorporated under the Companies Act, 1956, engaged in the business of manufacturing of toys. A Limited purchased a unit of machinery costing Rs. 60 lakhs as on April 01, 2014. As per Schedule II the general useful life of the assets is 15 years. However, as per A Ltd.'s estimation, the useful life of the asset is 20 years supported by the technical advice.

Issue: Should the company use the useful life as 15 years or 20 years?

Response: In this case, keeping in view the requirements under Schedule II, A Ltd. should depreciate the machinery over its useful life of 20 years as determined by the company and not over 15 years as indicated in Schedule II. A limited should also provide disclosures in this regard as recommended later in this Guidance Note in the notes to accounts to justify the reason for difference between the indicative use life and A's estimated useful life.

Illustration 2

Facts: B Limited had considered the minimum rates of depreciation mentioned in Schedule XIV for depreciating all its fixed assets till March 31, 2014. Based on the rates mentioned for SLM and WDV in Schedule XIV, B Limited had derived the useful lives for the assets. Schedule II of the Companies Act, 2013 is now applicable to B Limited w.e.f. April 1, 2014.

Issue: Whether B Limited needs to follow the useful lives mentioned in the Schedule II or derived useful lives considered till March 31, 2013 can be considered?

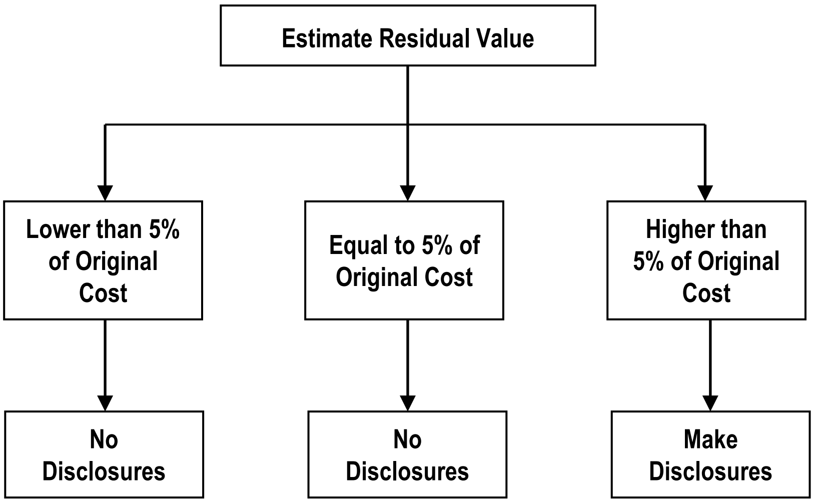
Response: W.e.f. April 1, 2014, B limited should estimate the remaining useful lives of its assets based on the definition of useful life in Schedule II and the factors specified in AS 6 for recognising depreciation in the statement of profit and loss. There is no relevance of the derived useful life as per Schedule XIV. However, if B Limited estimates useful lives different from those specified in Schedule II, it should disclose such differences in the financial statements and provide justification in this behalf duly supported by technical advice.

Residual Value of an Asset

15. As mentioned above, paragraph 3(i) of Part A of Schedule II, inter alia, states that the residual value of an asset shall not be more than five percent of the original cost of the asset; provided that where a company uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice. The aforesaid proviso can be taken to mean that the residual value of the asset is indicative in nature. Thus, where the estimate of the residual value of the asset is more than five percent of the original cost of the asset, the company should use that estimate of residual value provided it is supported by

technical advice, external or internal, and disclosures in this regard are made as recommended later in this Guidance Note. In case the residual value is estimated to be less than five percent of the original cost of the asset, the same should be used and it would not be necessary to make a disclosure in such a case. The chart given below summarises the position as stated above.

Determination of Residual Value



Continuous Process Plant (CPP)

16. Note 8 to Schedule II defines the expression 'Continues Process Plant' as:

> ''Continuous process plant'' means a plant which is required and designed to operate for twenty-four hours a day.

17. The words "required and designed to operate twenty-four hours a day" are very significant and should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a CPP is such that there is a requirement to run it continuously for twenty-four hours a day. If it is not so run, there are significant shut-down and/or start-up costs. If such a plant is shut-down, there may be significant spoilage of materials-in-process/ some damage to the plant itself/significant energy loss. It is, however, possible that due to various reasons, e.g., lack of demand, maintenance etc., such a plant may be shut down for some time. The shutdown does not change the inherent technical nature of the plant. For instance, a blast furnace which is required and designed to operate twenty-four hours a day, may be shut down due for various reasons; it would still be considered as a CPP and useful life as estimated would be applicable for providing depreciation.

18. There can be certain plants which though may work twenty-four hours a day, yet their technical design is not such that they have to be operated twenty-four hours a day, e.g., a textile weaving mill. In such cases, depreciation to be charged would be on the basis of estimated useful life.

19. A CPP is distinct from the repetitive process plant or assembly-line type plants. These plants are not CPP since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate twenty-four hours a day, e.g., an automobile manufacturing plant.

20. It is noted that Schedule XIV, inter alia, specified the general rates of 15.28% under Written Down Value method (WDV) and 5.33% under Straight Line Method (SLM) of depreciation for CPP,

other than those for which special rates had been prescribed. In other words, as per the depreciation rates provided under Schedule XIV for the CPP, the useful life was 20 years (approx). However, Schedule II indicates useful life of 25 years for CPP, other than those for which special rates have been prescribed in Schedule II. The principle of estimation of useful life as explained in paragraph 12 of this Guidance Note will also apply to CPP.

21. It may be noted that what should be considered as CPP under Schedule II is same as it was under Schedule XIV. Accordingly, in case a plant was not considered as CPP under Schedule XIV, the same cannot be considered as CPP under Schedule II.

Multiple Shift Depreciation

22. Note 6 to Schedule II to the Companies Act, 2013, states that:

> "6. The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated by NESD in Part C above), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period."

23. On the other hand, Schedule XIV specified the depreciation rates for double shift and triple shift separately. Therefore, an issue may arise whether the rates for extra shift as given under Schedule II should be applied without estimating the useful lives of the assets under multiple shifts.

24. It is noted that extra shift depreciation does not apply to CPP and the assets which have been marked as No Extra Shift Depreciation (NESD) under Schedule II. The concept of extra shift depreciation applies only to those assets for which the useful life has been estimated on single shift basis at the beginning of the year.

25. Where a company, which estimated the useful life of an asset on single shift basis at the beginning of the year, used the asset on double or triple shifts during the year, the depreciation expense should be increased by 50% or 100% as the case may be for that period. Further, for such assets, the company at the beginning of the next year should determine whether the asset used in extra shift during the past year was on sporadic basis and is expected to be used on sporadic basis in future also. In such a case, the useful life to be on single shift basis and if in future the asset is used on double or triple shift then as in the past, the depreciation expense for the double or triple shift should be increased by 50% or 100% as the case may be for the period of use. In case the company estimates that the use of the asset for extra shift would not be on sporadic basis i.e. the extra shift working for the asset would be on regular or continuous basis, it should reassess its useful life considering its use on extra shift basis. The reassessed useful life should then be used for the purpose of charging depreciation expense henceforth.

26. For assets which are not marked as NESD under Schedule II and for which the useful life has been estimated on double/triple shift basis at the beginning of the year, the concept of extra shift deprecation will not apply. For such assets, a company should consider whether there is any change in circumstances on which the useful life of asset was based or any new developments have taken place which may have impact on the estimated useful life of the asset. If there is no such indication, the company should continue to depreciate such assets on the basis of previous estimates. If there is any such indication, the company should reassess the remaining useful life of the assets on the basis of changed circumstances or new developments, e.g., use of the asset on single shift basis in future.

Unit of Production (UOP) Method of Depreciation

27. Schedule II to the Companies Act, 2013 defines 'Useful Life' as:

"useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity."

28. The depreciation on an asset can be provided, where appropriate, on the basis of the units expected to be obtained from the use of the asset. This method of providing depreciation is generally known as *'Unit of Production'* method (UOP).

29. Paragraph 12 of AS 6, state as follows:

"12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired."

30. In view of the above, as a result of application of Schedule II, a company may use UOP method, where appropriate, keeping in view the various factors mentioned in paragraph 12 of AS 6. UOP method is generally considered appropriate where the number of units that can be produced or serviced from the use of the asset is the major limiting factor for the use of the asset rather than the time. Following are some examples where UOP method can be identified appropriate:

(i) Useful life of Aircraft engine is restricted by number of flying hours

(ii) Useful life of Boiler is limited to number of hours

(iii) Useful life of Mould is limited by the number of imprints

31. A company will have to review the number of units that can be produced or serviced from the asset in the future periodically. The carrying amount of such an asset will be depreciated over the revised remaining number of units expected to be obtained or serviced on a prospective basis. Where, such an asset is idle for a long period of time, the company should assess whether the use of UOP method is still appropriate.

32. Under Schedule XIV primarily two methods of depreciation, i.e., Written Down Value (WDV) and Straight Line Method (SLM) were prescribed. Therefore, an issue may arise that whether the change in method of depreciation from SLM to UOP or WDV to UOP would be a change in accounting policy and need to be applied retrospectively or required to be applied prospectively.

33. In this regards, it may be noted that paragraph 15 of AS 6, states as follows:

"15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed."

34. In view of the above, with the introduction of UOP method in Schedule II, a company may change from SLM or WDV method to UOP method. In such cases, in accordance with AS 6, depreciation on the underlying asset should be calculated retrospectively using the UOP method from the date the asset came into use to the company with adjustment of any surplus or deficiency arising from change in method to the statement of profit and loss as such change is required by the statute. However, as a first time application of Schedule II, if a company changes its method of depreciation from WDV to SLM or vice versa, the same cannot be justified as required by law as both the methods were allowed under Schedule XIV and AS 6. In accordance with AS 6, a shift from WDV to SLM or vice versa can only be applied by the company if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the company. In such a case also, any surplus or deficiency arising from change in method should be adjusted to the statement of profit and loss in accordance with AS 6. It may also be noted that in case of change in method of depreciation, transitional provisions given under Note 7 (b) of Schedule II will not apply.

Illustration:

Facts: A Limited is a company incorporated under the Companies Act and engaged in the business of oil exploration. Keeping in view the requirement in Schedule XIV it was depreciating its oil and gas assets on SLM basis. In the financial year 2014-15, when A applies Schedule II it decides to depreciate the said assets by following the UOP method.

Issue: How should change in method be accounted for?

Response: In this case, in accordance with AS 6, A Limited should calculate depreciation on all such assets following the UOP method since the assets came into existence and recognise any deficiency/gain in the statement of profit and loss for the period ending on March 31, 2015.

Transition to Schedule II

35. Note 7 to Schedule II to the Companies Act, 2013, states that

"7. From the date this Schedule comes into effect, the carrying amount of the asset as on that date-

(a) shall be depreciated over the remaining useful life of the asset as per this Schedule;

(b) after retaining the residual value, may be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil."

36. An issue may arise that in what circumstances due to transition to Schedule II, the carrying amount of an asset may be transferred to retained earnings.

37. Note 7 (b) uses the phrase 'remaining useful life of an asset'. This means on transition to Schedule II, a company should estimate the remaining useful life of an asset over which the company expects to use the asset, which may or may not be equal to remaining useful life as per the rate of depreciation specified in Schedule XIV. In other words, there may be a situation that when a company initially applies Schedule II, the remaining useful life of some assets is

estimated at nil, whereas for other assets some useful life remains as per the said Schedule. In respect of an asset whose remaining useful life is nil, as per the option provided under Note 7 to Schedule II, the carrying amount of such assets may be transferred directly either to the opening balance of retained earnings or recognised in the statement of profit and loss as depreciation expense as required by AS 5 and AS 6. If the company opts to adjust the carrying amount of the assets to the retained earnings in accordance with the transitional provisions of Schedule II, the tax effect of the same has also to be adjusted directly against the retained earnings in accordance with the Announcement issued by the Institute of Chartered Accountants of India, "*Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account*".

38. If a company uses Straight Line Method (SLM) of depreciation, the asset will be depreciated equally over the new remaining useful life of the asset. However, if a company uses Written Down Value (WDV) method of depreciation, it will need to calculate a new rate for depreciation to depreciate the asset over its remaining useful life using the formula for calculation of rate for depreciation as per WDV method which is reproduced below –

R= {1 – (s/c)^1/n } x 100

Where R = Rate of Depreciation (in %)

n = Remaining useful life of the asset (in years)

s = Scrap value at the end of useful life of the asset

c = Cost of the asset/Written down value of the asset

Illustration:

Facts: B Limited has followed Schedule XIV rates for depreciation of a plant and machinery under WDV method by following the rate of 13.91% as it runs under single shift. The WDV of the asset as at March 31, 2014 is Rs. 23,63,919 and remaining useful life as estimated by the company is 11 years. B Limited estimates that the residual value of the asset is 5% of the original cost of the asset, i.e., Rs. 2,50,000.

Issue: On transition to Schedule II, how plant and machinery should be depreciated?

Response: As per the transitional provisions given under Schedule II assets are required to be depreciated over their remaining useful lives. In the above case, since B Ltd follows WDV method for depreciation, the carrying value of Rs. 23,63,919 of plant and machinery should be depreciated by following the WDV method over its remaining useful life of 11 years. B Limited should determine the rate of depreciation to be charged under WDV method as follows:

Rate of Depreciation: {1- (Residual Value/Cost of the Asset)^1/useful life}*100

Rate of Depreciation in the above case

= {1- (2,50,000/23,63,919)^1/11}*100

=18.47 %

Year	Carrying Value	Dep. For the year	WDV
1	23,63,919.00	4,36,690.25	19,27,228.75
2	19,27,228.75	3,56,019.82	15,71,208.93

3	15,71,208.93	2,90,251.75	12,80,957.19
4	12,80,957.19	2,36,633.11	10,44,324.07
5	10,44,324.07	1,92,919.53	8,51,404.54
6	8,51,404.54	1,57,281.22	6,94,123.32
7	6,94,123.32	1,28,226.43	5,65,896.90
8	5,65,896.90	1,04,538.97	4,61,357.93
9	4,61,357.93	85,227.33	3,76,130.59
10	3,76,130.59	69,483.16	3,06,647.43
11	3,06,647.43	56,647.43	2,50,000.00

Illustrations:

1. Facts: B Limited purchased a unit of plant and machinery on April 1, 2005, and depreciated the same at the rate of 4.75% on straight line basis as per the depreciation rate given in Schedule XIV (equivalent useful life approximately 21 years), even though the useful life as estimated by the management at the time of initial recognition of the asset was higher (30 years). For the financial year beginning on April 1, 2014, when B Limited applies Schedule II, it estimates that the remaining useful life of the plant and machinery as on April 1, 2014, is 18 years, which is different from the useful life remaining as per Schedule XIV i.e., 12 years.

Issue: Which remaining useful life of plant and machinery should be considered by the B Limited to provide depreciation?

Response: B Limited should depreciate the plant and machinery over its estimated remaining useful life of 18 years on prospective basis and not on the basis of remaining useful life as per Schedule XIV, i.e., 12 years (21 years – 9 years).

2. Facts: B Limited purchased machinery as on April 1, 2005 and depreciated the same on straight line method as per the depreciation rates given in Schedule XIV. For the financial year beginning on April 1, 2014, when B Limited applies Schedule II, it estimates that the remaining useful life of machinery is nil and requires to be disposed off.

Issue: What should be the treatment of carrying amount of machinery?

Response: The carrying amount of machinery (net of tax) may be recognised in the opening balance of the retained earnings as on April 01, 2014.

Regulatory Rates

39. Part B of Schedule II to the Companies Act, 2013, states as follows:

> "4. The useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule."

40. In view of the above, where a Regulatory Authority prescribes useful life, rate of depreciation or residual value for any specific asset for accounting purposes, the company should use that useful life, rate of depreciation or residual value even though it is different from that as estimated by the management. For example, Govt. of India, Ministry of Power vide resolution dated 6th January, 2006 has notified Tariff Policy in terms of section 3 of the Electricity Act, 2003. The said policy inter-alia

provides that rates of depreciation as notified by Central Electricity Regulatory Commission (CERC) would be applicable for the purpose of tariffs as well as accounting. Therefore, in accordance with Part B of Schedule II, companies which are regulated by the above mentioned tariff policy should apply the rate of depreciation as specified in the above mentioned tariff policy.

Purchase of Used Assets

41. The expression 'available for use by an entity' in the definition of 'useful life' of assets as given in paragraph 1 of Part A of Schedule II clarifies that the useful life of an asset is estimated on the basis of the expectations of the company that purchases the asset irrespective of whether the asset is a new asset or a used asset.

Illustration:

Facts: B Limited, a company incorporated under the Companies Act, acquired a second hand machinery for Rs. 5,00,000 from C Limited. As per the estimate of the C Limited, the useful life of the asset when it was newly purchased by it was 15 years out of which 8 years have already elapsed (duration for which machinery is used by the C Limited). B Limited, for the purpose of providing depreciation on SLM basis under Schedule II, estimates that the asset can be used for 10 years and the residual value is estimated to be nil.

Issue: What useful life of such second hand machinery should be considered by the B Limited for providing depreciation?

Response: In this case, B Limited should provide for depreciation on the machinery on the basis of useful life of 10 years and not 7 years remaining as per the earlier estimate of C Ltd. (15 years – 8 years). Therefore, depreciation expense to be recognised in the statement of profit and loss for the year would be Rs. 50,000 (5,00,000/10 yrs.).

Intangible Assets

42. The Ministry of Corporate Affairs (MCA), vide its notification G.S.R. 237 (E) dated March 31, 2014, made amendments to clause (ii) of paragraph 3 of Schedule II with regard to amortisation of intangible assets. Through the amendments, the MCA provides that revenue-based methodology **'may be'** used for amortisation of intangible assets **(Toll Roads)** created under 'Build, Operate and Transfer (BOT)', 'Build, Own, Operate and Transfer (BOOT)' or any other form of public private partnership (PPP) route in case of road projects.

43. The words **'may be'** used in clause (ii) of paragraph 3 of Schedule II indicates that revenue-based amortisation as provided in Schedule II is optional and not mandatory. Moreover, the option is available only for intangible assets arising from toll road projects. Therefore, a company can follow a basis other than revenue-based amortisation for intangible assets arising from toll road projects. Intangible assets other than those arising from toll-roads should be amortised in accordance with Accounting Standards (AS) 26, *Intangible Assets,* notified under the Companies (Accounting Standards) Rules, 2006.

Illustration:

Facts: B Limited is a company engaged in various projects of infrastructure development. B's basic business model is to enter into various infrastructure development projects with the Central and State Governments controlled enterprises under Public Private Partnership (PPP) Model. During the year 2011-12, B Limited entered into a contract with the State Government of Haryana for developing a coal-fired thermal power plant serving the states of Haryana, Delhi, Rajasthan and Punjab.

Issue: At the year-end, i.e., 31st March, 2015, for providing amortisation on the intangible assets arising from the above mentioned projects for developing thermal power plant, B Limited was of the view that the revenue-based amortisation methodology as permitted by the Schedule II may be applied. Whether the view taken by B Limited is appropriate?

Response: In this case, use of revenue-based amortisation is inappropriate as Schedule II permits revenue based amortisation only for intangible assets arising from toll road projects and not from any other infrastructure projects even though they are entered into through PPP model, BOT or BOOT.

Revaluation of Assets

44. Paragraph 1 of Part A of Schedule II defines 'depreciable amount' as:

> "The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value."

45. AS 6, also defines the term 'depreciable amount' in the same way. The expression ***'other amount substituted for historical cost'*** used in the said definitions means that in case of a revalued asset, the depreciable amount should be the carrying value of the asset after revaluation (revalued amount).

46. Thus the definition of 'depreciable amount' under Schedule II has been aligned with the definition of 'depreciable amount' under AS 6. Therefore, Schedule II requires depreciation to be provided on historical cost or the amount substituted for the historical cost. Accordingly, in case of revaluation of an asset, a company should recognise depreciation based on the revalued amount (substituted cost) of the asset. In accordance with paragraph 32 of Accounting Standard (AS) 10, *Accounting for Fixed Assets,* notified under the Companies (Accounting Standards) Rules, 2006, on disposal of an item of fixed asset, the difference between net disposal proceeds and the net book value (carrying amount) should be charged or credited to the statement of profit and loss. However, in case of loss on sale of fixed asset, if such loss is related to a previously recorded increase in the carrying amount of the asset (revaluation gain) as credit to revaluation reserve and which has not been subsequently reversed or utilised, such loss should be first charged directly to that revaluation reserve, and any remaining balance to the statement of profit and loss. However, some of the surplus may be transferred as the asset is used by a company. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost. Transfers from revaluation surplus to the revenue reserves are not made through the statement of profit and loss.

47. A company that followed the policy of recouping additional depreciation as a credit to the statement of profit and loss, with Schedule II becoming applicable starts recouping additional depreciation on account of revaluation as a credit to revenue reserves, such a company should disclose the change as a change in accounting policy in accordance with AS 5.

Component Approach

48. As per note 4 of Schedule II - "Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately." As per the amendment dated August 29, 2014 notified by the MCA, the said requirement shall be voluntary in respect for the financial year commencing on or after the April 1, 2014 and mandatory for financial statements in respect of financial years commencing on or after April 1, 2015.

49. The above requirement is commonly known as 'component accounting'. Companies will need to identify and depreciate significant components with different useful lives separately. The component

approach is already allowed in paragraph 8.3 of the current AS 10. Under AS 10, there seems to be a choice in this matter; however, Schedule II requires application of component accounting mandatorily. The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:

- Determine the threshold value to determine which asset requires componentisation.
- Threshold value in percentage of cost of component to the total cost of the asset
- Proportion of useful life of that part as compared to the useful life of the asset
- Potential impact on the total depreciation expenditure

50. Component accounting requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation and accounting for replacement costs. Currently, companies need to expense replacement costs in the year of incurrence. Under component accounting, companies will capitalise these costs as a separate component of the asset and decapitalise the carrying amount of previously recognised component. When it is not practicable to determine the carrying amount of the replaced part, the cost of the replacement may be used as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

51. As component accounting was hitherto not mandatory in India, it is possible that the separate cost of each significant component of an asset is not available in the books of account. For the purpose of determining the cost of such component, the following criteria can be used in the order given below:

(a) Break-up cost provided by the vendor;

(b) Cost break-up given by internal/external technical expert;

(c) Fair values of various components; or

(d) Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset

52. A company is required to apply component accounting (if appropriate) for all depreciable fixed assets (existing or newly acquired) as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset(s), company is not required to apply component accounting for such asset(s).

53. The guidance related to providing depreciation on fixed assets as provided in the Guidance Note from paragraph 12 onwards will apply *mutatis mutandis* to component accounting, where applicable, as well.

54. Further, under component accounting, an issue arises whether the transitional provision under Note 7 of Schedule II will be available to company on April 1, 2015, with respect to componentisation, though it adopted the other provisions (useful life) of Schedule II as on April 1, 2014. This Guidance Note clarifies that if a company determines the life of a component which is different from the remaining asset and such useful life happens to be nil as on the date of transition to Schedule II either on voluntary basis or on mandatory basis as the case may be, the carrying amount of such component may be transferred directly to the retained earnings. In other words, the transitional provisions of Schedule II may be applied *mutatis mutandis* w.r.t. component accounting. Further, if the company opts to adjust the carrying amount of the components to the retained earnings in accordance with the transitional provisions of Schedule II, the tax effect of the same has also to be adjusted directly against the retained earnings in accordance with the Announcement issued by the Institute of Chartered

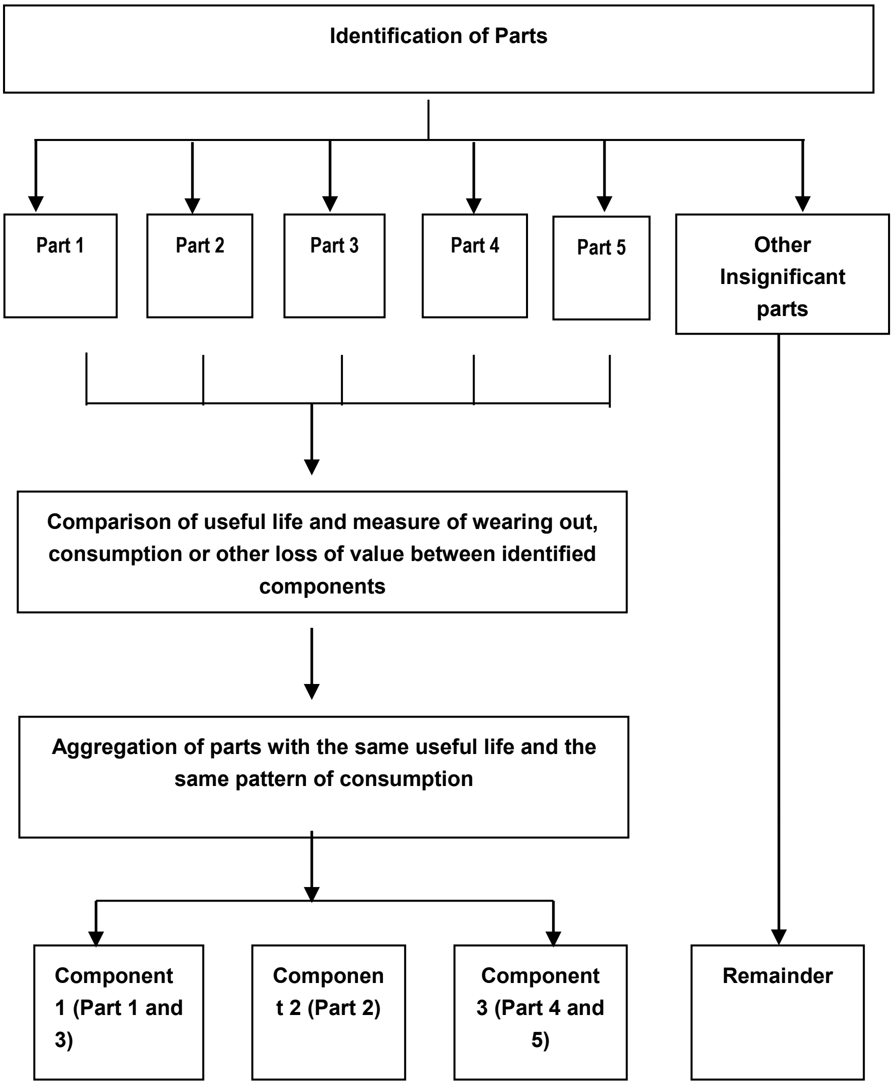
Accountants of India, *"Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account".*

55. Schedule II requires separate depreciation only for parts of an item of tangible fixed asset having:

(i) Significant cost, and

(ii) Different useful lives from remaining parts of the asset.

Following diagram depicts a method for bifurcating Tangible Fixed Assets into major components-



The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset.

For instance:

A Ship may be bifurcated into the following components –

(i) Hull

(ii) Keel

(iii) Engine

(iv) Navigation system

(v) Major overhaul/ inspections

(vi) Other fit out assets

Identification of significant parts is a matter of judgment and decided on case-to-case basis. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise. Hence, it may be necessary to involve technical experts to determine the parts of an asset, wherever appropriate.

Depreciation on Low Value Items

56. Note 8 to Schedule XIV to the Companies Act, 1956, stated as follows:

> "8. Notwithstanding anything mentioned in this Schedule depreciation on assets, whose actual cost does not exceed five thousand rupees, shall be provided depreciation at the rate of hundred per cent
>
> Provided that where the aggregate actual cost of individual items of plant & machinery costing Rs. 5,000 or less constitutes more than 10 per cent of the total actual cost of plant & machinery, rates of depreciation applicable to such items shall be the rates as specified in Item II of the Schedule."

57. It may be noted that Schedule II does not prescribe any such requirement to provide depreciation at the rate of hundred percent. Therefore, an issue may arise whether the earlier requirement of providing hundred percent depreciation on assets with value less than rupees five thousand can still be followed or not.

58. In this regard, it may be noted that the provisions of Schedule XIV permitting 100% depreciation of the cost of an asset having individual value of Rs. 5000/- or less was based on practices followed by the companies based on the materiality of the financial impact of such charge. As the life of the asset is a matter of estimation, the materiality of impact of such charge should be considered with reference to the cost of asset. The size of the company will also be a factor to be considered for such policy. Accordingly, a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

Pro-rata Depreciation

59. Note no. 2 in Schedule II prescribes that "where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata basis* from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed." The company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

Adoption of different methods for similar assets at different geographical locations

60. An issue may arise, whether a company can use different methods for depreciation for similar assets located at different locations.

61. As per the requirements of Schedule II and AS 6, it may be noted that the basic purpose of charging depreciation is to allocate depreciable amount of an asset over its useful life. As stated in paragraph 12 of this Guidance Note, for the purpose of estimating useful life of an asset, a company should consider various factors given in AS 6 such as expected physical wear and tear, obsolescence, etc. Therefore, selection of a method of depreciation is a matter of judgement by the management considering various factors, such as, type of asset, the nature of the use of such asset and circumstances prevailing in the business, to allocate the depreciable amount of an asset over its useful life so that the depreciation method best reflects the way the asset is consumed, i.e., depreciation should be allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset . As per AS 6, the selection of a method depends upon the facts and circumstances of the case and thus, the company should select the most appropriate method based on various factors, as discussed above.

62. Different methods for similar assets at different geographical locations can only be used if the said methods are selected based on the factors discussed in paragraph 61 above. Otherwise, the use of different methods for similar assets at different geographical locations is not justified.

Disclosures

63. Apart from the disclosures required under the accounting standards, Schedule II requires disclosure of useful life and/or residual value, if they are different from those specified under that Schedule. In this regard, following disclosures should be made:

(i) Disclosure of assets alongwith their useful lives where different from those specified under Schedule II including where the useful life estimated as per double/triple shift is different from that as would be estimated on the basis of increase in depreciation by 50% or 100% in case of double shift and triple shift respectively of single shift based depreciation.

(ii) The fact that the said useful lives/residual values are supported by technical advice.

Transitional provisions & Effective Date

64. This Guidance Note will be applicable for accounting periods beginning on or after April 1, 2016; its earlier application is encouraged. Any cumulative impact (net of taxes) due to its applicability should be recognised in revenue reserves and disclosed separately.

Appendix A

SCHEDULE II (As Amended)

USEFUL LIVES TO COMPUTE DEPRECIATION

PART ‘A’

1. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

2. For the purpose of this Schedule, the term depreciation includes amortisation.

3. Without prejudice to the foregoing provisions of paragraph 1,—

   (i) The useful life of an asset shall not ordinarily be different from the useful life specified in part C and the residual value of an asset shall not be more than five per cent. of the original cost of the asset:

   Provided that where a company adopts a useful life different from what is specified in part C or uses a residual value different from the limit specified above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

   (ii) For intangible assets, the provisions of the accounting standards applicable for the time being in force shall apply, except in case of intangible assets (Toll Roads) created under Build, Operate and Transfer', 'Build, Own, Operate and Transfer' or any other form of public private partnership route in case of road projects. Amortisation in such cases may be done as follows:

(a) Mode of amortization

$$\text{Amortisation Rate} = \frac{\text{Amortisation Amount}}{\text{Cost of Intangible Assets }(A)} \times 100$$

Amortisation Amount

$$= \text{Cost of Intangible Assets (A)} \times \frac{\text{Actual Revenue for the year }(B)}{\text{Projected Revenue from Intangible Asset (till the end of the concession period) }(C)}$$

(b) Meaning of particulars are as follows:-

Cost of Intangible Assets (A)	=	Cost incurred by the company in accordance with the accounting standards.
Actual Revenue for the year (B)	=	Actual revenue (Toll Charges) received during the accounting year.
Projected Revenue from Intangible Asset (C)	=	Total projected revenue from the Intangible Assets as provided to the project lender at the time of financial closure/agreement.

The amortization amount or rate should ensure that the whole of the cost of the intangible asset is amortised over the concession period.

Revenue shall be reviewed at the end of each financial year and projected revenue shall be adjusted to reflect such changes, if any, in the estimates as will lead to the actual collection at the end of the concession period.

(c) Example:-

Cost of creation of Intangible Assets	:	Rs. 500 Crores
Total period of Agreement	:	20 Years
Time used for creation of Intangible Assets	:	2 Years
Intangible Assets to be amortised in	:	18 Years

Assuming that the Total revenue to be generated out of Intangible Assets over the period would be Rs. 600 Crores, in the following manner:-

Year No.	Revenue (In Rs. Crores)	Remarks
Year 1	5	Actual
Year 2	7.5	Estimate*
Year 3	10	Estimate*
Year 4	12.5	Estimate*
Year 5	17.5	Estimate*
Year 6	20	Estimate*
Year 7	23	Estimate*
Year 8	27	Estimate*
Year 9	31	Estimate*
Year 10	34	Estimate*
Year 11	38	Estimate*
Year 12	41	Estimate*
Year 13	46	Estimate*
Year 14	50	Estimate*
Year 15	53	Estimate*
Year 16	57	Estimate*
Year 17	60	Estimate*
Year 18	67.5	Estimate*
Total	600	

'*' will be actual at the end of financial year

Based on this the charge for first year would be Rs. 4.16 Crore (approximately) (i.e Rs. 5/Rs. 600 × Rs. 500 Crores) which would be charged to profit and loss and 0.83% (i.e. Rs. 4.16 Crore/Rs. 500 Crore×100) is the amortisation rate for the first year.

Where a company arrives at the amortisation amount in respect of the said Intangible Assets in accordance with any method as per the applicable Accounting Standards, it shall disclose the same.

PART 'B'

4. The useful life or residual value of any specific asset, as notified for accounting purposes by a Regulatory Authority constituted under an Act of Parliament or by the Central Government shall be applied in calculating the depreciation to be provided for such asset irrespective of the requirements of this Schedule.

PART 'C'

5. Subject to Parts A and B above, the following are the useful lives of various tangible assets:

Nature of assets Useful Life

I.	**Buildings [NESD]**		
	(*a*)	Buildings (other than factory buildings) RCC Frame Structure 60 Years	
	(*b*)	Buildings (other than factory buildings) other than RCC Frame Structure	30 Years
	(*c*)	Factory buildings	-do-
	(*d*)	Fences, wells, tube wells	5 Years
	(*e*)	Others (including temporary structure, etc.)	3 Years
II.	**Bridges, culverts, bunders, etc. [NESD]**		30 Years
III.	**Roads [NESD]**		
	(*a*)	Carpeted roads	
		(i) Carpeted Roads-RCC	10 Years
		(ii) Carpeted Roads-other than RCC	5 Years
	(*b*)	Non-carpeted roads	3 Years
IV.	**Plant and Machinery**		
	(i)	**General rate applicable to plant and machinery not covered Under special plant and machinery**	
	(a)	Plant and Machinery other than continuous process plant not covered under specific industries	15 Years
	(b)	continuous process plant for which no special rate has been prescribed under (*ii*) below [NESD]	25 Years
	(ii)	**Special Plant and Machinery**	
	(a)	Plant and Machinery related to production and exhibition of Motion Picture Films	
		1. Cinematograph films—Machinery used in the production and exhibition of cinematograph films, recording and reproducing equipments, developing machines, printing machines, editing machines, synchronizers and studio lights except bulbs	13 Years
		2. Projecting equipment for exhibition of films	-do-
	(b)	Plant and Machinery used in glass manufacturing	
		1. Plant and Machinery except direct fire glass melting furnaces — Recuperative and regenerative glass melting furnaces	13 Years
		2. Plant and Machinery except direct fire glass melting furnaces — Moulds [NESD]	8 Years
		3. Float Glass Melting Furnaces [NESD]	10 Years

(c)	Plant and Machinery used in mines and quarries— Portable underground machinery and earth moving machinery used in open cast mining [NESD]		8 Years
(d)	Plant and Machinery used in Telecommunications [NESD]		
	1.	Towers	18 Years
	2.	Telecom transceivers, switching centres, transmission and other network equipment	13 Years
	3.	Telecom—Ducts, Cables and optical fibre	18 Years
	4.	Satellites	-do-
(e)	Plant and Machinery used in exploration, production and refining oil and gas [NESD]		
	1.	Refineries	25 Years
	2.	Oil and gas assets (including wells), processing plant and facilities	-do-
	3.	Petrochemical Plant	-do-
	4.	Storage tanks and related equipment	-do-
	5.	Pipelines	30 Years
	6.	Drilling Rig	-do-
	7.	Field operations (above ground) Portable boilers, drilling tools, well-head tanks, etc.	8 Years
	8.	Loggers	-do-
(f)	Plant and Machinery used in generation, transmission and distribution of power [NESD]		
	1.	Thermal/ Gas/ Combined Cycle Power Generation Plant	40 Years
	2.	Hydro Power Generation Plant	-do-
	3.	Nuclear Power Generation Plant	-do-
	4.	Transmission lines, cables and other network assets	-do-
	5.	Wind Power Generation Plant	22 Years
	6.	Electric Distribution Plant	35 Years
	7.	Gas Storage and Distribution Plant	30 Years
	8.	Water Distribution Plant including pipelines	-do-
(g)	Plant and Machinery used in manufacture of steel		
	1.	Sinter Plant	20 Years
	2.	Blast Furnace	-do-
	3.	Coke ovens	-do-
	4.	Rolling mill in steel plant	-do-
	5.	Basic oxygen Furnace Converter	25 Years

(h)	Plant and Machinery used in manufacture of non-ferrous metals		
	1.	Metal pot line [NESD]	40 Years
	2.	Bauxite crushing and grinding section [NESD]	-do-
	3.	Digester Section [NESD]	-do-
	4.	Turbine [NESD]	-do-
	5.	Equipments for Calcination [NESD]	-do-
	6.	Copper Smelter [NESD]	-do-
	7.	Roll Grinder	40 Years
	8.	Soaking Pit	30 Years
	9.	Annealing Furnace	-do-
	10.	Rolling Mills	-do-
	11.	Equipments for Scalping, Slitting , etc. [NESD]	-do-
	12.	Surface Miner, Ripper Dozer, etc., used in mines	25 Years
	13.	Copper refining plant [NESD]	-do-
(i)	Plant and Machinery used in medical and surgical operations [NESD]		
	1.	Electrical Machinery, X-ray and electrotherapeutic apparatus and accessories thereto, medical, diagnostic equipments, namely, Cat-scan, Ultrasound Machines, ECG Monitors, etc.	13 Years
	2.	Other Equipments.	15 Years
(j)	Plant and Machinery used in manufacture of pharmaceuticals and chemicals [NESD]		
	1.	Reactors	20 Years
	2.	Distillation Columns	-do-
	3.	Drying equipments/Centrifuges and Decanters	-do-
	4.	Vessel/storage tanks	-do-
(k)	Plant and Machinery used in civil construction		
	1.	Concreting, Crushing, Piling Equipments and Road Making Equipments	12 Years
	2.	Heavy Lift Equipments—	
		Cranes with capacity of more than 100 tons	20 Years
		Cranes with capacity of less than 100 tons	15 Years
	3.	Transmission line, Tunneling Equipments [NESD]	10 Years
	4.	Earth-moving equipments	9 Years
	5.	Others including Material Handling /Pipeline/ Welding Equipments [NESD]	12 Years
(l)	Plant and Machinery used in salt works [NESD]		15 Years

V.	**Furniture and fittings [NESD]**		
	(i)	General furniture and fittings	10 Years
	(ii)	Furniture and fittings used in hotels, restaurants and boarding houses, schools, colleges and other educational institutions, libraries; welfare centres; meeting halls, cinema houses; theatres and circuses; and furniture and fittings let out on hire for use on the occasion of marriages and similar functions.	8 Years
VI.	**Motor Vehicles [NESD]**		
	1.	Motor cycles, scooters and other mopeds	10 Years
	2.	Motor buses, motor lorries, motor cars and motor taxies used in a business of running them on hire	6 Years
	3.	Motor buses, motor lorries and motor cars other than those used in a business of running them on hire	8 Years
	4.	Motor tractors, harvesting combines and heavy vehicles	-do-
	5.	Electrically operated vehicles including battery powered or fuel cell powered vehicles	8 Years
VII.	**Ships [NESD]**		
	1.	Ocean-going ships	
		(*i*) Bulk Carriers and liner vessels	25 Years
		(*ii*) Crude tankers, product carriers and easy chemical carriers with or without conventional tank coatings.	20 Years
		(*iii*) Chemicals and Acid Carriers:	
		(a) With Stainless steel tanks	25 Years
		(b) With other tanks	20 Years
		(*iv*) Liquified gas carriers	30 Years
		(v) Conventional large passenger vessels which are used for cruise purpose also	-do-
		(vi) Coastal service ships of all categories	-do-
		(vii) Offshore supply and support vessels	20 Years
		(viii) Catamarans and other high speed passenger for ships or boats	-do-
		(*ix*) Drill ships	25 Years
		(x) Hovercrafts	15 Years
		(xi) Fishing vessels with wooden hull	10 Years
		(xii) Dredgers, tugs, barges, survey launches and other similar ships used mainly for dredging purposes	14 Years
	2.	Vessels ordinarily operating on inland waters—	
		(i) Speed boats	13 Years
		(ii) Other vessels	28 Years

VIII. Aircrafts or Helicopters [NESD] 20 Years

IX. Railways sidings, locomotives, rolling stocks, tramways and railways used by concerns, excluding railway concerns [NESD] 15 Years

X. Ropeway structures [NESD] 15 Years

XI. Office equipment [NESD] 5 Years

XII. Computers and data processing units [NESD]

(*i*) Servers and networks 6 Years

(*ii*) End user devices, such as, desktops, laptops, etc. 3 Years

XIII. Laboratory equipment [NESD]

(*i*) General laboratory equipment 10 Years

(ii) Laboratory equipments used in educational institutions 5 Years

XIV. Electrical Installations and Equipment [NESD] 10 years

XV. Hydraulic works, pipelines and sluices [NESD] 15 Years

Notes -

1. "Factory buildings" does not include offices, godowns, staff quarters.

2. Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.

3. The following information shall also be disclosed in the accounts, namely:—

(*i*) depreciation methods used; and

(*ii*) the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.

4.(a) Useful life specified in Part C of the Schedule is for whole of the asset and where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately

(b) The requirement under sub-paragraph (a) shall be voluntary in respect of the financial year commencing on or after the 1st April, 2014 and mandatory for financial statements in respect of financial years commencing on or after the 1st April, 2015.

5. Omitted

6. The useful lives of assets working on shift basis have been specified in the Schedule based on their single shift working. Except for assets in respect of which no extra shift depreciation is permitted (indicated by NESD in Part C above), if an asset is used for any time during the year for double shift, the depreciation will increase by 50% for that period and in case of the triple shift the depreciation shall be calculated on the basis of 100% for that period.

7. From the date this Schedule comes into effect, the carrying amount of the asset as on that date—

(a) shall be depreciated over the remaining useful life of the asset as per this Schedule;

(b) after retaining the residual value, may be recognized in the opening balance of retained earnings where the remaining useful life of an asset is nil.

8. ''Continuous process plant'' means a plant which is required and designed to operate for twenty-four hours a day.

Guidance Note on the Schedule III to the Companies Act, 2013

1. Introduction

1.1 Schedule III to the Companies Act, 2013 ('the Act') provides the manner in which every company registered under the Act shall prepare its Balance Sheet, Statement of Profit and Loss and notes thereto. In the light of various economic and regulatory reforms that have taken place for companies over the last several years, there was a need for enhancing the disclosure requirements under the Old Schedule VI to the Act and harmonizing and synchronizing them with the notified Accounting Standards as applicable ('AS'/'Accounting Standard(s)'). Accordingly, the Ministry of Corporate Affairs (MCA) had issued a revised form of Schedule VI on February 28, 2011 and this has formed the basis for the Schedule III of Companies Act, 2013. As per the Act and rules / notifications thereunder, the Schedule applies to all companies for the Financial Statements to be prepared for the financial year commencing on or after April 1, 2014.

1.2 The requirements of the Schedule III however, do not apply to companies as referred to in the proviso to Section 129(1) of the Act, i.e., any insurance or banking company, or any company engaged in the generation or supply of electricity or to any other class of company for which a form of Balance Sheet and Statement of Profit and Loss has been specified in or under any other Act governing such class of company.

1.3 It may be clarified that for companies engaged in the generation and supply of electricity, however, neither the Electricity Act, 2003, nor the rules framed thereunder, prescribe any specific format for presentation of Financial Statements by an electricity company. Section 1 (4) of the Companies Act states that the Companies Act will apply to electricity companies, to the extent it is not inconsistent with the provisions of the Electricity Act. Keeping this in view, Schedule III may be followed by such companies till the time any other format is prescribed by the relevant statute.

2. Objective and Scope

2.1. The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Schedule III. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

2.2. In preparing this Guidance Note, reference has been made to the Accounting standards notified under Section 133 of the Companies Act, 2013 read together with Paragraph 7 of the Companies (Accounts) Rules, 2014 and various other pronouncements of the ICAI. The primary focus of the Guidance Note has been to lay down broad guidelines to deal with practical issues that may arise in the implementation of the Schedule III.

2.3. As per the clarification issued by ICAI regarding the authority attached to the Documents Issued by ICAI, "'*Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is* *satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.*"

3. Applicability

3.1. As per the Government Notification no. S.O. 902 (E) dated 26th March, 2015, the Schedule III is applicable for the Balance Sheet and Statement of Profit and Loss to be prepared for the financial year commencing on or after April 1, 2014.

3.2. Early adoption of the Schedule III is not permitted since Schedule VI is a statutory format.

3.3. The Schedule III requires that except in the case of the first Financial Statements laid before the company after incorporation, the corresponding amounts for the immediately preceding period are to be disclosed in the Financial Statements including the Notes to Accounts. Accordingly, corresponding information will have to be presented starting from the first year of application of the Schedule III. Thus for the Financial Statements prepared for the year 2014-15(1stApril 2014to 31st March 2015), corresponding amounts need to be given for the financial year 2013-14.

3.4. *ICAI had earlier issued the Statement on the Amendments to Schedule VI to the Companies Act, 1956 in March 1976 (as amended). Wherever guidance provided in this publication is different from the guidance in the aforesaid Statement, this Guidance Note will prevail.*

3.5. Applicability of the Schedule III format to interim Financial Statements prepared by companies in the first year of application of the Schedule:

Relevant paragraphs of *AS-25 Interim Financial Reporting* are quoted below:

"10. If an enterprise prepares and presents a complete set of Financial Statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of Financial Statements.

11. If an enterprise prepares and presents a set of condensed Financial Statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual Financial Statements and the selected explanatory notes as required by this Statement. Additional line items or notes should be included if their omission would make the condensed interim Financial Statements misleading."

3.6. Accordingly, if a company is presenting condensed interim Financial Statements, its format should also going forward conform to that used in the company's most recent annual Financial Statements, i.e., the Schedule III of Companies Act, 2013.

3.7. The format of Balance Sheet currently prescribed under Clause 41 to the Listing Agreement is also based the format of Balance Sheet in the Schedule III.

3.8. The formats of the Balance Sheet and Statement of Profit and Loss prescribed under the SEBI (Issue of Capital & Disclosure Requirements) Regulations 2009 ('ICDR Regulations') is inconsistent with the format of the Balance Sheet/ Statement of Profit and Loss in the Schedule III. However, the formats of Balance Sheet and Statement of Profit and Loss under ICDR Regulations are "illustrative formats". Accordingly, to make the data comparable and meaningful for users, companies should use the Schedule III format to present the restated financial information for inclusion in the offer document. Consequently, among other things, this will involve classification of assets and liabilities into current and non-current for earlier years presented as well.

Attention is also invited to the General Circular no 62/2011 dated 5th September 2011 issued by the Ministry of Company Affairs which clarifies that 'the presentation of Financial Statements for the limited purpose of IPO/FPO during the financial year 2011-12 may be made in the format of the pre-Revised Schedule VI under the Companies Act, 1956. However, for period beyond 31st March 2012, they would prepare only in the new format as prescribed by the Schedule VI of the Companies Act, 1956'. In the absence of similar clarification with regard to use of Revised Schedule VI vis-à-vis, for the periods after 31st March 2012, the Schedule III format will have to be adhered to, which is anyway, similar to the Revised Schedule VI format under Companies Act 1956 for standalone financials except for an additional disclosure requirement with respect to Corporate Social Responsibility Expenditure.

4. Summary of Schedule III

4.1. Main principles

4.1.1. The Schedule III requires that if compliance with the requirements of the Act and/ or the notified Accounting Standards requires a change in the treatment or disclosure in the Financial Statements as compared to that provided in the Schedule III, the requirements of the Act and/ or the notified Accounting Standards will prevail over the Schedule.

4.1.2. The Schedule III clarifies that the requirements mentioned therein for disclosure on the face of the Financial Statements or in the notes are minimum requirements. Line items, sub-line items and sub-totals can be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant for understanding of the company's financial position and/or performance.

4.1.3. The terms used in the Schedule III will carry the meaning as defined by the applicable Accounting Standards. For example, the terms such as 'associate', 'related parties', etc. will have the same meaning as defined in Accounting Standards notified under Companies (Accounting Standards) Rules, 2006.

4.1.4. In preparing the Financial Statements including the Notes to Accounts, a balance will have to be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation.

4.1.5. All items of assets and liabilities are to be bifurcated between current and non-current portions and presented separately on the face of the Balance Sheet. Such classification was not required by the Old Schedule VI, but was introduced in the Revised Schedule VI itself.

4.1.6. There is an explicit requirement to use the same unit of measurement uniformly throughout the Financial Statements and notes thereon. Moreover, rounding off requirements (where opted for) have been changed to eliminate the option of presenting figures in terms of hundreds and thousands if turnover exceeds 100 crores.

4.2. Major changes related to the Balance sheet (brought in by Revised Schedule VI onwards)

4.2.1. The Schedule III (and earlier, the Revised Schedule VI) prescribes only the vertical format for presentation of Financial Statements. Thus, a company will now not have an option to use horizontal format for the presentation of Financial Statements as prescribed in Old Schedule VI.

4.2.2. Current and non-current classification has been introduced for presentation of assets and liabilities in the Balance Sheet. The application of this classification will require assets and liabilities to be segregated into their current and non-current portions. For instance, current maturities of a long-term borrowing will have to be classified under the head "Other current liabilities."

4.2.3. Number of shares held by each shareholder holding more than 5 percent shares in the company now needs to be disclosed. In the absence of any specific indication of the date of holding, such information should be based on shares held as on the Balance Sheet date.

4.2.4. Details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back will need to be disclosed only for a period of five years immediately preceding the Balance Sheet date including the current year.

4.2.5. Any debit balance in the Statement of Profit and Loss will be disclosed under the head "Reserves and surplus." Earlier, any debit balance in Statement of Profit and Loss carried forward after deduction from uncommitted reserves was required to be shown as the last item on the Assets side of the Balance Sheet.

4.2.6. Specific disclosures are prescribed for Share Application money. The application money not exceeding the capital offered for issuance and to the extent not refundable will be shown separately on the face of the Balance Sheet. The amount in excess of subscription or if the requirements of minimum subscription are not met will be shown under "Other current liabilities."

4.2.7. The term "sundry debtors" has been replaced with the term "trade receivables." 'Trade receivables' are defined as dues arising only from goods sold or services rendered in the normal course of business. Hence, amounts due on account of other contractual obligations can no longer be included in the trade receivables.

4.2.8. The Old Schedule VI required separate presentation of debtors outstanding for a period exceeding six months based on date on which the bill/invoice was raised whereas, the Schedule III (and earlier, the Revised Schedule VI) requires separate disclosure of trade receivables outstanding for a period exceeding six months from the date the bill/invoice is due for payment.

4.2.9. "Capital advances" are specifically required to be presented separately under the head "Loans & advances" rather than including elsewhere.

4.2.10. Tangible assets under lease are required to be separately specified under each class of asset. In the absence of any further clarification, the term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee.

4.2.11. In the Old Schedule VI, details of only capital commitments were required to be disclosed. Under the Schedule III (and earlier, the Revised Schedule VI), other commitments also need to be disclosed.

4.2.12. The Schedule III (and earlier, the Revised Schedule VI) requires disclosure of all defaults in repayment of loans and interest to be specified in each case. Earlier, no such disclosure was required in the Financial Statements. However, disclosures pertaining to defaults in repayment of dues to a financial institution, bank and debenture holders continue to be required in the report under Companies (Auditor's Report) Order, 2015 (CARO).

4.2.13. The Schedule III (and earlier, the Revised Schedule VI) introduced a number of other additional disclosures. Some examples are:

(a) Rights, preferences and restrictions attaching to each class of shares, including restrictions on the distribution of dividends and the repayment of capital;

(b) Terms of repayment of long-term loans;

(c) In each class of investment, details regarding names of the bodies corporate in whom investments have been made, indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities, and the nature and extent of the investment made in each such body corporate (showing separately partly-paid investments);

(d) Aggregate provision for diminution in value of investments separately for current and long-term investments;

(e) Stock-in-trade held for trading purposes, separately from other finished goods.

4.3. Main changes related to Statement of Profit and Loss (brought in by Revised Schedule VI and added to by Schedule III)

4.3.1. The name has been changed to "Statement of Profit and Loss" as against 'Profit and Loss Account' as contained in the Old Schedule VI.

4.3.2. Unlike the Old Schedule VI, the Schedule III (and earlier Revised Schedule VI) lays down a format for the presentation of Statement of Profit and Loss. This format of Statement of Profit and Loss does not mention any appropriation item on its face. Further, the Schedule III (and earlier Revised Schedule VI) format prescribes such 'below the line' adjustments to be presented under "Reserves and Surplus" in the Balance Sheet.

4.3.3. In addition to specific disclosures prescribed in the Statement of Profit and Loss, any item of income or expense which exceeds one percent of the revenue from operations or Rs. 100,000 (earlier 1 % of total revenue or Rs. 5,000), whichever is higher, needs to be disclosed separately.

4.3.4. The Old Schedule VI required the parent company to recognize dividends declared by subsidiary companies even after the date of the Balance Sheet if they were pertaining to the period ending on or before the Balance Sheet date. Such requirement no longer exists in the Schedule III(and earlier Revised Schedule VI). Accordingly, as per *AS-9 Revenue Recognition*, dividends should be recognized as income only when the right to receive dividends is established as on the Balance Sheet date.

4.3.5. In respect of companies other than finance companies, revenue from operations need to be disclosed separately as revenue from (a) sale of products, (b) sale of services and (c) other operating revenues.

4.3.6. Net exchange gain/loss on foreign currency borrowings to the extent considered as an adjustment to interest cost needs to be disclosed separately as finance cost.

4.3.7. Break-up in terms of quantitative disclosures for significant items of Statement of Profit and Loss, such as raw material consumption, stocks, purchases and sales have been simplified and replaced with the disclosure of "broad heads" only. The broad heads need to be decided based on considerations of materiality and presentation of true and fair view of the Financial Statements.

4.3.8. Schedule III has brought in an additional requirement under additional information to be provided requiring companies to disclose amount of expenditure incurred on corporate social responsibility activities.

4.4. Disclosures no longer required (brought in by Revised Schedule VI)

The Schedule III (and earlier Revised Schedule VI) has removed a number of disclosure requirements that were not considered relevant in the present day context. Examples include:

(a) Disclosures relating to managerial remuneration and computation of net profits for calculation of commission;

(b) Information relating to licensed capacity, installed capacity and actual production;

(c) Information on investments purchased and sold during the year;

(d) Investments, sundry debtors and loans & advances pertaining to companies under the same management;

(e) Maximum amounts due on account of loans and advances from directors or officers of the company;

(f) Commission, brokerage and non-trade discounts

However, there are certain disclosures such as value of imports calculated on CIF basis, earnings/expenditure in foreign currency, etc. that still continue in the Schedule III (and earlier Revised Schedule VI).

5. Structure of the Schedule III

The Structure of Schedule III is as under:

I. General Instructions

II. Part I – Form of Balance Sheet

III. General Instructions for Preparation of Balance Sheet

IV. Part II – Form of Statement of Profit and Loss

V. General Instructions for Preparation of Statement of Profit and Loss

VI. General Instructions for the Preparation of Consolidated Financial Statements

6. General Instructions to The Schedule III

6.1. The General Instructions lay down the broad principles and guidelines for preparation and presentation of Financial Statements.

6.2. As laid down in the Preface to the Statements of Accounting Standards issued by ICAI, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the Financial Statements should be prepared in conformity with such law. Accordingly, by virtue of this principle, disclosure requirements of the Old Schedule VI were considered to prevail over Accounting Standards. However, since the Schedule III(and earlier, the Revised Schedule VI) gives overriding status to the requirements of the Accounting Standards and other requirements of the Act, such principle of law overriding the Accounting Standards is inapplicable in the context of the Schedule III (and earlier, the Revised Schedule VI).

6.3. The Schedule III requires that if compliance with the requirements of the Act including applicable Accounting Standards require any change in the treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes interse, in the Financial Statements or statements forming part thereof, the same shall be made and the requirements of Schedule III shall stand modified accordingly.

6.4. Implications of all instructions mentioned above can be illustrated by means of the following example. One of the line items to be presented on the face of the Balance Sheet under Current assets is “Cash and cash equivalents”. The break-up of these items required to be presented by the Schedule III comprises of items such as Balances with banks held as margin money or security against borrowings, guarantees, etc. and bank deposits with more than 12 months maturity. According to *AS-3 Cash Flow Statements*, Cash is defined to include cash on hand and demand deposits with banks. Cash Equivalents are defined as short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. The Standard further explains that an investment normally qualifies as a cash equivalent only when it has a short maturity of three months or less from the date of acquisition. Hence, normally, deposits with original maturity of three months or less only should be classified as cash equivalents. Further, bank balances held as margin money or security against borrowings are neither in the nature of demand deposits, nor readily available for use by the company, and accordingly, do not meet the aforesaid definition of cash equivalents. Thus, this is an apparent conflict between the requirements of the Schedule III and the Accounting Standards with respect to which items should form part of Cash and cash equivalents. As laid down in the General Instructions, Para 1 of Schedule III, requirements of the Accounting Standards would prevail over the Schedule III and the company should make necessary modifications in the Financial Statements, which may include addition, amendment, substitution or deletion in the head/sub-head or any other changes interse. Accordingly, the conflict should be resolved by changing the caption "*Cash and cash equivalents*" to "*Cash and bank balances*," which may have two sub-headings, viz., "*Cash and cash equivalents"* and *"Other bank balances."* The former should include only the items that constitute Cash and cash equivalents defined in accordance with AS 3 (and not the Schedule III), while the remaining line-items may be included under the latter heading.

6.5. Para 2 of the General Instructions to the Schedule III states that the disclosure requirements of the Schedule are in addition to and not in substitution of the disclosure requirements specified in the notified Accounting Standards. They further clarify that the additional disclosures specified in the Accounting Standards shall be made in the Notes to Accounts or by way of an additional statement unless required to be disclosed on the face of the Financial Statements. All other disclosures required by the Act are also required to be made in the Notes to Accounts in addition to the requirements set out in the Schedule III.

6.6. An example to illustrate the above point is the specific disclosure required by *AS-24 Discontinuing Operations* on the face of the Statement of Profit and Loss which has not been incorporated in the Schedule III. The disclosure pertains to the amount of pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation. Accordingly, such disclosures specifically required by the Accounting Standard on the face of either the Statement of Profit and Loss or Balance Sheet will have to be so made even if not forming part of the formats prescribed under the Schedule III.

6.7. All the other disclosures required by the Accounting Standards will continue to be made in the Financial Statements. Further, the disclosures required by the Act will continue to be made in the Notes to Accounts. An example of this is the separate disclosure required by Sub Section (3) of Section 182 of the Act for donations made to political parties. Such disclosures would be made in the Notes.

6.8. Though not specifically required by the Schedule III, disclosures mandated by other Acts or legal requirements will have to be made in the Financial Statements. For example, The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 requires specified disclosures to be made in the annual Financial Statements of the buyer wherever such Financial Statements are required to be audited under any law. Accordingly, such disclosures will have to be made in the buyer company's annual Financial Statements.

6.9. The above principle would apply to disclosures required by other legal requirements as well such as, disclosures required under Clause 32 to the Listing Agreement, etc. A further extension of the above principle also means that specific disclosures required by various pronouncements of regulatory bodies such as the ICAI announcement for disclosures on derivatives and unhedged foreign currency exposures, and other disclosure requirements prescribed by various ICAI Guidance Notes, such as Guidance Note on Employee Share-based Payments, etc. should continue to be made in the Financial Statements in addition to the disclosures specified by the Schedule III.

6.10. In the Old Schedule VI, break-up of amounts disclosed on the face of the Balance Sheet and Profit and Loss Account was required to be given in the Schedules. Additional information was required to be furnished in the Notes to Account. The Schedule III (and earlier, the Revised Schedule VI) requires all information relating to each item on the face of the Balance Sheet and Statement of Profit and Loss to be cross-referenced to the Notes to Accounts. The manner of such cross-referencing to various other informations contained in the Financial Statements has also been changed to "Note No." as compared to "Schedule No." in the Old Schedule VI. Hence, the same is suggestive of a change in the old format of presentation from Schedules and Notes to Accounts to the new format of only Notes to Accounts. The instructions state that the Notes to Accounts should provide where required, narrative descriptions or disaggregations of items recognized in those statements. Hence, presentation of all narrative descriptions and disaggregations should preferably be presented in the form of Notes to Accounts rather than in the form of Schedules. Such style of presentation is also in line with the manner of presentation of Financial Statements followed by companies internationally and would facilitate comparability of Financial Statements.

6.11. Para 3 of the General Instructions of the Schedule III also states that the Notes to Accounts should also contain information about items that do not qualify for recognition in Financial Statements. These disclosures normally refer to items such as Contingent Liabilities and Commitments which do not get recognised in the Financial Statements. These have been dealt with later in this Guidance Note. Some of the other disclosures relating to items that are not recognized in the Financial Statements also emanate from the Accounting Standards, such as, disclosures required under *AS9Revenue Recognition*on circumstances in which revenue recognition is to be postponed pending the resolution of significant uncertainties. Contingent Assets, however, are not to be disclosed in the Financial Statements as per *AS29 Provisions, Contingent Liabilities and Contingent Assets.*

6.12. The General Instructions also lay down the principle that in preparing Financial Statements including Notes to Accounts, a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation. Compliance with this requirement is a matter of professional judgement and may vary on a case to case basis based on facts and circumstances. However, it is necessary to strike a balance between overburdening Financial Statements with excessive detail that may not assist users of Financial Statements and obscuring important information as a result of too much aggregation. For example, a company should not obscure important information by including it among a large amount of insignificant detail or in a way that it obscures important differences between individual transactions or associated risks.

6.13. The Schedule III (and earlier, the Revised Schedule VI) has specifically introduced a new requirement of using the same unit of measurement uniformly across the Financial Statements. Such requirement should be taken to imply that all figures disclosed in the Financial Statements including Notes to Accounts should be of the same denomination.

6.14. The Schedule III (and earlier, the Revised Schedule VI) has also introduced new rounding off requirements as compared to the Old Schedule VI. The new requirement does not prescribe the option to present figures in terms of hundreds and thousands if the turnover equals or exceeds `Rs. 100 crores. Rather, they allow rounding off in crores, which was earlier permitted only when the turnover equaled or exceeded five hundredcrores rupees. Similarly, where turnover is below `Rs. 100 crore, the Schedule III (and earlier, the Revised Schedule VI) gives an option to present figures in lakhs and millions as well, which did not exist earlier. However, it is not compulsory to apply rounding off and a company can continue to disclose full figures. But, if the same is applied, the rounding off requirement should be complied with.

Old Schedule VI	Schedule III (and earlier, the Revised Schedule VI)
• **Turnover <Rs. 100 Crores** – Round off to the nearest hundreds, thousands or decimal thereof • Turnover Rs. 100 to Rs. 500 Crores- Round off to the nearest hundreds, thousands, lakhs or millions or decimal thereof	• **Turnover <Rs. 100 Crores** - Round off to the nearest hundreds, thousands, **lakhs or millions** or decimal thereof.
• Turnover >Rs. 500 Crores- Round off to the nearest hundreds, thousands, lakhs, millions or crores, or decimal thereof.	• **Turnover >Rs. 100 Crores** - Round off to **the** nearest lakhs, millions or **crores**, or decimal thereof

6.15. The instructions also clarify that the terms used in the Schedule III shall be as per the applicable Accounting Standards. For example, the term 'related parties' used at several places in the Schedule III should be interpreted based on the definition given in *AS-18 Related Party Disclosures.*

6.16. The Notes to the General Instructions re-clarify that the Schedule III sets out the minimum requirements for disclosure in the Financial Statements including notes. It states that line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Balance Sheet and Statement of Profit and Loss when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements, apart from, when required for compliance with amendments to the Act or the Accounting Standards.

The application of the above requirement is a matter of professional judgement. The following examples illustrate this requirement. Earnings before Interest, Tax, Depreciation and Amortization is often an important measure of financial performance of the company relevant to the various users of Financial Statements and stakeholders of the company. Hence, a company may choose to present the same as an additional line item on the face of the Statement of Profit and Loss. The method of computation adopted by companies for presenting such measures should be followed consistently over the years. Further, companies should also disclose the policy followed in the measurement of such line items.

6.17. Similarly, users and stakeholders often want to know the liquidity position of the company. To highlight the same, a company may choose to present additional sub-totals of Current assets and Current liabilities on the face of the Balance Sheet.

6.18. One example of addition or substitution of line items, sub-line items and sub-totals to cater to industry-specific disclosure requirements can be noted from Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007. The Directions prescribe that every non-banking finance company is required to separately disclose in its Balance Sheet the provisions made under the Directions without netting them from the income or against the value of assets. Though not specifically required by the Schedule, such addition or substitution of line items can be made in the notes forming part of the Financial Statements as well.

7. General Instructions For Preparation of Balance Sheet : Notes 1 To 5

7.1. Current/Non-current assets and liabilities:

The Schedule III requires all items in the Balance Sheet to be classified as either Current or Non-current and be reflected as such. Notes 1 to 3 of the Schedule III define Current Asset, Operating Cycle and Current Liability as below:

7.1.1. "An asset shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current."

7.1.2. "An operating cycle is the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months."

7.1.3. "A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current."

7.1.4. The Schedule III defines "current assets" and "current liabilities", with the non-current category being the residual. It is therefore necessary that the balance pertaining to each item of assets and liabilities contained in the Balance Sheet be split into its current and non-current portions and be classified accordingly as on the reporting date.

7.1.5. Based on the definition, current assets include assets such as raw material and stores which are intended for consumption or sale in the course of the company's normal operating cycle. Items of inventory which may be consumed or realized within the company's normal operating cycle should be classified as current even if the same are not expected to be so consumed or realized within twelve months after the reporting date. Current assets would also include assets held primarily for the purpose of being traded such as inventory of finished goods. They would also include trade receivables which are expected to be realized within twelve months from the reporting date and Cash and cash equivalents which are not under any restriction of use.

7.1.6. Similarly, current liabilities would include items such as trade payables, employee salaries and other operating costs that are expected to be settled in the company's normal operating cycle or due to be settled within twelve months from the reporting date. It is pertinent to note that such operating liabilities are normally part of the working capital of the company used in the company's normal operating cycle and hence, should be classified as current even if they are due to be settled more than twelve months after the end of the reporting date.

7.1.7. Further, any liability, pertaining to which the company does not have an unconditional right to defer its settlement for at least twelve months after the Balance Sheet/reporting date, will have to be classified as current.

7.1.8. The application of this criterion could be critical to the Financial Statements of a company and requires careful evaluation of the various terms and conditions of a loan liability. To illustrate, let us understand how this requirement will apply to the following example:

Company X has taken a five year loan. The loan contains certain debt covenants, e.g., filing of quarterly information, failing which the bank can recall the loan and demand repayment thereof. The company has not filed such information in the last quarter; as a result of which the bank has the right to recall the loan. However, based on the past experience and/or based on the discussions with the bank the management believes that default is minor and the bank will not demand the repayment of loan. According to the definition of Current Liability, what is important is, whether a borrower has an unconditional right at the Balance Sheet date to defer the settlement irrespective of the nature of default and whether or not a bank can exercise its right to recall the loan. If the borrower does not have such right, the classification would be "current." It is pertinent to note that as per the terms and conditions of the aforesaid loan, the loan was not repayable on demand from day one. The loan became repayable on demand only on default in the debt covenant and bank has not demanded the repayment of loan upto the date of approval of the accounts. In the Indian context, the criteria of a loan becoming repayable on demand on breach of a covenant, is generally added in the terms and conditions as a matter of abundant caution. Also, banks generally do not demand repayment of loans on such minor defaults of debt covenants. Therefore, in such situations, the companies generally continue to repay the loan as per its original terms and conditions. Hence, considering that the practical implications of such minor breach are negligible in the Indian scenario, an entity could continue to classify the loan as "non-current" as on the Balance Sheet date since the loan is not actually demanded by the bank at any time prior to the date on which the Financial Statements are approved. However, in case a bank has recalled the loan before the date of approval of the accounts on breach of a loan covenant that occurred before the year-end, the loan will have to be classified as current. Further, the above situation should not be confused with a loan which is repayable on demand from day one. For such loans, even if the lender does not demand repayment of the loan at any time, the same would have to be continued to be classified as "current".

7.2. The term "Operating Cycle" is defined as the time between the acquisition of assets for processing and their realization in Cash or cash equivalents. A company's normal operating cycle may be longer than twelve months e.g. companies manufacturing wines, etc. However, where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.

7.2.1. Where a company is engaged in running multiple businesses, the operating cycle could be different for each line of business. Such a company will have to classify all the assets and liabilities of the respective businesses into current and non-current, depending upon the operating cycles for the respective businesses.

Let us consider the following other examples:

1. A company has excess finished goods inventory that it does not expect to realize within the company's operating cycle of fifteen months. Since such finished goods inventory is held primarily for the purpose of being traded, the same should be classified as "current".
2. A company has sold 10,000 tonnes of steel to its customer. The sale contract provides for a normal credit period of three months. The company's operating cycle is six months. However, the company does not expect to receive the payment within twelve months from the reporting date. Therefore, the same should be classified as "Non-Current" in the Balance Sheet. In case, the company expects to realize the amount upto 12 months from the Balance Sheet date (though beyond operating cycle), the same should be classified as "current".

7.3. For the purpose of Schedule III, a company also needs to classify its employee benefit obligations as current and non-current categories. While *AS-15 Employee* Benefits governs the measurement of various employee benefit obligations, their classification as current and non-current liabilities will be governed by the criteria laid down in the Schedule III. In accordance with these criteria, a liability is classified as "current" if a company does not have an unconditional right as on the Balance Sheet date to defer its settlement for twelve months after the reporting date. Each company will need to apply these criteria to its specific facts and circumstances and decide an appropriate classification of its employee benefit obligations. Given below is an illustrative example on application of these criteria in a simple situation:

(a) Liability toward bonus, etc., payable within one year from the Balance Sheet date is classified as "current".

(b) In case of accumulated leave outstanding as on the reporting date, the employees have already earned the right to avail the leave and they are normally entitled to avail the leave at any time during the year. To the extent, the employee has unconditional right to avail the leave, the same needs to be classified as "current" even though the same is measured as 'other long-term employee benefit' as per *AS-15.*However, whether the right to defer the employee's leave is available unconditionally with the company needs to be evaluated on a case to case basis – based on the terms of Employee Contract and Leave Policy, Employer's right to postpone/deny the leave, restriction to avail leave in the next year for a maximum number of days, etc. In case of such complexities the amount of Non-current and Current portions of leave obligation should normally be determined by a qualified Actuary.

(c) Regarding funded post-employment benefit obligations, amount due for payment to the fund created for this purpose within twelve months is treated as "current" liability. Regarding the unfunded post-employment benefit obligations, a company will have settlement obligation at the Balance Sheet date or within twelve months for employees such as those who have already resigned or are expected to resign (which is factored for actuarial valuation) or are due for retirement within the next twelve months from the Balance Sheet date. Thus, the amount of obligation attributable to these employees is a "current" liability. The remaining amount attributable to other employees, who are likely to continue in the services for more than a year, is classified as "non-current" liability. Normally the actuary should determine the amount of current &non-current liability for unfunded post-employment benefit obligation based on the definition of Current and Non-current assets and liabilities in the Schedule III.

7.4. The Schedule III requires Investments to be classified as Current and Non-Current. However, *AS13 'Accounting for Investments'* requires to classify Investments as Current and Long-Term. As per *AS 13*, current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A long-term investment is an investment other than a current investment.

7.4.1. Accordingly, as per *AS-13*, the assessment of whether an Investment is "Long-term" has to be made with respect to the date of Investment whereas, as per the Schedule III, "Non-current" Investment has to be determined with respect to the Balance Sheet date.

7.4.2. Though the Schedule III clarifies that the Accounting Standards would prevail over itself in case of any inconsistency between the two, it is pertinent to note that AS-13 does not lay down presentation norms, though it requires disclosures to be made for Current and Long-term Investments. Accordingly, presentation of all investments in the Balance Sheet should be made based on Current/Non-current classification as defined in the Schedule III. The portion of long-term investment as per *AS13* which is expected to be realized within twelve months from the Balance Sheet date needs to be shown as Current investment under the Schedule III.

7.5. Settlement of a liability by issuing of equity

7.5.1. The Schedule III clarifies that, "the terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification". A consequence of this is that if the conversion option in convertible debt is exercisable by the holder at any time, the liability cannot be classified as "current" if the maturity for cash settlement is greater than one year. A question therefore arises as to how does the aforesaid requirement affect the classification of items for say, a) convertible debt where the conversion option lies with the issuer, or b) mandatorily convertible debt instrument.

7.5.2. Based on the specific exemption granted only to those cases where the conversion option is with the counterparty, the same should not be extended to other cases where such option lies with the issuer or is a mandatorily convertible instrument. For all such cases, conversion of a liability into equity should be considered as a means of settlement of the liability as defined in the Framework For the Preparation and Presentation of Financial Statements issued by ICAI. Accordingly, the timing of such settlement would also decide the classification of such liability in terms of Current or Non-current as defined in the Schedule III.

7.6 As per the classification in the Schedule III and in line with the ICAI's earlier announcement with regard to the presentation and classification of net Deferred Tax asset or liability, the same should always be classified as "non-current".

8. Part I: Form of Balance Sheet and Note 6 to General Instructions for Preparation of Balance Sheet

As per the Framework for The Preparation and Presentation of Financial Statements, asset, liability and equity are defined as follows:

An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

I. Equity and Liabilities

8.1. Shareholders' Funds

Under this head, following line items are to be disclosed:

- Share Capital;
- Reserves and Surplus;
- Money received against share warrants.

8.1.1. Share capital

8.1.1.1. Notes to the General Instructions require a company to disclose in the Notes to Accounts line items/sub-line items referred to inNotes6A to 6Q. Clauses (a) to (l) of Note 6 A deal with disclosures for Share Capital and such disclosures are required for each class of share capital (different classes of preference shares to be treated separately).

8.1.1.2. As per ICAI Guidance Note on Terms Used in Financial Statements, 'Capital' refers "*to the amount invested in an enterprise by its owners e.g. paid-up share capital in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise*."

8.1.1.3. The said Guidance Note defines 'Share Capital' as the *"aggregate amount of money paid or credited as paid on the shares and/or stocks of a corporate enterprise."*

8.1.1.4. In respect of disclosure requirements for Share Capital, the Schedule III states that "different classes of preference share capital to be treated separately". A question arises whether the preference shares should be presented as share capital only or does it mean that a company compulsorily needs to decide whether preference shares are liability or equity based on its economic substance using *AS31Financial Instruments: Presentation* principles and present the same accordingly. The Schedule III deals only with presentation and disclosure requirements. Accounting for various items is governed by the applicable Accounting Standards. However, since Accounting Standards *AS 30 Financial Instruments: Recognition and Measurement, AS 31* and *AS 32 Financial Instruments: Disclosures* are yet to be notified and Section 85(1) of the Act refers to Preference Shares as a kind of share capital, Preference Shares will have to be classified as Share Capital.

8.1.1.5. Presently, in the Indian context, generally, there are two kinds of share capital namely - Equity and Preference. Within Equity/Preference Share Capital, there could be different classes of shares, say, Equity Shares with or without voting rights, Compulsorily Convertible Preference Shares, Optionally Convertible Preference Shares, etc. If the preference shares are to be disclosed under the head 'Share Capital', until the same are actually redeemed, they should continue to be shown under the head 'Share Capital'. Preference shares of which redemption is overdue should continue to be disclosed under the head 'Share Capital'.

8.1.1.6. Clause (a) of Note 6A - the number and amount of shares authorized :

As per the Guidance Note on Terms Used in Financial Statements 'Authorised Share Capital' means *"the number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital."*

8.1.1.7. Clause (b) of Note 6A - the number of shares issued, subscribed and fully paid, and subscribed but not fully paid :

The disclosure is for shares:

- Issued;
- Subscribed and fully paid;
- Subscribed but not fully paid.

Though the disclosure is only for the number of shares, to make the disclosure relevant to understanding the company's share capital, even the amount for each category should be disclosed. Issued shares are those which are offered for subscription within the authorised limit. It is possible that all shares offered are not subscribed to and to the extent of unsubscribed portion, there will be difference between shares issued and subscribed. As per the Guidance Note on Terms Used in Financial Statements, the expression 'Subscribed Share Capital' is *"that portion of the issued share capital which has actually been subscribed and allotted. This includes any bonus shares issued to the shareholders."*

Though there is no requirement to disclose the amount per share called, if shares are not fully called, it would be appropriate to state the amount per share called. As per the definition contained in the Guidance Note on Terms Used in Financial Statements, the expression 'Paid-up Share Capital' is *"that* *part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise."* As per the Old Schedule VI, debit balance on the allotment or call account is presented in the Balance Sheet not as an asset but by way of deduction from Called-up Capital. However, as required by Clause (k) of Note 6A of the Schedule III, calls unpaid are to be disclosed separately as per the Schedule III.

However, the unpaid amount towards shares subscribed by the subscribers of the Memorandum of Association should be considered as 'subscribed and paid-up capital' in the Balance Sheet and the debts due from the subscriber should be appropriately disclosed as an asset in the balance sheet.

8.1.1.8. Clause (c) of Note 6A – par value per share :

Par value per share is the face value of a share as indicated in the Capital Clause of the Memorandum of Association of a company. It is also referred to as '*face value'* per share. In the case of a company having share capital, (unless the company is an unlimited company), the Memorandum shall also state the amount of share capital with which the company is registered and their division thereof into shares of fixed amount as required under clause (a) to the sub-section (4) of section 13 of the Act. In the case of a company limited by guarantee, Memorandum shall state that each member undertakes to contribute to the assets of the company in the event of winding-up while he is a member or within one year after he ceases to be a member, for payment of debts and liabilities of the company, as the case may be. There is no specific mention for the disclosure by companies limited by guarantee and having share capital, and companies limited by guarantee and not having share capital. Such companies need to consider the requirement so as to disclose the amount each member undertakes to contribute as per their Memorandum of Association.

8.1.1.9. Clause (d) of Note 6A- a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period :

As per the Schedule III, opening number of shares outstanding, shares issued, shares bought back, other movements, etc. during the year and closing number of outstanding shares should be shown. Though the requirement is only for a reconciliation of the number of shares, as given for the disclosure of issued, subscribed capital, etc. [Clause (b) of Note 6A] above, to make the disclosure relevant for understanding the company's share capital, the reconciliation is to be given even for the amount of share capital. Reconciliation for the comparative previous period is also to be given. Further, the above reconciliation should be disclosed separately for both Equity and Preference Shares and for each class of share capital within Equity and Preference Shares.

8.1.1.10. Clause (e) of Note 6A - the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital.

As per the Guidance Note on Terms Used in Financial Statement, the expression 'Preference Share Capital' means *"that part of the share capital of a corporate enterprise which enjoys preferential rights in respect of payments of fixed dividend and repayment of capital. Preference shares may also have full or partial participating rights in surplus profits or surplus capital."* The rights, preferences and restrictions attached to shares are based on the classes of shares, terms of issue, etc., whether equity or preference. In respect of Equity Share Capital, it may be with voting rights or with differential voting rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed under Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.In respect of Preference shares, the rights include (a) as respects dividend, a preferential right to be paid a fixed amount or at a fixed rate and, (b)as respects capital, a preferential right of repayment of amount of capital on winding up. Further, Preference shares can be cumulative, non-cumulative, redeemable, convertible, non-convertible etc. All such rights, preferences and restrictions attached to each class of preference shares, terms of redemption, etc. have to be disclosed separately.

8.1.1.11. Clause (f) of Note 6A - shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate :

The requirement is to disclose shares of the company held by -

- Its holding company;
- Its ultimate holding company;
- Subsidiaries of its holding company;
- Subsidiaries of its ultimate holding company;
- Associates of its holding company; and
- Associates of its ultimate holding company.

Aggregation should be done for each of the above categories.

The terms 'subsidiary', 'holding company' and 'associate' should be understood as defined under *AS-21, Consolidated Financial Statements* and *AS-18, Related Party Disclosures*. Based on the aforesaid definitions, for the purposes of the above disclosures, shares held by the entire chain of subsidiaries and associates starting from the holding company and ending right upto the ultimate holding company would have to be disclosed. Further, all the above disclosures need to be made separately for each class of shares, both within Equity and Preference Shares.

8.1.1.12. Clause (g) of Note 6A - shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held :

In the absence of any specific indication of the date of holding, the date for computing such percentage should be taken as the Balance Sheet date. For example, if during the year, any shareholder held more than 5% Equity shares but does not hold as much at the Balance Sheet date, disclosure is not required. Though it is not specified as to whether the disclosure is required for each class of shares or not, companies should disclose the shareholding for each class of shares, both within Equity and Preference Shares. Accordingly, such percentage should be computed separately for each class of shares outstanding within Equity and Preference Shares. This information should also be given for the comparative previous period.

8.1.1.13. Clause (h) of Note 6A - shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts :

Shares under options generally arise under promoters or collaboration agreements, loan agreements or debenture deeds (including convertible debentures), agreement to convert preference shares into equity shares, ESOPs or contracts for supply of capital goods, etc. The disclosure would be required for the number of shares, amounts and other terms for shares so reserved. Such options are in respect of unissued portion of share capital.

8.1.1.14. Clause (i) of Note 6A– For the period of five years immediately preceding the date as at which the Balance Sheet is prepared :(a) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash. (b) Aggregate number and class of shares allotted as fully paid up by way of bonus shares. (c) Aggregate number and class of shares bought back.

(a) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

The following allotments are considered as shares allotted for payment being received in cash and not as without payment being received in cash and accordingly, the same are not to be disclosed under this Clause:

(i) If the subscription amount is adjusted against a *bona fide* debt payable in money at once by the company;

(ii) Conversion of loan into shares in the event o*f default* in repayment.

(b) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

As per the Guidance Note on Terms Used in Financial Statements 'Bonus shares' are defined as shares allotted by capitalisation of the reserves or surplus of a corporate enterprise. The requirement of disclosing the source of bonus shares is omitted in the Schedule III.

(c) Aggregate number and class of shares bought back.

The total number of shares bought back for each class of shares needs to be disclosed.

All the above details pertaining to aggregate number and class of shares allotted for consideration other than cash, bonus shares and shares bought back need to be disclosed only if such event has occurred during a period of five years immediately preceding the Balance Sheet date. Since disclosure is for the aggregate number of shares, it is not necessary to give the year-wise break-up of the shares allotted or bought back, but the aggregate number for the last five financial years needs to be disclosed.

8.1.1.15. Clause (j) of Note 6A- Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date:

This disclosure would cover securities, such as Convertible Preference Shares, Convertible Debentures/bonds, etc. – optionally or otherwise into equity.

Under this Clause, disclosure is required for any security, when it is either convertible into equity or preference shares. In this case, terms of such securities and the earliest date of conversion are required to be disclosed. If there are more than one date of conversion, disclosure is to be made in the descending order of conversion. If the option can be exercised in different periods then earlier date in that period is to be considered. In case of compulsorily convertible securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered. Terms of convertible securities are required to be disclosed under this Clause. However, in case of Convertible debentures/bonds, etc., for the purpose of simplification, reference may also be made to the terms disclosed under the note on Long-term borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same again under this clause.

8.1.1.16. Clause (k) of Note 6(A) - Calls unpaid (showing aggregate value of calls unpaid by directors and officers):

A separate disclosure is required for the aggregate value of calls unpaid by directors and also officers of the company. The Old Schedule VI required disclosures of calls due by directors only. The total calls unpaid should be disclosed. The terms 'director' and 'officer' should be interpreted based on the definitions in the Act.

8.1.2. Reserves and Surplus

Note 6(B) of the General Instructions deals with the disclosures of “Reserves and Surplus” in the Notes to Accounts and the classification thereof under the various types of reserves.

8.1.2.1. Reserve:

The Guidance Note on Terms Used in Financial Statements defines the term ‘Reserve’ as *“the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.”*‘Reserves’ should be distinguished from ‘provisions’. For this purpose, reference may be made to the definition of the expression `provision’ in *AS-29 Provisions, Contingent Liabilities and Contingent Assets.*

As per *AS-29*, *a `provision’ is “a liability which can be measured only by using a substantial degree of estimation”. A ‘liability’ is “a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.” 'Present obligation’ – “an obligation is a present obligation if, based on the evidence available, its existence at the Balance Sheet date is considered probable, i.e., more likely than not.”*

8.1.2.2. CapitalReserves :

It is necessary to make a distinction between capital reserves and revenue reserves in the accounts. A revenue reserve is a reserve which is available for distribution. The term “Capital Reserve” has not been defined under the Schedule III. However, as per the Guidance Note on Terms Used in Financial Statements, the expression ‘capital reserve’ is defined as “a reserve of a corporate enterprise which is not available for distribution as dividend”. Though the Schedule III does not have the requirement of “transferring capital profit on reissue of forfeited shares to capital reserve”, since profit on re-issue of forfeited shares is basically profit of a capital nature and, hence, it should be credited to capital reserve.

8.1.2.3. Capital Redemption Reserve :

Under the Act, Capital Redemption Reserve is required to be created in the following two situations:

a) Under the provisions of Section 55 of the Act, where the redemption of preference shares is out of profits, an amount equal to nominal value of shares redeemed is to be transferred to a reserve called ‘capital redemption reserve’.

b) Under Section 69 of the Act, if the buy-back of shares is out of free reserves, the nominal value of the shares so purchased is required to be transferred to capital redemption reserve from distributable profit.

8.1.2.4. Securities Premium Reserve :

The Guidance Note of Terms Used in Financial Statements defines ‘Share Premium’ as *“the excess of the issue price of shares over their face value.”* Though the terminology used in the Schedule III is ‘Securities Premium Reserve” the nomenclature as per the Act is “Securities Premium Account”. Accordingly, the terminology of the Act should be used.

8.1.2.5. Debenture Redemption Reserve :

According to Section 71 of the Act where a company issues debentures, it is required to create a debenture redemption reserve for the redemption of such debentures. The company is required to credit adequate amounts, from out of its profits every year to debenture redemption reserve, until such debentures are redeemed.

On redemption of the debentures for which the reserve is created, the amounts no longer necessary to be retained in this account need to be transferred to the General Reserve.

8.1.2.6. Revaluation Reserve :

As per the Guidance Note of Terms Used in Financial Statements, 'Revaluation reserve' is *'a reserve created on the revaluation of assets or net assets of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the book values thereof.'* Accordingly, if a company has carried out revaluation of its assets, the corresponding amount would be disclosed as "Revaluation Reserve"

8.1.2.7. Share Options Outstanding Account :

Presently, as per the Guidance Note on Accounting for Employee Share-based Payments, Stock Options Outstanding Account is shown as a separate line-item. The Schedule III requires this item to be shown as a part of 'Reserve and Surplus'.

8.1.2.8. Other Reserves (specify the nature and purpose of reserve and the amount in respect thereof) :

Every other reserve which is not covered in the paragraphs 8.1.2.2 to 8.1.2.7 is to be reflected as `Other Reserves'. However, since the nature, purpose and the amount are to be shown, each reserve is to be shown separately. This would include reserves to be created under other statutes like Tonnage Tax Reserve to be created under the Income Tax Act, 1961.

8.1.2.9. Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.

Appropriations to the profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'. Under the Schedule III, the Statement of Profit and Loss will no longer reflect any appropriations, like dividends transferred to Reserves, bonus shares, etc.

Please also refer to the discussion in Para 10.9 below.

8.1.2.10. Additions and deductions since the last Balance Sheet to be shown under each of the specified heads:

This requires the company to disclose the movement in each of the reserves and surplus since the last Balance Sheet.

Please refer to Para 10.9 of this Guidance note.

8.1.2.11 As per Schedule III, a reserve specifically represented by earmarked investments shall be termed as a 'fund'

8.1.2.12 Debit balance in the Statement of Profit and Loss and in Reserves and Surplus:

Debit balance in the Statement of Profit and Loss which would arise in case of accumulated losses, is to be shown as a negative figure under the head 'Surplus'. The aggregate amount of the balance of 'Reserves and Surplus', is to be shown after adjusting negative balance of surplus, if any. If the net result is negative, the negative figure is to be shown under the head 'Reserves and Surplus'.

8.1.3. Money received against Share Warrants

Generally, in case of listed companies, share warrants are issued to promoters and others in terms of the Guidelines for preferential issues viz., SEBI (Issue of Capital and Disclosure Requirements), Guidelines, 2009. AS 20*Earning Per Share* notified under the Companies (Accounting Standards) Rules, 2006 defines' share warrants' as "financial instruments which give the holder the right to acquire equity shares". Thus, effectively, share warrants are nothing but the amount which would ultimately form part of the Shareholders' funds. Since shares are yet to be allotted against the same, these are not reflected as part of Share Capital but as a separate line-item – 'Money received against share warrants.'

8.2. Share Application Money pending allotment

8.2.1. Share Application money pending allotment is to be disclosed as a separate line item on the face of Balance Sheet between "Shareholders' Funds" and "Non-current Liabilities". Share application money not exceeding the issued capital and to the extent not refundable is to be disclosed under this line item. If the company's issued capital is more than the authorized capital and approval of increase in authorized capital is pending, the amount of share application money received over and above the authorized capital should be shown under the head "Other Current Liabilities".

8.2.2. Clause (g) of Note6Gof General Instructions for preparation of Balance sheet lists various circumstances and specifies the information to be disclosed in respect of share application money. However, amount shown as 'share application money pending allotment' will not include share application money to the extent refundable. For example, the amount in excess of issued capital, or where minimum subscription requirement is not met. Such amount will have to be shown separately under 'Other Current Liabilities'.

8.2.3. Various disclosure requirements pertaining to Share Application Money are as follows:

- terms and conditions;
- number of shares proposed to be issued;
- the amount of premium, if any;
- the period before which shares are to be allotted;
- whether the company has sufficient authorized share capital to cover the share capital amount on allotment of shares out of share application money;
- Interest accrued on amount due for refund;
- The period for which the share application money has been pending beyond the period for allotment as mentioned in the share application form along with the reasons for such share application money being pending.

The above disclosures should be made in respect of amounts classified under both Equity as well as Current Liabilities, wherever applicable.

8.2.4. As per power given under section 50 of the Act, a company, if so authorized by its Articles, may accept from any member the whole or a part of the amount remaining unpaid on any shares held by him, although no part of that amount has been called up. The shareholder who has paid the money in advance is not a creditor for the amount so paid as advance, as the same cannot be demanded for repayment and the company cannot pay him back unless Articles so provide. The amount of calls paid in advance does not form part of the paid-up capital. The Department of Company Affairs has clarified that it is better to show "Calls in Advance" under the head "Current Liabilities and Provisions" (Letter No. 8/16(1)/61-PR, dated 9.5.1961). Thus, under the Schedule III, calls paid in advance are to be reflected under "Other Current Liabilities". The amount of interest which may accrue on such advance should also is to be reflected as a liability.

8.2.5. "Share application money pending allotment" is required to be shown as a separate line item on the face of the Balance Sheet after Shareholders' Funds. However, under "Other current liabilities" there is a statement that Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity. The two requirements appear to be conflicting.

However, from the format as set out in the Schedule, it appears that the Regulator's intention is to specifically highlight the amount of Share application money pending allotment, though they may be, in substance, in nature of Equity. Accordingly, the equity element should continue to be disclosed on the face of the Balance Sheet as a separate line item, rather than as a component of Shareholders' Funds.

8.3. Non-current liabilities

A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

Based on the above definitions, on the face of the Balance Sheet, the following items shall be disclosed under non-current liabilities.

- Long-term borrowings;
- Deferred tax liabilities (Net);
- Other Long-term liabilities;
- Long-term provisions.

8.3.1. Long-term borrowings:

8.3.1.1. Long-term borrowings shall be classified as:

(a) Bonds/debentures;

(b) Term loans;

- from banks;
- from other parties;

(c) Deferred payment liabilities;

(d) Deposits;

(e) Loans and advances from related parties;

(f) Long term maturities of finance lease obligations;

(g) Other loans and advances (specify nature).

8.3.1.2. Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

8.3.1.3. Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed. The word "others" used in the phrase "directors or others" would mean any person or entity other than a director. Therefore, this is not restricted to mean only related parties. However, in the normal course, a person or entity guaranteeing a loan of a company will generally be associated with the company in some manner.

8.3.1.4. Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by installments, the date of maturity for this purpose must be reckoned as the date on which the first installment becomes due.

8.3.1.5. Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

8.3.1.6. Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case.

8.3.1.7. The phrase "long-term" has not been defined. However, the definition of 'non-current liability' in the Schedule III may be used as long-term liability for the above disclosure. Also, the phrase "term loan" has not been defined in the Schedule III. Term loans normally have a fixed or pre-determined maturity period or a repayment schedule.

8.3.1.8. As referred to in para 72 of the 2005 edition of the ICAI Statement on Companies (Auditor's Report) Order, 2003 (CARO) in the banking industry, for example, loans with repayment period beyond thirty six months are usually known as "term loans" (The same guidance is relevant for this item as per CARO 2015 also). Cash credit, overdraft and call money accounts/ deposit are, therefore, not covered by the expression "terms loans". Term loans are generally provided by banks and financial institutions for acquisition of capital assets which then become the security for the loan, i.e., end use of funds is normally fixed.

8.3.1.9 Deferred payment liabilities would include any liability for which payment is to be made on deferred credit terms. E.g. deferred sales tax liability, deferred payment for acquisition of fixed assets etc.

8.3.1.10 The current maturities of all long-term borrowings will be disclosed under 'other current liabilities' and not under long-term borrowings and short-term borrowings. Hence, it is possible that the same bonds / debentures / term loans may be bifurcated under both long-term borrowings as well as under other current liabilities. Further, long-term borrowings are to be sub-classified as secured and unsecured giving the nature of the security for the secured position.

8.3.1.11 The Schedule III also stipulates that the nature of security shall be specified separately in each case. A blanket disclosure of different securities covering all loans classified under the same head such as 'All Term loans from banks' will not suffice. However, where one security is given for multiple loans, the same may be clubbed together for disclosure purposes with adequate details or cross referencing.

8.3.1.12 The disclosure about the nature of security should also cover the type of asset given as security e.g. inventories, plant and machinery, land and building, etc. This is because the extent to which loan is secured may vary with the nature of asset against which it is secured.

8.3.1.13 When promoters, other shareholders or any third party have given any personal security for any borrowing, such as shares or other assets held by them, disclosure should be made thereof, though such security does not result in the classification of such borrowing as secured.

8.3.1.14 The Schedule III requires that under the head "Borrowings," period and amount of "continuing default (in case of long-term borrowing) and default (in case of short-term borrowing) as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case". The word "loan" has been used in a more generic sense. Hence, the disclosures relating to default should be made for all items listed under the category of borrowings such as bonds/ debentures, deposits, deferred payment liabilities, finance lease obligations, etc. and not only to items classified as "loans" such as term loans, or loans and advances, etc.

8.3.1.15 Also, a company need not disclose information for defaults other than in respect of repayment of loan and interest, e.g., compliance with debt covenants. The Schedule III requires specific disclosures only for default in repayment of loans and interest and not for other defaults.

8.3.1.16 Though two different terms, viz., continuing default (in case of long-term borrowing) and default (in case of short-term borrowing) have been used, the requirement should be taken to disclose default "as on the Balance Sheet date" in both the cases. Pursuant to this requirement, details of any default in repayment of loan and interest existing as on the Balance Sheet date needs to be separately disclosed. Any default that had occurred during the year and was subsequently made good before the end of the year does not need to be disclosed.

8.3.1.17 Terms of repayment of term loans and other loans shall be disclosed. The term 'other loans' is used in general sense and should be interpreted to mean all categories listed under the heading 'Long-term borrowings' as per Schedule III. Disclosure of terms of repayment should be made preferably for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.

8.3.1.18 Disclosure of repayment terms should include the period of maturity with respect to the Balance Sheet date, number and amount of instalments due, the applicable rate of interest and other significant relevant terms if any.

8.3.1.19 Deposits classified under Borrowings would include deposits accepted from public and inter corporate deposits which are in the nature of borrowings.

8.3.1.20 Loans and advances from related parties are required to be disclosed. Advances under this head should include those advances which are in the nature of loans.

8.4. Other Long-term liabilities

This should be classified into:

a) Trade payables; and

b) Others.

8.4.1 A payable shall be classified as 'trade payable' if it is in respect of amount due on account of goods purchased or services received in the normal course of business. As per the Old Schedule VI, the term 'sundry creditors' included amounts due in respect of goods purchased or services received or in respect of other contractual obligations as well. Hence, amounts due under contractual obligations can no longer be included within Trade payables. Such items may include dues payables in respect of statutory obligations like contribution to provident fund, purchase of fixed assets, contractually reimbursable expenses, interest accrued on trade payables, etc. Such payables should be classified as "others" and each such item should be disclosed nature-wise. However, Acceptances should be disclosed as part of trade payables in terms of the Schedule III.

8.4.2 The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 however, requires specified disclosures to be made in the annual Financial Statements of the buyer wherever such Financial Statements are required to be audited under any law. Though not specifically required by the Schedule III, such disclosures will still be required to be made in the annual Financial Statements.

8.4.3 The following disclosures are required under Sec 22 of MSMED Act 2006 under the Chapter on Delayed Payments to Micro and Small Enterprises:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier as at the end of accounting year;

(b) the amount of interest paid by the buyer under MSMED Act, 2006 along with the amounts of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period (where the principal has been paid but interest under the MSMED Act, 2006 not paid);

(d) The amount of interest accrued and remaining unpaid at the end of accounting year; and

(e) The amount of further interest due and payable even in the succeeding year, until such date when the interest dues as above are actually paid to the small enterprise, for the purpose of disallowance as a deductible expenditure under section 23.

The terms "appointed day", "buyer", "enterprise", "micro enterprise", "small enterprise" and" supplier", shall be as defined under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

8.5. Long-Term Provisions

8.5.1 This should be classified into provision for employee benefits and others specifying the nature. Provision for employee benefits should be bifurcated into long-term (non-current) and other current and the long-term portion is disclosed under this para. All long-term provisions, other than those related to employee benefits should be disclosed separately based on their nature. Such items would include Provision for warranties etc. While AS-15 *Employee Benefits* governs the measurement of various employee benefit obligations, their classification as current and non-current liability will be governed by the criteria laid down in the Schedule III. Accordingly, a liability is classified as current if a company does not have an unconditional right as on the Balance Sheet date to defer its settlement for 12 months after the reporting date. Each company will need to apply these criteria to its specific facts and circumstances and decide an appropriate classification for its employee benefit obligations.

8.6. Current Liabilities

This should be classified on the face of the Balance Sheet as follows:

- Short-term borrowings;
- Trade payables;
- Other current liabilities;
- Short-term provisions.

8.6.1. Short-term borrowings

8.6.1.1. (i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand
- from banks;
- from other parties.

(b)Loans and advances from related parties;

(c) Deposits;

(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the Balance Sheet date in repayment of loans and interest shall be specified separately in each case.

8.6.1.2 Loans payable on demand should be treated as part of short-term borrowings. Short-term borrowings will include all loans within a period of 12 months from the date of the loan. In the case of short-term borrowings, all defaults existing as at the date of the Balance Sheet should be disclosed (item-wise). Current maturity of long-term borrowings should not be classified as short-term borrowing. They have to be classified under Other current liabilities. Guidance on disclosure on various matters under this Para should also be drawn, to the extent possible, from the guidance given under Long-term borrowings.

8.6.2. Trade payables

Guidance on disclosure under this clause should be drawn from the guidance given under Other Long-term borrowings to the extent applicable.

8.6.3. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon;

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature).

The portion of long term debts / lease obligations, which is due for payments within twelve months of the reporting date is required to be classified under “Other current liabilities” while the balance amount should be classified under Long-term borrowings.

Trade Deposits and Security Deposits which are not in the nature of borrowings should be classified separately under Other Non-current/Current liabilities. Other Payables may be in the nature of statutory dues such as Withholding taxes, Service Tax, VAT, Excise Duty etc.

8.6.4. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits;

(b) Others (specify nature).

Others would include all provisions other than provisions for employee benefits such as Provision for dividend, Provision for taxation, Provision for warranties, etc. These amounts should be disclosed separately specifying nature thereof.

II. Assets

8.7. Non-current assets

Definition and Presentation

An asset shall be classified as 'current' when it satisfies any of the following criteria:

(a) it is expected to be realized in, or is intended for sale or consumption in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is Cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as 'non-current'.

Based on the above definition, on the face of the Balance Sheet, the following items shall be disclosed under non-current assets: -

(a) Fixed Assets
   (i) Tangible assets;
   (ii) Intangible assets;
   (iii) Capital work-in-progress;
   (iv) Intangible assets under development

(b) Non-current investments

(c) Deferred tax assets (net)

(d) Long-term loans and advances

(e) Other non-current assets

8.7.1 Fixed Assets

Fixed assets are classified as:

S.No.	Particulars	Relevant Accounting Standards as notified under Companies (Accounting Standards) Rules, 2006
1.	Tangible assets	AS 10, AS 6
2.	Intangible assets	AS 26
3.	Capital work-in-progress	AS 10
4.	Intangible assets under development	AS 26

8.7.1.1 Tangible Assets

The company shall disclose the following in the Notes to Accounts as per 6(I) of Part I of the Schedule III.

(i) Classification shall be given as:
   (a) Land;

(b) Buildings;

(c) Plant and Equipment;

(d) Furniture and Fixtures;

(e) Vehicles;

(f) Office equipment;

(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

The term "under lease" should be taken to mean assets given on operating lease in the case of lessor and assets held under finance lease in the case of lessee. Further, leasehold improvements should continue to be shown as a separate asset class.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

All acquisitions, whether by way of an asset acquisition or through a business combination are to be disclosed as part of the reconciliation in the note on Fixed Assets. Acquisitions through 'Business Combinations' need to be disclosed separately for each class of assets. Similarly, though not specifically required, it is advisable that asset disposals through demergers, etc. may also be disclosed separately for each class of assets.

The term "business combination" has not been defined in the Act or the Accounting Standards as notified under the Companies (Accounting Standards) Rules, 2006. However, related concepts have been enumerated in AS14*Accounting for Amalgamations* and AS10*Accounting for Fixed Assets*. Accordingly, such terminology should be interpreted to mean an amalgamation or acquisition or any other mode of restructuring of a set of assets and/or a group of assets and liabilities constituting a business.

Other adjustments should include items such as capitalization of exchange differences where such option has been exercised by the Company as per AS11*The Effects of Changes in Foreign Exchange Rates* and/or adjustments on account of exchange fluctuations for fixed assets in case of non-integral operations as perAS11and/or borrowing costs capitalised in accordance with AS 16 *Borrowing Costs*. Such adjustments should be disclosed separately for each class of assets.

Since reconciliation of gross and net carrying amounts of fixed assets is required, the corresponding depreciation/amortization for each class of asset should be disclosed in terms of Opening Accumulated Depreciation, Depreciation/amortization for the year, Deductions/Other adjustments and Closing Accumulated Depreciation/Amortization. Similar disclosures should also be made for Impairment, if any, as applicable.

(iv) Where any amounts have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off or addition shall show the reduced or increased figures, as applicable. Disclosure by way of a note would also be required to show the amount of the reduction or increase, as applicable, together with the date thereof for the first five years subsequent to the date of such reduction or increase.

The Schedule III has introduced office equipment as a separate line item while dropping items like, livestock, railway sidings, etc. However, if the said items exist, the same should be disclosed separate asset class specifying nature thereof.

The Revised Schedule does not prescribe any particular classification/presentation for leasehold land. AS 19 *Leases,* excludes land leases from its scope. The accounting treatment for leasehold land should be continued with as is being currently followed under the prevailing Indian generally accepted accounting principles and practices. Accordingly, Leasehold land should also continue to be presented as a separate asset class under Tangible Assets. Also, Freehold land should continue to be presented as a separate asset class.

AS10 *Accounting for Fixed Assets* also requires a company to disclose details such as gross book value of revalued assets, method adopted to compute revalued amounts, nature of indices used, year of appraisal, involvement of external valuer as long as the concerned assets are held by the enterprise.

The Schedule III is clear that the disclosure requirements of the Accounting Standards are in addition to disclosures required under the Schedule. Also, in case of any conflict, the Accounting Standards will prevail over the Schedule. Keeping this in view, companies should make disclosures required by the Schedule III only for five years. However, details required by AS10 will have to be given as long as the asset is held by the company.

However, it may be noted that, AS 26 Intangible Assets does not permit revaluation of intangible assets.

8.7.1.2 Intangible assets

The company shall disclose the following in the Notes to Accounts as per 6(J) of Part I of the Schedule III.

(i) Classification shall be given as:

   (a) Goodwill;

   (b) Brands /trademarks;

   (c) Computer software;

   (d) Mastheads and publishing titles;

   (e) Mining rights;

   (f) Copyrights, and patents and other intellectual property rights, services and operating rights;

   (g) Recipes, formulae, models, designs and prototypes;

   (h) Licenses and franchise;

   (i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every Balance Sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase, as applicable, together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Classification of intangible assets (as listed above) has been introduced under the Schedule III, which did not exist earlier.

The guidance given above on Tangible Assets, to the extent applicable, is also to be used for Intangible Assets.

8.7.1.3Capital work-in-progress

As per the Schedule III, capital advances should be included under Long-term loans and advances and hence, cannot be included under capital work-in-progress.

8.7.1.4Intangible assets under development

Intangible assets under development should be disclosed under this head provided they can be recognised based on the criteria laid down inAS 26*Intangible Assets*.

8.7.2 Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares;

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a)Aggregate amount of quoted investments and market value thereof;

(b)Aggregate amount of unquoted investments;

(c)Aggregate provision for diminution in value of investments

If a debenture is to be redeemed partly within 12 months and balance after 12 months, the amount to be redeemed within 12 months should be disclosed as current and balance should be shown as non-current.

8.7.2.1 Trade Investment

Note 6(K)(i) of Part I requires that non-current investments shall be classified as "trade investment" and "other investments". The term "trade investments" is defined neither in Schedule III nor in Accounting Standards.

The term "trade investment" is, however, normally understood as an investment made by a company in shares or debentures of another company, to promote the trade or business of the first company.

8.7.2.2 Investment property

As per AS13 *Accounting for Investments*, an investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

8.7.2.3 Aggregate provision for diminution in value

As per the Schedule III, this amount should be disclosed separately in the notes. However, as per AS13 all long-term (non-current) investments are required to be carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognize the decline. Accordingly, the value of each long-term investment should be carried at cost less provision for other than temporary diminution in the value thereof. It is recommended to disclose the amount of provision netted-off for each long-term investment.

However, the aggregate amount of provision made in respect of all non-current investments should also be separately disclosed to comply with the specific disclosure requirement in Schedule III.

8.7.2.4 Controlled special purpose entities

Under investments, there is also a requirement to disclose the names of bodies corporate, including separate disclosure of investments in "controlled special purpose entities" in addition to subsidiaries, etc. The expression "controlled special purpose entities" however, has not been defined either in the Act or in the Schedule III or in the Accounting Standards. Accordingly, no disclosures would be additionally required to be made under this caption. If and when such terminology is explained/ introduced in the applicable Accounting Standards, the disclosure requirement would become applicable.

8.7.2.5 Basis of valuation

The Schedule III requires disclosure of the "basis of valuation" of non-current investments which are carried at other than cost. However, what should be understood by such terminology has not been clarified. The term 'basis of valuation' was not used in the Old Schedule VI. Hence, the same may be interpreted in the following ways:

One view is that basis of valuation would mean the market value, or valuation by independent valuers, valuation based on the investee's assets and results, or valuation based on expected cash flows from the investment, or management estimate, etc. Hence, for all investments carried at other than cost, the basis of valuation for each individual investment should be disclosed.

The other view is that, disclosure for basis of valuation should be either of:

- At cost;
- At cost less provision for other than temporary diminution;
- Lower of cost and fair value.

However, making disclosures in line with the latter view would be sufficient compliance with the disclosure requirements.

8.7.2.6 Quoted investments

The term quoted investments has not been defined in the Schedule III. The expression "quoted investment", as defined in the Old Schedule VI, means an investment as respects which there has been granted a quotation or permission to deal on a recognized stock exchange, and the expression "unquoted investment" shall be construed accordingly.

8.7.2.7 Under each sub-classification of Investments, there is a requirement to disclose details of investments including names of the bodies corporate and the nature and extent of the investment in each such boy corporate. The term "nature and extent" should be interpreted to mean the number and face value of shares. There is also a requirement to disclose partly-paid shares. However, it is advisable to clearly disclose whether investments are fully paid or partly paid.

8.7.2.8 Disclosure relating to partnership firms in which the company has invested, etc. (under Current and Non-current Investments in the Balance Sheet)

A company, as a juridical person, can enter into partnership. The Schedule III provides for certain disclosures where the company is a partner in partnership firms.

In the Balance Sheet, under the sub-heading "Current Investments" and "Non-current Investments", separate disclosure is to be made of any investment in the capital of partnership firm by the company. In addition, in the Notes to Accounts separate disclosure is required with regard to the names of the firms, along with the names of all their partners, total capital and the shares of each partner.

The disclosure in the Balance Sheet relating to the value of the investment in the capital of a partnership firm as the amount to be disclosed as on the date of the Balance Sheet can give rise to certain issues, the same are discussed in the following paragraphs.

(a) In case of a change in the constitution of the firm during the year, the names of the other partners should be disclosed by reference to the position existing as on the date of the company's Balance Sheet.

(b) The total capital of the firm to be disclosed should be with reference to the amount of the capital on the date of the company's Balance Sheet.

    If it is not practicable to draw up the Financial Statements of the partnership upto such date and, are drawn up to different reporting dates, drawing analogy from AS-21 and AS-27, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's Financial Statements. In any case, the difference between reporting dates should not be more than six months. In such cases, the difference in reporting dates should be disclosed.

(c) For disclosure of the share of each partner it is suggested to disclose share of each partner in the profits of the firm rather than the share in the capital since, ordinarily, the expression "share of each partner" is understood in this sense. Moreover, disclosure is already required of the total capital of the firm as well as of the company's share in that capital. The share of each partner should be disclosed as at the date of the company's Balance Sheet

(d) The Statement of investments attached to the Balance Sheet is required to disclose, *inter alia,* the total capital of the partnership firm in which the company is a partner. Where such a partnership firm has separate accounts for partner's capital, drawings or current, loans to or from partners, etc., disclosure must be made with regard to the total of the capital accounts alone, since this is what constitutes the capital of the partnership firm. Where, however, such accounts have not been segregated, or where the partnership deed provides that the capital of each partner is to be calculated by reference to the net amount at his credit after merging all the accounts, the disclosure relating to the partnership capital must be made on the basis of the total effect of such accounts taken together.

Separate disclosure is required by reference to each partnership firm in which the company is a partner. The disclosure must be made along with the name of each such firm and must then indicate the total capital of each firm, the names of all the partners in each firm and the respective shares of each partner in the firm.

8.7.2.9 A limited liability partnership is a body corporate and not a partnership firm as envisaged under the Partnership Act, 1932. Hence, disclosures pertaining to Investments in partnership firms will not include investments in limited liability partnerships. The investments in limited liability partnerships will be disclosed separately under other investments. Also, other disclosures prescribed for Investment in partnership firms, need not be made for investments in limited liability partnerships.

8.7.2.10 Any application money paid towards securities, where security has not been allotted on the date of the Balance Sheet shall be disclosed as a separate line item. If the amount is material, details about the allotment since made or when the allotment is expected to be completed may also be disclosed.

In case the investment is of current investment in nature, such share application money shall be accordingly, disclosed under current investments.

8.7.3 Long-term loans & advances

(i) Long-term loans and advances shall be classified as:

- (a) Capital Advances;
- (b) Security Deposits;
- (c) Loans and advances to related parties (giving details thereof);
- (d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Under the Schedule III, Capital Advances are not to be classified under Capital Work in Progress, since they are specifically to be disclosed under this para.

Capital advances are advances given for procurement of fixed assets which are non-current assets. Typically, companies do not expect to realize them in cash. Rather, over the period, these get converted into fixed assets which, by nature, are non-current assets. Hence, capital advances should be treated as non-current assets irrespective of when the fixed assets are expected to be received and should not be classified as Short-Term/Current.

Details of loans and advances to related parties need to be disclosed. Since the Schedule III states that the terms used therein should be interpreted based on applicable the Accounting Standards, the term "details" should be interpreted to understand the disclosure requirements contained in AS 18*Related Party Disclosure*. Accordingly, making disclosures beyond the requirements of AS-18 would not be necessary.

Other loans and advances should include all other items in the nature of advances recoverable in cash or kind such as Prepaid expenses, Advance tax, CENVAT credit receivable, VAT credit receivable, Service tax credit receivable, etc. which are not expected to be realized within the next twelve months or operating cycle whichever is longer, from the Balance Sheet date.

Each item of loans and advances should be further sub-classified as a) Secured, considered good, b) Unsecured, considered good and c) Doubtful. Further, the amount of allowance for bad and doubtful loans and advances is required to be disclosed separately under the "relevant heads". Therefore, the amount of such allowance also should be disclosed separately for each category of loans and advances.

8.7.4 Other non-current assets

Other non-current assets shall be classified as:

(i) Long term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature)

Long term Trade Receivables, shall be sub-classified as:

(i) (a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful

(ii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iii) Debts due by directors or other officers of the company orany of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

A receivable shall be classified as 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business. Whereas as per the Old Schedule VI, the term 'sundry debtors' included amounts due in respect of goods sold or services rendered or in respect of other contractual obligations as well. Hence, amounts due under contractual obligations cannot be included within Trade Receivables. Such items may include dues in respect of insurance claims, sale of fixed assets, contractually reimbursable expenses, interest accrued on trade receivables, etc. Such receivables should be classified as "others" and each such item should be disclosed nature-wise.

Guidance in respect of above items may also be drawn from the guidance given in respect of Long-term loans &advances to the extent applicable.

The Schedule III does not contain any specific disclosure requirement for the unamortized portion of expense items such as share issue expenses, ancillary borrowing costs and discount or premium relating to borrowings. The Old Schedule VI required these items to be included under the head "Miscellaneous Expenditure."

As per AS 16 *Borrowing Costs* ancillary borrowing costs and discount or premium relating to borrowings could be amortized over the loan period. Further, share issue expenses, discount on shares, ancillary costs-discount-premium on borrowing, etc., being special nature items are excluded from the scope of AS 26*Intangible Assets* (Para 5). Keeping this in view, certain companies have taken a view that it is an acceptable practice to amortize these expenses over the period of benefit, i.e., normally 3 to 5 years. The Schedule III does not deal with any accounting treatment and the same continues to be governed by the respective Accounting Standards/practices. Further, the Schedule III is clear that additional line items can be added on the face or in the notes. Keeping this in view, entity can disclose the unamortized portion of such expenses as "Unamortized expenses", under the head "other current/ non-current assets", depending on whether the amount will be amortized in the next 12 months or thereafter.

8.8 Current assets

As per the Schedule III, all items of assets and liabilities are to be bifurcated between current and non-current portions. In some cases, the items presented under the "non-current" head of the Balance Sheet do not have a corresponding "current" head especially for Assets. For example: Security Deposits have been shown under "Long-term loans & advances", however, the same is not reflected under the "short-term loans & advances". Since Schedule III permits the use of additional line items, in such cases the current portion should be classified under the Short-term category of the respective balance as a separate line item and other relevant disclosures e.g. doubtful amount, related provision etc. should be made.

8.8.1 Current investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

Guidance in respect of above items may be drawn from the guidance given in respect of Non-current investments to the extent applicable.

Based on these criteria, if a debenture is to be redeemed partly within twelve months and balance after twelve months, the amount to be redeemed within twelve months should be disclosed as current and balance should be shown as non-current.

Additionally, the Schedule III also require basis of valuation of individual investment. It is pertinent to note that there is no requirement to classify investments into trade & non-trade in respect of current investments.

The aggregate provision for diminution in the value of current investments that needs to be separately disclosed is the amount written down based on the measurement principles of Current Investments as per AS-13 on a cumulative basis, though such write-down is not actually a 'provision' as per the Standard.

8.8.2Inventories

(i) Inventories shall be classified as:

   (a) Raw materials;

   (b) Work-in-progress;

   (c) Finished goods;

   (d) Stock-in-trade (in respect of goods acquired for trading);

   (e) Stores and spares;

   (f) Loose tools;

   (g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

As per the Schedule III, goods in transit should be included under relevant heads with suitable disclosure. Further, mode of valuation for each class of inventories should be disclosed.

The heading Finished goods should comprise of all finished goods other than those acquired for trading purposes.

8.8.3 Trade Receivables (current)

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

   (a) Secured, considered good;

   (b) Unsecured considered good;

   (c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

A trade receivable will be treated as current, if it is likely to be realized within twelve months from the date of Balance Sheet or operating cycle of the business.

The Old Schedule VI required separate presentation of debtors (i) outstanding for a period exceeding six months (i.e., based on billing date) and (ii) other debtors. However, the Schedule III (and earlier, the Revised Schedule VI) requires separate disclosure of "Trade Receivables outstanding for a period exceeding six months from the date they became due for payment" only for the current portion of trade receivables.

Where no due date is specifically agreed upon, normal credit period allowed by the company should be taken into consideration for computing the due date which may vary depending upon the nature of goods or services sold and the type of customers, etc.

All other guidance given under Long-term Trade Receivables to the extent applicable are applicable here also.

8.8.4 Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

  (a) Balances with banks;

  (b) Cheques, drafts on hand;

  (c) Cash on hand;

  (d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than twelve months maturity shall be disclosed separately.

The term "cash and bank balances" in the Old Schedule VI is replaced with 'Cash and cash equivalents' in the Schedule III.

Please also refer to the earlier discussion under the section on General Instructions in para 6.4 for classification of items under this head.

"Other bank balances" would comprise of items such as balances with banks to the extent of held as margin money or security against borrowings etc, and bank deposits with more than three months maturity. Banks deposits with more than more than twelve months maturity will also need to be separately disclosed under the sub-head 'Other bank balances'. The non-current portion of each of the above balances will have to be classified under the head "Other Non-current assets" with separate disclosure thereof.

8.8.5Short-term loans &Advances

(i) Short-term loans and advances shall be classified as:

  (a) Loans and advances to related parties (giving details thereof);

  (b) Others (specify nature).

(ii) The above shall also be sub-classified as:

  (a) Secured, considered good;

  (b) Unsecured, considered good;

  (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

The guidance for disclosures under this head should be drawn from guidance given for items comprised within Long-term Loans and Advances.

8.8.6 Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories e.g. unbilled Revenue, unamortized premium on forward contracts etc.

In case any amount classified under this category is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed.

8.8.7 Contingent liabilities and commitments

(i) Contingent liabilities shall be classified as:

- (a) Claims against the company not acknowledged as debt;
- (b) Guarantees;
- (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) Uncalled liability on shares and other investments partly paid
- (c) Other commitments (specify nature).

8.8.7.1 The provisions of AS-29*Provisions, Contingent Liabilities and Contingent Assets,* will be applied for determining contingent liabilities.

8.8.7.2A contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations. However, where a company undertakes to perform its own obligations, and for this purpose issues, what is called a "guarantee", it does not represent a contingent liability and it is misleading to show such items as contingent liabilities in the Balance Sheet. For various reasons, it is customary for guarantees to be issued by Bankers e.g. for payment of insurance premia, deferred payments to foreign suppliers, letters of credit, etc. For this purpose, the company issues a "counter-guarantee" to its Bankers. Such "counter-guarantee" is not really a guarantee at all, but is an undertaking to perform what is in any event the obligation of the company, namely, to pay the insurance premia when demanded or to make deferred payments when due. Hence, such performance guarantees and counter-guarantees should not be disclosed as contingent liabilities.

8.8.7.3 The Schedule III also requires disclosures pertaining to various commitments such as Capital commitments not provided for and Uncalled liability on shares. It also requires disclosures pertaining to 'Other commitments', with specification of nature thereof, which was not required by the Old Schedule VI.

8.8.7.4 The word 'commitment' has not been defined in the Schedule III. The Guidance Note on Terms Used in Financial Statements issued by ICAI defines 'Capital Commitment' as future liability for capital expenditure in respect of which contracts have been made. Hence, drawing inference from such definition, the term 'commitment' would simply imply future liability for contractual expenditure. Accordingly, the term 'Other commitments' would include all expenditure related contractual commitments apart from capital commitments such as commitments arising from long-term contracts for purchase of raw material, employee contracts, lease commitments, etc. The scope of such terminology is very wide and may include contractual commitments for purchase of inventory, services, investments, sales, employee contracts, etc. However, to give disclosure of all contractual commitments would be contrary to the overarching principle under General Instructions that "a balance shall be maintained between providing excessive detail that may not assist users of Financial Statements and not providing important information as a result of too much aggregation."

8.8.7.5 Disclosures relating to lease commitments for non-cancellable leases are required to be disclosed by *AS-19 Leases*.

8.8.7.6 Accordingly, the disclosures required to be made for 'other commitments' should include only those non-cancellable contractual commitments (i.e. cancellation of which will result in a penalty disproportionate to the benefits involved) based on the professional judgement of the management which are material and relevant in understanding the Financial Statements of the company and impact the decision making of the users of Financial Statements.

Examples may include commitments in the nature of buy-back arrangements, commitments to fund subsidiaries and associates, non-disposal of investments in subsidiaries and undertakings, derivative related commitments, etc.

8.8.7.7 The Schedule III requires disclosure of the amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share to be disclosed separately. It also requires separate disclosure of the arrears of fixed cumulative dividends on preference shares. The Old Schedule VI specifically required proposed dividend to be disclosed under the head "Provisions." In the Schedule III, this needs to be disclosed in the notes. Hence, a question that arises is as to whether this means that proposed dividend is not required to be provided for when applying the Schedule III. *AS-4 Contingencies and Events Occurring After the Balance Sheet date* requires that dividends stated to be in respect of the period covered by the Financial Statements, which are proposed or declared by the enterprise after the Balance Sheet date but before approval of the Financial Statements, should be adjusted. Keeping this in view and the fact that the Accounting Standards override the Schedule III, companies will have to continue to create a provision for dividends in respect of the period covered by the Financial Statements and disclose the same as a provision in the Balance Sheet, unless *AS-4* is revised. Hence, the disclosure to be made in the notes is over and above the disclosures pertaining to a) the appropriation items to be disclosed under Reserves and Surplus and b) Provisions in the Balance Sheet.

8.8.7.8 The Schedule III requires that where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the Balance Sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

8.8.7.9 The Schedule III also states that if, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated. It is difficult to contemplate a situation where any asset other than fixed assets and non-current investments has a realizable value that is lower than its carrying value, and the same is not given effect to in the books of account, since Accounting Standards do not permit the same. AS13*Accounting for Investments* requires current investments to be valued at lower of cost and fair value. AS2 *Valuation of Inventories* also requires inventories to be valued at the lower of cost and net realizable value. Further, Allowance for bad and doubtful debts is required to be shown as a deduction from both Long-term loans &advances and Other Non-current assets as well as Trade Receivables and Short-term loans and advances as per Schedule III. Hence, a diligent application of the requirements of Accounting Standards and Schedule III will normally not leave any scope for making any additional disclosures in this regard.

9. Part II – Statement of Profit and Loss

Part II deals with disclosures relating to the Statement of Profit and Loss. The format prescribed is the vertical form wherein disclosure for revenues and expenses is in various line items. Part II of the Schedule contains items I to XVI which lists items of Revenue, Expenses and Profit / (Loss). "General Instructions for Preparation of Statement of Profit and Loss" govern the other disclosure and presentation.

As per the Guidance Note 'Terms Used in Financial Statements', the phrase 'Profit and Loss statement' is defined as "*the Financial Statement which presents the revenues and expenses of an enterprise for an accounting period and shows the excess of revenues over expenses (or vice versa) It is also known as profit and loss account.*"

As per Note 1 to "General Instructions for Preparation of Statement of Profit and Loss", the provisions of this part also apply to the income and expenditure account referred to in sub clause (ii) of clause (40) of section 2 of the Companies Act, 2013 in the same manner as they apply to a Statement of Profit and Loss.

The specific format laid down for presentation of various items of Income and Expenses in the Statement of Profit and Loss indicates that expenses should be aggregated based on their nature. Accordingly, functional classification of expenses is prohibited.

As per the Framework For The Preparation and Presentation Of Financial Statements, Income and expenses are defined as follows:

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

9.1 Revenue from operations:

The aggregate of Revenue from operations needs to be disclosed on the face of the Statement of Profit and Loss as per Schedule III

9.1.1 Note 2(A) to General Instructions for the Preparation of Statement of Profit and Loss require that in respect of a company other than a finance company, Revenue from operations is to be separately disclosed in the notes, showing revenue from:

(a) Sale of products

(b) Sale of services

(c) Other operating revenues

(d) Less: Excise duty

9.1.2 As per AS-9 "*Revenue Recognition*", the above disclosure in respect of Excise Duty needs to be shown on the face of the Statement of Profit and Loss. Since Accounting Standards override Schedule III, the presentation in respect of excise duty will have to be made on the face of the Statement of Profit and Loss. In doing so, a company may choose to present the elements of revenue from sale of products, sale of services and other operating revenues also on the face of the Statement of Profit and Loss instead of the Notes.

9.1.3 Indirect taxes such as Sales tax, Service tax, Purchase tax etc. are generally collected from the customer on behalf of the government in majority of the cases. However, this may not hold true in all cases and it is possible that a company may be acting as principal rather than as an agent in collecting these taxes. Whether revenue should be presented gross or net of taxes should depend on whether the company is acting as a principal and hence responsible for paying tax on its own account or, whether it is acting as an agent i.e. simply collecting and paying tax on behalf of government authorities. In the former case, revenue should also be grossed up for the tax billed to the customer and the tax payable should be shown as an expense. However, in cases, where a company collects tax only as an intermediary, revenue should be presented net of taxes.

9.1.4 However, as per the Guidance Note on Value Added Tax, "Value Added Tax (VAT) is collected from the customers on behalf of the VAT authorities and, therefore, its collection from the customers is not an economic benefit for the enterprise and it does not result in any increase in the equity of the enterprise". Accordingly, VAT should not be recorded as Revenue of the enterprise. At the same time, the payment of VAT should not be treated as an expense in the Financial Statements of the company.

9.1.5 Further, as per the definition of Revenue in the Guidance Note on Terms Used in Financial Statement, "It excludes amounts collected on behalf of third parties such as certain taxes". The Guidance Note on VAT further states, "Where the enterprise has not charged VAT separately but has made a composite charge, it should segregate the portion of sales which is attributable to tax and should credit the same to 'VAT Payable Account' at periodic intervals".

9.1.6 For non-finance companies, revenue from operations needs to be disclosed separately as revenue from

(a) sale of products,

(b) sale of services and

(c) other operating revenues.

It is important to understand what is meant by the term "other operating revenues" and which items should be classified under this head vis-à-vis under the head "Other Income".

9.1.7 The term "other operating revenue" is not defined. This would include Revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities, but which is not revenue arising from the sale of products or rendering of services. Whether a particular income constitutes "other operating revenue" or "other income" is to be decided based on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held. For instance, a group engaged in manufacture and sale of industrial and consumer products also has one real estate arm. If the real estate arm is continuously engaged in leasing of real estate properties, the rent arising from leasing of real estate is likely to be "other operating revenue". On the other hand, consider a consumer products company which owns a 10 storied building. The company currently does not need one floor for its own use and has given the same temporarily on rent. In that case, lease rent is not an "other operating revenue"; rather, it should be treated as "other income".

9.1.8 To take other examples, sale of Fixed Assets is not an operating activity of a company, and hence, profit on sale of fixed assets should be classified as other income and not other operating revenue. On the other hand, sale of manufacturing scrap arising from operations for a manufacturing company should be treated as other operating revenue since the same arises on account of the company's main operating activity.

9.1.9 Net foreign exchange gain should be classified as Other Income. This is because such gain or loss arises purely on account of fluctuation in exchange rates and not on account of sale of products or services rendered, unless the business of the company is to deal in foreign exchange.

9.1.10 As per Note 2(A) to General Instructions for Preparation of Statement of Profit and loss, in respect of a finance company, revenue from operations shall include revenue from

(a) Interest; and

(b) Other financial services

Revenue under each of the above heads is to be disclosed separately by way of Notes to Accounts to the extent applicable.

9.1.11 The term finance company is not defined under the Companies Act, 2013, or Schedule III. Hence, the same should be taken to include all companies carrying on activities which are in the nature of "business of non-banking financial institution" as defined under section 45I(f) of the Reserve Bank of India Act, 1935.

The relevant extract is reproduced below:

(a) ''business of a non-banking financial institution'' means carrying on of the business of a financial institution referred to in clause (c) and includes business of a non-banking financial company referred to in clause (f);

(c) ''financial institution'' means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:–

(i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own:

(ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature:

(iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972:

(iv) the carrying on of any class of insurance business;

(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;

(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person, but does not include any institution, which carries on as its principal business,–

    (a) agricultural operations; or

    (aa) industrial activity; or

    (b) the purchase or sale of any goods (other than securities) or the providing of any services; or

    (c) the purchase, construction or sale of immovable property, so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons;

Explanation.– For the purposes of this clause, ''industrial activity'' means any activity specified in sub-clauses (i) to (xviii) of clause (c) of section 2 of the Industrial Development Bank of India Act, 1964;

(f) ''non-banking financial company'' means–

  (i) a financial institution which is a company;

  (ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

  (iii) such other non-banking institution or class of such institutions, as the bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

9.1.12 Accordingly, applying the aforesaid definition, the term "finance company" would cover all NBFCs - Asset Finance companies, Investment companies, Leasing and Hire Purchase companies, Loan companies, Infra Finance companies, Core Investment companies, Micro-finance companies, etc. Further, Housing Finance Companies regulated by National Housing Bank should also be considered as a finance company.

9.2 Other income:

The aggregate of 'Other income' is to be disclosed on face of the Statement of Profit and Loss.

9.2.1 As per Note 4 to General Instructions for the preparation of Statement of Profit and Loss 'Other Income shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain / loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

9.2.2 All kinds of interest income for a company other than a finance company should be disclosed under this head such as interest on fixed deposits, interest from customers on amounts overdue, etc.

9.2.3 Clause (a) of Note 5 (vii) requires a separate disclosure for Dividends from subsidiary companies. The Old Schedule VI specifically required parent companies to recognise dividend declared by subsidiary companies even if declared after the Balance Sheet date if they are related to the period covered by the Financial Statements. The Schedule III (and earlier, the Revised Schedule VI) does not prescribe any such accounting requirement. Accordingly, dividend income from subsidiary companies should be recognized in accordance with AS-9, i.e. only when they have a right to receive the same on or before the Balance Sheet date. Normally, the right to receive is established only when the dividend is approved by the shareholders at the Annual General Meeting of the investee company.

9.2.4 Other income items such as interest income, dividend income and net gain on sale of investments should be disclosed separately for Current as well as Long-term Investments as required by AS13 "*Accounting for Investments*". If it is a net loss the same should be classified under expenses.

9.2.5 For other non-operating income, income should be disclosed under this head net off expenses directly attributable to such income. However, the expenses so netted off should be separately disclosed.

9.3 Share of profits/losses in a Partnership firm

9.3.1 Though, there is no specific requirement in the Schedule III to disclose profit or losses on investments in a partnership firm as was required by the Old Schedule VI, the same should be disclosed as discussed as under.

9.3.2 Share of profit or loss in a partnership firm accrues the moment the same is computed and credited or debited to the Capital/Current/any other account of the company in the books of the partnership firm. Hence, the same should be accordingly accounted for in the books of the company.

9.3.3 Separate disclosure of profits or losses from partnership firms should be made. In a case where the company was a partner during the year but is not a partner at the end of the year, the disclosure should be made for the period during which the company was a partner.

9.3.4 The company's share of the profits or losses of the partnership firm should be calculated by reference to the company's own accounting year. The Financial Statements of the partnership for computing the share of profits and losses should be drawn up to the same reporting date. If it is not practicable to draw up the Financial Statements of the partnership upto such date and, are drawn up to a different reporting date, drawing analogy from AS-21 and AS-27, adjustments should be made for the effects of significant transactions or other events that occur between that date and the date of the parent's Financial Statements. In any case, the difference between reporting dates should not be more than six months. In such cases, the difference in reporting dates should be disclosed.

9.3.5 In case the year ending of the company and of the firm fall on different dates, the Financial Statements of the company should also contain a note to indicate that the accounting period of the partnership firm in respect of which the profits or losses have been accounted for in the company's books.

9.3.6 If however, a partnership firm happens to be in the nature of a Jointly Controlled Operation as defined in AS-27, the share of incomes, expenses, assets or liabilities will have to be accounted for in the Standalone Financial Statements as prescribed in AS-27.

9.3.7 In case the partnership firm is a Subsidiary under AS-21, Associate under AS-23 or Jointly Controlled Entity/Jointly Controlled Operation under AS-27, in the Consolidated Financial Statements, the share of profit/loss from the firm should be accounted for in terms of the applicable Accounting Standard as stated above.

9.3.8 The aforesaid principles should also be applied to accounting for the share of profits and losses in an Association of Persons (AOP).

9.4 Share of profits/losses in a Limited Liability Partnership (LLP)

9.4.1 A Limited Liability Partnership, as per the LLP Act, is a body corporate and the share of profit/loss in the LLP does not accrue to the partners till the same is transferred to the Partners' Capital/Current Account as per the terms of the LLP Agreement. Accordingly, the share of profit/loss should be accounted in the books of the company as and when the same is credited/debited to the Partners' Capital Account.

9.4.2 Depending upon the terms of agreement between the Partners, the LLP may be a Subsidiary under AS-21, Associate under AS-23 or Jointly Controlled Entity under AS-27. Hence, accounting in respect of the same in the Consolidated Financial Statements would be governed by the applicable Accounting Standards.

9.5 Expenses

The aggregate of the following expenses are to be disclosed on the face of the Statement of Profit and Loss:

- Cost of materials consumed
- Purchases of Stock-in-Trade
- Changes in inventories of finished goods, work in progress and stock in trade
- Employee benefits expense
- Finance costs
- Depreciation and amortization expense
- Other expenses

9.5.1 Cost of materials consumed

9.5.1.1 This disclosure is applicable for manufacturing companies. Materials consumed would consist of raw materials, packing materials (where classified by the company as raw materials) and other materials such as purchased intermediates and components which are 'consumed' in the manufacturing activities of the company. Where packing materials are not classified as raw materials the consumption thereof should be disclosed separately. However, intermediates and components which are internally manufactured are to be excluded from the classification:

9.5.1.2 For purpose of classification of inventories, internally manufactured components may be disclosed as below:

i. where such components are sold without further processing they are to be disclosed as 'finished products'.

ii. where such components are sold only after further processing, the better course is to disclose them as 'work-in-progress' but they may also be disclosed as 'manufactured components' subject to further processing or with such other suitable description as 'semi-finished products' or 'intermediate products'.

iii. where such components are sometimes sold without further processing and sometimes after further processing it is better to disclose them as 'manufactured components'.

9.5.1.3 For the purpose of interpreting the requirement to classify the raw materials, some guidance may be necessary with regard to the question as to what constitutes raw materials. According to the strict dictionary connotation of this term, raw materials would include only materials obtained in the state of nature. Such a definition would, however, be unrealistic in context of this requirement because it would exclude even a basic material such as steel. Generally speaking, the term "raw materials" would include materials which physically enter into the composition of the finished product. Materials, such as stores, fuel, spare parts etc, which do not enter physically into the composition of the finished product, would therefore, be excluded from the purview of the term "raw materials".

9.5.1.4 The requirement is silent with regard to containers and packaging materials. It is, therefore, open to question whether such materials constitute a category of "raw materials" for the purpose of the classification. The matter should be decided in the light of the facts and circumstances of each case, the nature of the containers and packaging materials, their relative value in comparison to the raw materials consumed, and other similar considerations. Where, however, packaging materials, because of their nature are included in raw materials it is preferable to show the description as "raw materials including packaging materials consumed".

9.5.1.5 Since in case of a company which falls under the category of manufacturing or manufacturing and trading company, disclosure is required with regard to raw materials consumed, care should be taken to ensure that the figures relate to actual consumption rather than “derived consumption”. The latter figure is ordinarily obtained by deducting the closing inventory from the total of the opening inventory and purchases, but this figure may not always represent a fair indication of actual consumption because it might conceal losses and wastages. On the other hand, if the figure of actual consumption can be compiled from issue records or other similar data, it is likely to be more accurate. Where this is not possible, the derived figure of consumption may be shown and it is left to the company, according to the circumstances of each case, to determine whether any footnote is required to indicate that the consumption disclosed is on the basis of derived figures rather than actual records of issue.

9.5.1.6 Where the consumption is disclosed on the basis of actual records of issue, a further question arises with regard to the treatment of shortages, losses and wastages. In most manufacturing companies, these are inevitable. It is, therefore, suggested that the company should itself establish reasonable norms of acceptable margins. Any shortages, losses or wastages which are within these norms may be regarded as an ordinary incidence of the manufacturing process and may, therefore, be included in the figure of consumption. On the other hand, any shortages, losses or wastages which are beyond the permitted margin or when they are known to have occurred otherwise than in the manufacturing process, should not be included in the consumption figures. Whether or not such abnormal variations need to be separately disclosed in the accounts would depend upon the facts and circumstances of each case. The General Instructions for Preparation of Statement of Profit and Loss does not require any specific disclosures.

9.5.1.7 In the case of industries where there are several processes, materials may move from process to process, so that the finished product of one department constitutes the raw materials of the next. Since the disclosure requirement provides only for disclosure of raw material under broad heads and goods purchased under broad heads and also having regard to the fact that the consumption of raw materials for production of such intermediates would have to be accounted as raw materials consumed, it follows that internal transfers from one department to another should be disregarded in determining the consumption figures to be disclosed. .

9.5.2 Purchases of Stock in Trade

Stock-in-trade refers to goods purchased normally with the intention to resell or trade in. In case, any semi-finished goods/materials are purchased with an intention of doing further processing activities on the same, the same should be included in ‘cost of materials consumed’ rather than under this item.

9.5.3 Changes in inventories of finished goods, work-in-progress and stock-in-trade

This requires disclosure of difference between opening and closing inventories of finished goods, work-in-progress and stock-in-trade. The difference should be disclosed separately for finished goods, work in progress and stock in trade.

9.5.4 Employee benefits expense [Note 5(i)(a)]

This requires disclosure of the following details:

9.5.4.1 Salaries and wages

The aggregate amounts paid/payable by the company for payment of salaries and wages are to be disclosed here. Expenses on account of bonus, leave encashment, compensation and other similar payments also need to be disclosed here. Where a separate fund is maintained for Gratuity payouts, contribution to Gratuity fund should be disclosed under the sub-head Contribution to provident and other funds.

The term employee should be deemed to include directors who are either in whole-time or part-time employment of the company. It will exclude those directors who attend only Board meetings and are not under a contract of service with the company. Those who act as consultants or advisers without involving the relationship of master and servant with the company should also be excluded. A distinction should be made between persons engaged under a contract of service and those engaged under a contract for services. Only the former are to be included in the computation. Whether part-time employees are to be included would depend on the facts and circumstances of each case - the basic criterion being whether they are employed under a contract of service or a contract for services.

9.5.4.2Contribution to provident and other funds

The aggregate amounts paid/payable by a company on account of contributions to provident fund and other funds like Gratuity fund, Superannuation fund, etc. are to be disclosed here.

Contributions for such funds for contract labour may also be separately disclosed here. However, penalties and other similar amounts paid to the statutory authorities are not strictly in the nature of 'contribution' and should not be disclosed here.

9.5.4.3 Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP)

The amount of expense under this head should be determined in accordance with the Guidance Note on Accounting for Employee Share based Payments and/or the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999, as applicable. All disclosures required by the aforesaid Guidance Note should be made here.

9.5.4.4 Staff welfare expense

The total expenditure on Staff welfare is to be disclosed herein.

9.5.5 As per Note 3 of to the General Instructions for the Preparation of the Statement of Profit and Loss, disclosure of Finance costs is to be bifurcated under the following:

(A) Interest expense

(B) Other borrowing costs

(C) Applicable net gain/loss on foreign currency transactions and translation

A) Interest expense

This would cover interest paid on borrowings from banks and others, on debentures, bonds or similar instruments etc. Finance charges on finance leases are in the nature of interest expense and hence should also be classified as interest expense.

B) Other borrowing costs

Other borrowing costs would include commitment charges, loan processing charges, guarantee charges, loan facilitation charges, discounts/premium on borrowings, other ancillary costs incurred in connection with borrowings, or amortization of such costs, etc.

C) Applicable net gain/loss on foreign currency transactions and translation

As per Para 4(e) of AS-16, borrowing costs also include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Any such exchange differences would need to be disclosed under this head.

9.5.6 Depreciation and amortization expense [Note 5(i)(b)]

A company has to disclose depreciation provided on fixed assets and amortization of intangible assets under this head.

9.5.7 Other Expenses

All other expenses not classified under other heads will be classified here. For this purpose, any item of expenditure which exceeds one percent of the revenue from operations or `Rs. 1,00,000, whichever is higher (as against the requirement of Old Schedule VI of 1 percent of total revenue or Rs. 5,000 whichever is higher), needs to be disclosed separately.

Further Note 5(vi) requires a separate disclosure of each of the following items, which will also be classified under 'Other expenses'

- Consumption of stores and spare parts;
- Power and fuel;
- Rent;
- Repairs to buildings;
- Repairs to machinery;
- Insurance;
- Rates and taxes, excluding taxes on income;
- Miscellaneous expenses.

9.6 Exceptional items

The term 'Exceptional items' is not defined in Schedule III. However, AS-5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*" has a reference to such items in Paras 12, 13 and 14.

"Para 12: 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.

Para 13: Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items 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. Disclosure of such information is sometimes made in the notes to the Financial Statements.

Para 14: Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include: the write-down of inventories to net realisable value as well as the reversal of such write-downs; a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;"

- ✓ *disposals of items of fixed assets;*
- ✓ *disposals of long-term investments;*
- ✓ *legislative changes having retrospective application;*
- ✓ *litigation settlements; and*
- ✓ *other reversals of provisions.*

In case the company has more than one such item of income / expense of the above nature, the aggregate of such items should be disclosed on the face of the Statement of Profit and Loss. Details of the all individual items should be disclosed in the Notes. [Note 5 (i) (l) to the General Instructions for preparation of the Statement of Profit and Loss]

9.7 Extraordinary items

The term 'Extraordinary items' is not defined in Schedule III. However, AS 5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*" at para 4.2 defines 'extraordinary items' as: '*Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. Further* para 8 of AS-5 discusses about the disclosure of extraordinary items as below:

Extraordinary items should be disclosed in the Statement of Profit and Loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the Statement of Profit and Loss in a manner that its impact on current profit or loss can be perceived."

In case the company has more than one such item of income / expense of the above nature, the aggregate of such items should be disclosed on the face of the Statement of Profit and Loss. Details of the all individual items should be disclosed in the Notes. [Note 5 (i) (l) to the General Instructions for Preparation of the Statement of Profit and Loss].

9.8 Tax expense:

This is to be disclosed on the face of the Statement to Profit and Loss and bifurcated into:

(1) Current tax and

(2) Deferred tax

9.8.1 Current tax

9.8.1.1 The term 'Current tax' has been defined under AS-22 "Accounting for Taxes" on Income as the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period. Hence, details of all taxes on income payable under the applicable taxation laws should be disclosed here.

9.8.1.2 Presentation for Minimum Alternate Tax (MAT) credit should be made as prescribed by the ICAI Guidance Note on "Accounting for Credit Available in Respect of Minimum Alternative tax under the Income-tax Act, 1961'. The relevant portion is as under:

"*Profit and Loss Account:*

15. According to paragraph 6 of Accounting Standards Interpretation (ASI) 6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein."

The Disclosure in this regard should be made as under :

Current tax (MAT)	XX
Less : MAT credit entitlement	(XX)
Net Current tax	XX

9.8.1.3 Any interest on shortfall in payment of advance income-tax is in the nature of finance cost and hence should not be clubbed with the Current tax. The same should be classified as Interest expense under finance costs. However, such amount should be separately disclosed.

9.8.1.4 Any penalties levied under Income tax laws should not be classified as Current tax. Penalties which are compensatory in nature should be treated as interest and disclosed in the manner explained above. Other tax penalties should be classified under Other expenses.

9.8.1.5 Wealth tax payable by a company on assets liable for wealth tax should not be included within current tax since the same is not a tax on income. Accordingly, wealth tax should be included in Rates and taxes under other expenses.

9.8.1.6 Excess/Short provision of tax relating to earlier years should be separately disclosed.

9.8.2 Deferred tax

9.8.2.1 Any charge/credit for deferred taxes needs to be disclosed separately on the face of the Statement of Profit and Loss.

9.8.2.2AS22 *"Accounting for Taxes on Income" defines 'Deferred tax' as the tax effect of timing differences.*

Timing differences are defined as "differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods."

9.9 Profit / (loss) for the period from Discontinuing operations

9.9.1 *The term 'Discontinuing operations' is defined in* AS 24 *"Discontinuing operations" as a component of an enterprise:*

a. *that the enterprise, pursuant to a single plan, is:*

  (i) *disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or*

  (ii) *disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or*

  (iii) *terminating through abandonment; and*

b. *that represents a separate major line of business or geographical area of operations; and*

c. *that can be distinguished operationally and for financial reporting purposes.*

9.9.2 Profit or loss from Discontinuing Operations needs to be separately disclosed on the face of Statement of Profit and Loss. This disclosure is in line with the disclosure requirement of AS-24 Para 32(a) which requires the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto to be disclosed on the face of the Statement of Profit and Loss.

9.9.3 Further, AS-24 Para 32(b) requires the following disclosure to be made on the face of the Statement of Profit and Loss as well:

"(b) the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation."

Accordingly, such disclosures for discontinuing operations should be made wherever applicable.

9.10 Tax expense of discontinuing operations

In case there are any taxes payable / tax credits available on profits / losses of discontinuing operations, the same needs to be disclosed as a separate line item on the Statement of Profit and Loss.

9.11 Earnings per equity share

Computation of Basic and Diluted Earnings Per Share should be made in accordance with AS20 *Earnings Per Share*. It is pertinent to note that the nominal value of equity shares should be disclosed along with the Earnings Per Share figures as required by AS20.

10 Other additional information to be disclosed by way of Notes to Statement of Profit and Loss

Besides the above disclosures, Para 5 of the General instructions for Preparation of Statement of Profit and Loss also require disclosure on the following items:

10.1 Adjustments to the carrying amount of investments [Clause (h) of Note 5(i)]

In case there are any adjustments to carrying amount of investments pursuant to diminution in value of the investment (or reversal thereof) in conformity with AS 13 "*Accounting for Investments*", the same should be disclosed here.

10.2 Net gain or loss on foreign currency translation (other than considered as finance cost) Clause (i) of Note 5(i)

Any gains / losses on account of foreign exchange fluctuations are to be disclosed separately as per AS11. Thus net exchange loss should be classified under Other expenses and the amount so included should be separately disclosed. Under this head, exchange differences to the extent classified as borrowing costs as per Para 4(e) of AS-16 should not be disclosed. Refer para9.6.5 [Note 3(c) of Schedule III].

10.3 Payments to the auditor [Clause (j) of Note 5(i)]

Payments covered here should be for payments made to the firm of auditor(s). Expenses incurred towards such auditor's remuneration should be disclosed under each of the following sub-heads as follows:

As :

(a) Auditor,

(b) For taxation matters,

(c) For company law matters,

(d) For management services,

(e) For other services,

(f) For reimbursement of expenses;

10.4 Prior period items [Clause (m) of Note 5 (i)]

The term 'Prior period Items' is not defined in Schedule III. AS 5 "*Net Profit or Loss for the period, Prior period items and changes in Accounting Policies*", in para 4.3 defines 'Prior period items' as "*Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the Financial Statements of one or more prior periods".*

10.5 The Schedule III requires the following additional information to be given by way of notes:

Nature of company	Disclosures required
Manufacturing companies	Raw materials under broad heads Goods purchased under broad heads
Trading companies	Purchases of goods traded under broad heads
Companies rendering or supplying services	Gross income derived from services rendered under broad heads
Company that falls under more than one category	It will be sufficient compliance with the requirements, if purchases, sales and consumption of raw material and the gross income from services rendered are shown under broad heads.

10.6 The disclosure requirements to be made for the above in the Financial Statements are discussed as under:

The disclosures required as above are not very clear and give rise to the following questions:

(a) Whether a company is required to disclose quantitative details or not?

(b) Whether a manufacturing company will disclose purchase, sale or consumption of raw materials?

(c) What is meant by "good purchased" in case of manufacturing companies?

(d) While there is a requirement to disclose gross income in case of a service company and sales in case of a company falling under more than one category, there is no clear requirement to disclose sales for a manufacturing or a trading company.

(e) With regard to a company falling under more than one category different interpretations seem possible. One interpretation is that it should disclose purchase, sale and consumption for raw material. The other interpretation is that purchase relates to traded goods, sale relates to all goods sold (both manufactured goods and traded goods) and for raw material, only consumption needs to be disclosed.

10.7 Since the Schedule III gives a note stating that "Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements", a company may consider the following in deciding the disclosures required:

(a) Apparently, there is no need to give quantitative details for any of the items.

(b) Considering the ambiguity and on a conservative interpretation, a manufacturing company may disclose the following under broad heads:

   (i) Consumption of major items of raw materials (including other items classified as raw material such as intermediates/components/packing material)

   (ii) Goods purchased for trading (if any)

   (iii) Though the Schedule III does not specifically require, it is also suggested to disclose major items of opening and closing stock. However, it is not mandatory.

(iv) Considering the requirement to disclose gross income in case of a service company and sales in case of a company falling in more than one category, disclosure of sales of finished goods should also be made under broad heads.

(c) The term "broad heads" may be interpreted to mean broad categories of raw materials, goods purchased, etc. These categories should be decided based on the nature of each business and other facts and circumstances. Normally, 10 percent of total value of sales/services, purchases of trading goods and consumption of raw material is considered as an acceptable threshold for determination of broad heads. Any other threshold can also be considered taking into account the concept of materiality and presentation of true and fair view of Financial Statements.

(d) Similar principle may be followed to decide disclosure requirement in other cases.

10.8 Based on the above perspectives, given below is a suggested format for making this disclosure:

10.8.1 Manufacturing company

(Amount in ₹)

Particulars	Consumption
Raw materials	
Raw material A	XX (YY)
Raw material B	XX (YY)
Others	XX (YY)
Total	**XX (YY)**

Particulars	Purchases
Goods purchased	
Traded item A	XX (YY)
Traded item B	XX (YY)
Others	XX (YY)
Total	**XX (YY)**

Particulars	Sales values	Closing Inventory	Opening Inventory
Manufactured goods			

Finished goods A	XX (YY)	XX	XX
Finished goods B	XX (YY)	XX	XX
Others	XX (YY)	XX	XX
Total	**XX** **(YY)**	**XX**	**XX**
Traded goods			
Traded goods A	XX (YY)	XX	XX
Traded goods B	XX (YY)	XX	XX
Others	XX (YY)	XX	XX
Total	**XX** **(YY)**	**XX**	**XX**

Particulars	WIP
Work in Progress	
Goods A WIP	XX (YY)
Goods B WIP	XX (YY)
Others	XX (YY)
Total	**XX** **(YY)**

10.8.2 Trading company

Particulars	Purchase	Sales
Traded goods		
Traded goods A	XX (YY)	XX (YY)
Traded goods B	XX (YY)	XX (YY)
Others	XX	XX

	(YY)	(YY)
Total	**XX** **(YY)**	**XX** **(YY)**

10.8.3 Service Company

Particulars	Amount
Services rendered	
Service A	XX (YY)
Service B	XX (YY)
Others	XX (YY)
Total	**XX** **(YY)**

Note : Figures in brackets represent previous year figures.

A company falling under more than one category will make the above disclosures, to the extent relevant.

10.9 The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve [Clause (a) of Note 5(iv)]

10.9.1 Disclosure is required for amounts set aside or proposed to be set aside to reserves out of the profits for the period. The said transfers can be in terms of the applicable statute under which the Financial Statements are prepared i.e., the Companies Act, 2013 or any other applicable statute e.g. Income Tax Act, 1961, or RBI Act, 1932, etc. Further, profits may also be appropriated to free reserves as deemed appropriate by the management.

10.9.2 The transfer to reserves as above should, however, not include provisions made to meet any specific liability, contingency or commitment known to exist at the date as on which the Balance Sheet is made up.

10.10 The aggregate, if material, of any amounts withdrawn from such reserves [Clause (b) of Note 5 (iv):

In case the company has made any withdrawals from any reserves created in terms of Clause (a) of Note5(iv) above, the same is to be disclosed separately.

It may be noted that such setting aside as well as withdrawal from reserves is to be disclosed under applicable Line item of Reserves and Surplus, and not under the Statement of Profit and Loss since the same is an appropriation of profits and not a charge against revenue.

10.11 The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments and amounts withdrawn from such provisions, as no longer required [Clause (a) of Note5(v) and Clause (b) of Note5(v)]

The amounts in respect of the items under this requirement should be separately disclosed as a charge to the Statement of Profit and Loss. Provisions no longer required should be credited to the Statement of Profit and Loss.

10.12 Clause (b) of Note 5(vii) requires disclosure for 'Provisions for losses of subsidiary companies'.

However, as per AS-13, a provision in respect of losses made by subsidiary companies is made only when the same results in an other than temporary diminution in the value of investments in the subsidiary. Accordingly, the aforesaid disclosure should be made separately only where such a provision has been made in respect of the investment in such loss-making subsidiary.

10.13 Clause (k) of Note 5(i) requires disclosure for 'expenditure incurred on corporate social responsibility activities'.

This new requirement introduced by the Companies Act 2013 is that the companies which are covered under Section 135 are required to disclose the amount of expenditure incurred on corporate social responsibility activities. The Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities issued may be referred to for disclosure requirements, which are essentially as under:

a) From the perspective of better financial reporting and in line with the requirements of Schedule III in this regard, it is recommended that all expenditure on CSR activities, that qualify to be recognised as expense should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.

b) The notes to accounts relating to CSR expenditure should also contain the following:

(1) Gross amount required to be spent by the company during the year.

(2) Amount spent during the year on:

In cash Yet to be paid in cash Total

(i) Construction/acquisition of any asset

(ii) On purposes other than (i) above

The above disclosure, to the extent relevant, may also be made in the notes to the cash flow statement, where applicable.

(c) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per Accounting Standard (AS) 18, Related Party Disclosures.

(d) Where a provision is made in accordance with paragraph 8 above the same should be presented as per the requirements of Schedule III to the Companies Act, 2013. Further, movements in the provision during the year should be shown separately.

11 Other Disclosures

The Statement of Profit and Loss shall also contain by way of a note the following information, namely:-

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

- Export of goods calculated on F.O.B. basis;
- Royalty, know-how, professional and consultation fees;
- Interest and dividend;
- Other income, indicating the nature thereof

11.1 Value of imports calculated on C.I.F. basis by the company during the financial year [Clause (a) of Note 5(viii)]

The above disclosure is to be given in respect of –

Raw materials;

Components and spare parts;

Capital goods.

11.1.1 One of the requirements of disclosure as a note to the Statement of Profit and Loss is the value of imports of raw materials calculated on C.I.F. basis. The manner in which the term "raw materials" should be interpreted for this purpose, is as discussed in para9.5.1.3 of this Guidance Note.

11.1.2 Disclosure is also required to be made as to the value of imports of components and spare parts and capital goods respectively. The term "components" may be interpreted in the same manner as the term "intermediates or components" in connection with the requirement, discussed earlier in para9.5.1.2 of this Guidance Note, to disclose the consumption of purchased components or intermediates. The term "spare parts" would ordinarily relate to spare parts for plant and machinery and other capital equipment. The total value of imports of components and spare parts may be disclosed in the aggregate. It may be appropriate to sub-classify the value of imports between components and spare parts respectively since the nature of these two items is not entirely similar. Such separate classification however, is not a mandatory requirement of the Schedule III. However, wherever the records for raw materials and components are maintained together, the information required under this clause pertaining to components can be presented collectively with raw materials.

11.1.3 As regards "capital goods", disclosure would be involved in respect of imported plant and machinery, furniture and fixtures, transport equipment, intangible assets and other types of expenditure which is treated as capital expenditure in the books of account. It is undoubtedly anomalous to disclose the value of imports of capital goods by way of a note on the Statement of Profit and Loss, since by the very definition, capital assets do not form part of the Statement of Profit and Loss. However, since this is the specific requirement of the Schedule III, it would have to be complied as such. Since this disclosure is required for the Statement of Profit and Loss, it would not be advisable to disclose the imports of capital goods by way of a note on Fixed Assets- Tangible Assets or Capital work-in-progress, even though it would be more appropriate to do so.

11.1.4 It is significant that this requirement covers only imported spare parts. It apparently does not apply to goods imported for sale, imported stores, etc. However, the practice followed by most companies is that imported stores are being clubbed with imported spare parts for the purposes of this disclosure. This is probably due to the practical difficulty involved in separating stores from spare parts. Hence, where it is not possible to segregate the two owing to practical difficulties, the total value of imports of stores and spare parts may be shown against a caption which clearly indicates that the value shown relates to both the stores as well as the spare parts.

11.1.5 The disclosure in respect of imports of the foregoing items is to be made on accrual basis. This is because disclosure is required in respect of the value of imports "during the financial year". Consequently, if the particular item has been imported during the accounting year, it should be disclosed as such, even though the payment is not made in that year.

11.1.6 It is also to be noted that the disclosure under this requirement relates to the imports as such. It is not linked with the consumption of the material or utilization of capital goods.

11.1.7 While a subsequent requirement relates to expenditure in foreign currency for designated items, the requirement presently under discussion is not linked with any particular expenditure in foreign currency or local currency. Consequently, the value of imports of raw materials, components and spare parts and capital goods is to be disclosed irrespective of whether or not such imports have resulted in an expenditure in foreign currency. It is possible that imports may have been arranged on Rupee payment terms without involving any foreign currency expenditure but even so, the value of the imports would have to be suitably disclosed.

11.1.8 Disclosure should be made in Indian currency. Where the imports involve foreign currency expenditure, the amount be disclosed would be the corresponding Rupee value of the imports as translated in the books of account on normal principles relating to the translation of foreign currencies.

11.1.9 The value of the imports is to be calculated on C.I.F. basis – that is inclusive of cost, insurance and freight. It is possible that the imported materials may have been shipped by an Indian carrier and the insurance may have been arranged with an Indian insurer, so that, really, there is no element of import of services with regard to the insurance and freight. Even so, the Schedule III requires the value of the imports to be disclosed on a C.I.F. basis, and while this may be anomalous in the types of situations indicated above, the requirement should ordinarily be complied with. If for any reason, there is some practical difficulty in disclosing the value of the imports on C.I.F. basis, a footnote should be appended to the statement indicating the precise method by which the value of imports has been arrived at. For example, it may be stated that, because of practical difficulties in disclosing the value of imports on C.I.F. basis, such disclosure has been made on F.O.B. basis. Without attempting to particularize the various circumstances under which it may be difficult to disclose the value of imports on a C.I.F. basis, one example may be cited. A company may have standing arrangements with a shipping line or with an insurer so that all imports are covered through such a standing arrangement. In that case, it may be difficult to allocate the insurance or freight to each specific shipment. Similarly, if a company is a self insurer, or if it owns its own fleet of ships, disclosure of the value of imports cannot be made on a C.I.F. basis. In situations of this kind the matter should be covered by a suitable explanatory note but otherwise, wherever possible, the value of imports should be disclosed on a C.I.F. basis. It may be noted that the requirement to disclose the value on a C.I.F. basis relates to the method of computation of the value, rather than the terms of the import contract. It is not to be implied that this method of valuation is restricted to a case where the import contract is itself on a C.I.F. basis.

11.1.10 Disclosure is required with regard to the value of imports "by the company". This implies that only direct imports by the company are involved in the disclosure. If the company purchases imported materials in the open market, no disclosure would be necessary under this requirement. Similarly, if the company canalized its imports through another agency such as the State Trading Corporation, no disclosure would be required, since it is the latter agency which is the importing entity. On the other hand, if a company purchases import entitlements and thereafter imports materials on the basis of those entitlements, the value of such imports would need to be disclosed, since they are the imports of the company, irrespective of the manner in which the company procured the import entitlements. Within this rather broad statement of the case, it is apprehended that practical difficulties may arise in determining whether or not a particular import has been made "by the company".

11.1.11 For the purpose of this requirement, only direct imports are to be taken into consideration. Imported materials purchased locally, and imports canalized through other sources, need not be disclosed. While this distinction may be clear in the large majority of cases, problems may arise in individual cases. In particular, in the case of indirect imports, care should be taken to determine whether the source from which the imports have been obtained represent an agency or an independent principal. If a company has appointed a person or a company as its agent for the purpose of securing the import of raw materials, etc., the imports through such agent must be regarded as the company's imports, and the value of such imports should be disclosed pursuant to the requirement under this Note. On the other hand, if another person or company has already imported the materials and the company in question merely purchases such imported materials, on a principal to principal basis, (except in cases where importing the materials is done under specific requisition resulting in substance agent-principal relationship) the value of such imports should be ignored by the latter company, and included by the former.

11.1.12 The value of imports should also include goods which are in transit on the Balance Sheet date, provided significant risks and rewards of ownership in those goods have already passed to the purchasing company. For the purpose of determining whether or not the property has passed, reference may be made to the terms of the import contract, and recognized legal principles, relating to this matter. Conversely, goods-in-transit at the beginning of the year should be excluded on a similar basis so that they do not form part of the value of the current year's imports or succeeding year's for the purpose of the same disclosure relating to the value of imports.

11.1.13 Since the requirement is to disclose the value of imports during the accounting year, it may be necessary to determine when the significant risks and rewards of ownership to the goods has passed from the overseas exporter to the Indian importer in accordance with the well recognized legal principles relating to this matter, irrespective of the fact whether or not the goods have been physically received.

11.1.14 A particular problem may, however, arise in the case of import of capital goods where delivery is to be made in installments through part shipments from time to time. The contract may provide for the total value of the entire shipment and it may, therefore, be difficult to determine the separate value of the part shipments received during the accounting year. Since the disclosure which is required is in respect of imports during the accounting year, it may be necessary to estimate, on a reasonable basis, the separate value of part shipments. If such estimates are reasonable, no objection needs be taken thereto.

11.1.15 It follows from this that, in appropriate cases, the disclosure would include the value of goods in transit at the end of the year if the significant risks and rewards of ownership in such goods has already passed to the Indian importer. Conversely, it may be necessary to exclude the value of the opening inventory in transit if the title to such inventory had already passed to the Indian importer prior to the end of the previous year.

11.1.16 For the purpose of working out the C.I.F. value of imports, it may be necessary to make approximations in suitable cases. For example, a company may be actually importing materials on the basis of F.O.B. contracts so that the values directly available from its records would be those relating to F.O.B. terms. In such cases, a standard formula may be applied in order to convert the F.O.B. values to C.I.F. For example, the company's accountant may calculate that a loading of, say, eleven per cent on the F.O.B. values is ordinarily adequate and correct in order to convert the F.O.B. values to C.I.F. If such approximations are reasonable, no objection should ordinarily be taken thereto.

11.2 Expenditure in foreign currency during the financial year [Clause (b) of Note5(viii)]

The above is to be disclosed for expenditure incurred on account of royalty, know-how, professional and consultation fees, interest and other matters;

11.2.1 In addition to the requirement discussed earlier relating to the disclosure of the value imported materials, and the disclosure relating to the consumption of imported materials as compared to indigenous materials, there is also a further requirement to disclose expenditure in foreign currency on account of royalty, know-how, professional consultation fees, interest, and other matters.

11.2.2 In this particular case, the disclosure is to be made with regard to the expenditure in foreign currency. Consequently, if no foreign currency expenditure is involved, no disclosure would be required, even though the specific services covered by this requirement have been imported free of cost or against Rupee payment or against any other method of payment or adjustment not involving the expenditure of foreign currency. Although the disclosure is required to be made with regard to items involving expenditure in foreign currency, the amount to be disclosed would be the Indian Rupee amount. It should be noted that every company is required to follow accrual system of accounting and the requirement refers to 'expenditure', the disclosure should be on the basis of the expenditure incurred and recorded in the books of account and not on the basis of remittance. The appropriate Rupee figure can be obtained by converting the foreign exchange figure through the application of a rate of exchange which is suitable for that purpose, having regard to normal principles of foreign currency translation/conversion in accounts. If so desired, the foreign currency figure may also be given as additional information but this cannot be regarded as mandatory.

11.2.3 While the requirement relating to the disclosure of imports clearly specifies the different heads under which the disclosure is to be made, and while the requirement relating to foreign exchange earnings also similarly indicates the specific heads under which the disclosure is to be classified, there is no such requirement with regard to the disclosure of expenditure in foreign currency. It is true that the specific items in respect of which such disclosure is to be made have been indicated, but this does not by itself imply that the disclosure is to be classified with reference to those items. At the same time, since such classification should not be difficult, it is advisable to classify the foreign currency expenditure between royalty, know-how, professional consultation fess, interest and other matters. In other words, the classification as between these items is certainly desirable but is probably not mandatory, having regard to the precise terms of the Schedule III. It may also be noted that under old Schedule VI, for the same requirement, the practice has been to classify between different heads and disclose.

11.2.4 The various items specified above do not call for any particular comments since they are expressed through well understood terms. The residual item relating to "other matters" appears to be sufficiently exhaustive so as to cover any items for which foreign currency expenditure is involved. It is necessary to point out that disclosure is required with regard to "other matters" rather than with regard to "other similar matters". Consequently, it would not be reasonable to infer that disclosure is limited to items of a nature similar to royalty, know-how, professional consultation fees and interest. At the same time, however, it would be unreasonable to suggest that disclosure should be made once again with regard to the expenditure involved in foreign currency for an item whose import value has already been disclosed in response to the earlier requirement. Ordinarily, the requirement presently under discussion relates to expenditure on intangible items rather than on the import of tangible goods. However, if any foreign currency expenditure on the import of tangible goods has not been disclosed pursuant to the earlier requirements, it would need to be disclosed under this requirement. For example, foreign currency expenditure on the import of stores may not have been disclosed on the basis that the earlier requirement necessitates disclosure only with regard to the value of imports of "components and spare parts". In that case, the foreign currency expenditure involved in the import of stores would need to be disclosed under the requirement presently under discussion since this requirement covers "expenditure in foreign currency" on account of royalty, know-how, professional consultation fees, interest and *other matters.* Disclosure would also be involved under this requirement of any foreign currency expenditure in the payment of taxes in an overseas country on income earned in that country in a case where the payment of such taxes involves actual remittance from India. Where, however, the payment of taxes in the overseas country is made through deduction at source rather than by actual remittance from India, the method of disclosure has been suggested in a subsequent paragraph of this Note dealing with foreign exchange earnings where it has been recommended that foreign exchange earnings received subject to deduction of tax at source should be disclosed both gross and net.

11.2.5 The disclosure of expenditure in foreign currency is to be made on accrual basis since all the items in the Statement of Profit and Loss are stated on an accrual basis.

11.2.6 A further question which needs to be resolved is whether the disclosure is to be made of the gross amount of the expenditure, or of the net amount after tax deduction at source, in a case where such deduction is involved. So far as the company in concerned the gross expenditure is the amount of expenditure incurred in foreign currency even though a part of it may have been paid in Rupees to the Government to meet the statutory obligation of deducting tax at source. Deduction of tax at source by itself is not the finality of the matter and is merely a preliminary stage towards settlement of tax liability of the non-resident. Ultimately, on assessment of the non-resident, the full amount of tax deducted at source may have to be refunded. In view of this, the preferable course seems to be to disclose the gross expenditure that has been incurred by the company.

11.2.7 Disclosure is to be limited only to those cases where the company itself incurs a foreign currency expenditure. Where an expenditure involves foreign currency but the original payment by the company itself is in Rupees, no disclosure is necessary. For instance, if a company has borrowed a loan from a Government agency and incurs expenditure in payment of interest on that loan, the company may be aware that the interest paid by it to the Government agency in Rupees will ultimately be remitted by the Government agency to a foreign lender. However, since the company itself does not incur any foreign currency expenditure, no disclosure is required in its accounts.

11.3 Total value of all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption; [Clause (c) of Note 5(viii)]

11.3.1 Apart from the disclosure relating to the C.I.F. value of imports, separate disclosure is also required with reference to the value of imported raw materials, spare parts and components consumed during the accounting year. There is no guidance, for the purpose of this requirement, as to the manner in which the imported materials are to be evaluated i.e., C.I.F. basis or F.O.B. basis or any other basis. Even though the value of materials imported by the company itself is required to be stated on a C.I.F. basis, it does not follow that this basis is necessarily appropriate to the disclosure of the value of imported materials consumed. In the latter case, it would be more appropriate to make the disclosure on the basis of the actual cost to the company of the imported materials which have been consumed, since it is this cost which enters into the company's accounts. Consequently, the value of imported materials consumed should include not only their cost but also incidental expenses directly related to the purchase of such materials. There is another reason for this suggestion and that is based on the fact that the value imported materials consumed is required to be compared with the value of indigenous materials consumed. Moreover, in the company's accounts, the total figure shown for consumption of materials (inclusive of indigenous and imported materials) would ordinarily be based on the value inclusive of the cost of such materials and various incidental charges. Therefore, in order to facilitate correlation with the total amount shown for consumption of materials in the Statement of Profit and Loss account as well as in order to facilitate comparison between the value of indigenous consumption and imported consumption, it is desirable that the value of imported materials consumed should be stated on a similar and consistent basis by including the cost of such materials and various incidental charges.

11.3.2 On the face of it, it would appear that this requirement duplicates the earlier requirement relating to the disclosure of the value of imports of raw materials, components and spare parts. However, there is a difference. The earlier requirement relates to the disclosure of the value of imports *per se* irrespective of whether or not the materials imported have been consumed in the company's operations. The latter requirement, on the other hand relates only to the value of the imported materials consumed in the company's operation.

11.3.3 As in the case of earlier requirement, it is not relevant to consider whether or not the imported materials which have been consumed have necessitated an expenditure in foreign currency. Even if no foreign currency expenditure is involved, the value of consumption of imported materials is still required to be disclosed.

11.3.4 The disclosure is to be made in Indian currency by applying normal methods for the translation of foreign currencies where the original expenditure was incurred in a foreign currency.

11.3.5 A question may arise whether to include the consumption of locally purchased materials of foreign origin. Apart from the difficulties of ascertaining which locally purchased materials are of imported origin, it is logical to interpret this requirement as requiring disclosure only of materials imported directly or indirectly by the company. This would include materials imported directly by the company as well as indirect imports made to be company's knowledge or at its request through canalizing agents such as the State Trading Corporation.

11.3.6 It is not entirely clear whether the requirement herein implies that the value of imported raw materials, spare parts and components should be separately disclosed for each of these three items, or whether a composite disclosure for all the three items taken together is sufficient. The latter part of this clause states that "the percentage of each to the total consumption" is also to be disclosed. This may be taken to imply that the consumption is to be shown separately for raw materials, spare parts and components respectively. However, wherever the records for raw materials and components are maintained together, the information required under this clause can be presented collectively.

11.3.7 While raw materials are undoubtedly consumed in the course of operations, this term is hardly appropriate to spare parts and components. Spare parts may be utilized for repairs and maintenance or for other similar purposes, and components may be assembled into the finished product. In either case, the spare parts and components can hardly be said to have been "consumed". However, without going into the semantics relating to the word "consumed", the intention appears to be reasonably clear and disclosure may, therefore, be made on the basis of indicating the value of imported spare parts and components utilized in the company's operations.

11.3.8 In addition to disclosing the value of imported raw materials spare parts and components consumed during the accounting year, disclosure is also required with regard to the value of indigenous raw materials, spare parts and components similarly consumed during that year. In both cases, the value of the consumption should be determined on the same identical basis, so that like is compared with like. Thereafter, it is also required that the relative percentages of consumption value in respect of imported items and indigenous items should be stated as a percentage of total consumption for each of the categories of raw materials, spare parts and components respectively.

11.3.9 Care should be taken to ensure that the total consumption agrees with the figures in the Statement of Profit and Loss. In the case of consumption of raw materials, the separate figures for such consumption is generally disclosed in one figure in the Statement of Profit and Loss, in which case, the total consumption classified as between imported and indigenous should agree with this figure. Sometimes, however, the total consumption of raw materials is not shown as one figure in the Statement of Profit and Loss. Instead, a note is given indicating the consumption of raw materials shown under more than one head of account. In that case, care should be taken to ensure that the total figure for consumption of raw materials analysed as between imported and indigenous agrees with the total consumption shown in the Statement of Profit and Loss inclusive of the figure of consumption charged to other heads of account.

11.3.10 The term “spare parts” for the purpose of the foregoing requirements would refer to spares for plant and machinery and other items of a similar nature or intended for a similar purpose. This term would not ordinarily include stores. The term “stores” refers to materials and supplies which assist the manufacturing process but which do not directly enter into the furnished product. It is a term of wider import than “spare parts” and ordinarily, the term “stores” would include “spare parts”. Since the present requirement is limited to spare parts, it would appear to be unnecessary to disclose the separate figures relating to the consumption of stores – imported and indigenous. It is somewhat curious that disclosure should be required with regard to spare parts and not with regard to stores, but this is nevertheless, the logical interpretation of the words used in the relevant clause. Where the segregation between stores and spare parts is not possible owing to practical difficulties, the value of consumption of imported and indigenous stores and spare parts may be shown against a caption which clearly indicates that the value shown relates to both stores and spare parts.

11.3.11 As regards spare parts, the substantive requirement of Schedule III (Other expenses para 9.5.7) requires a composite figure to be disclosed in respect of consumption of stores and spare parts, whereas the analysis here is required only in respect of consumption of spare parts. Consequently, the total figure analysed for consumption of spare parts may not agree directly with the figure disclosed in the Statement of Profit and Loss for consumption of stores and spare parts, unless in the Statement of Profit and Loss, these two figures are separately itemized. In any case, however, a reconciliation statement should be kept on the company’s working paper files to indicate that the figures have been agreed.

11.3.12 As regards components, the clause does not indicate clearly whether the classification of imported and indigenous components is to be restricted to purchased components, or whether it would also include components manufactured internally. Normally, imported components would in any case be restricted to those which are purchased, with the possible exception of a rare case in which components are fabricated outside India by a branch or department of the same company and are then shipped to India for incorporation into the finished product. Ignoring such an exception, it would appear that if imported components are to be restricted to those which are purchased, indigenous components would also have to be similarly restricted, otherwise the comparison would be vitiated. Consequently, it is suggested that this requirement may be interpreted in a manner whereby the classification of components between imported and indigenous would be limited to purchased components, ignoring any components which are manufactured internally.

11.3.13 Under some systems accounting, the consumption is originally charged in the accounts on the basis of standard or pre-determined rates. Periodically, an adjustment is made in the total consumption account in order to accord with the actual rates at which relevant materials may have been purchased. A problem may arise with reference to the classification of the total net debit or credit for such price adjustment as between imported and indigenous consumption. The most obvious method of solving this difficulty – which should be acceptable in most cases – is to allot the total debit or credit adjustment between imported and indigenous consumption, in the same ratio as the figure for imported and indigenous consumption prior to such debit or credit adjustment. A similar procedure may also be followed in the case of any other special debit or credit adjustments which are entered in the consumption accounts to reflect adjustments to the total consumption figure. On a slightly different context, a similar problem arises where the same item is partly purchased locally and partly imported and stocks are not physically kept separately. In such cases, it appears to be permissible to assume that consumption is on a pro-rata basis, e.g., in the ratio of opening stock plus purchase.

11.4 Total amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related [Clause (d) of Note 5(viii)];

11.4.1 The requirement is to the disclosure with regard to the amount remitted to non-resident shareholders on account of dividends. This disclosure is to be made with reference to the amount remitted during the accounting year in foreign currencies. Consequently, if the dividend has been paid to a non-resident shareholder in Indian Rupees, disclosure would not appear to be necessary. Also, if a non-resident shareholder has indicated that all dividends payable to him are to be deposited in a Rupee account with his bankers in India, and if such deposit is actually made on the basis of the necessary sanctions from the Reserve Bank of India, no disclosure would be required because such a deposit does not constitute any payment in foreign currency. It is possible that the non-resident shareholder may ultimately arrange for foreign currency remittances out of his Rupee bank account but this would be no concern of the company which pays the dividends into his Rupee bank account. However, by way of additional information, deposits regarding such dividends paid in the bank account may be given, indicating the fact.

11.4.2 As in the case of other disclosure relating to imports, exports, foreign exchange expenditure and earnings, etc. the amount to be disclosed in respect of foreign currency dividends is to be stated in Indian Rupees. If so desired, additional information may be furnished with regard to the foreign currency equivalent to the dividend, which has been remitted, but the basic requirement is to disclose the rupee amount. Disclosure of the foreign currency equivalent is not mandatory.

11.4.3 Since disclosure is required with regard to the "amount remitted during the year", it would appear that the information is to be furnished in the year of actual payment of dividend rather than in the year in which the dividend is proposed or declared. In other words, the disclosure should be made on a cash basis, contrary to the fact that the other disclosures are to be made on accrual basis.

11.4.4 In addition to the disclosure relating to the amount of dividends remitted in foreign currency, further disclosure is also required with regard to the number of non-resident shareholders to whom the dividends were remitted, the number of shares held by them, and the year to which the dividends relate. These requirements should not be difficult to comply with and no particular problem in likely to be encountered.

11.4.5 A question may arise as to whether or not any information is to be furnished with regard to the number of non-resident shareholders and the number of shares held by them, in particular year in which no dividend has been remitted to the non-resident shareholders. The answer is in negative, since, as already indicated earlier, the information relating to the number of non-resident shareholders and the number of shares held by them is intended to be linked to the basic information relating to the dividends remitted to non-resident shareholders.

11.5 Earnings in Foreign exchange [Clause (e) of Note 5 (viii)]

11.5.1 Foreign exchange earnings have to be classified under the following heads:-

(i) export of goods calculated on F.O.B. basis;

(ii) royalty, know-how, professional and consultation fees;

(iii) interest and dividends; and

(iv) other income (indicating the nature thereof).

11.5.2 In this case also, as in the case of disclosure relating to foreign currency expenditure, the question arises as to whether foreign currency earnings have to be disclosed on a cash basis or on an accrual basis. The considerations relating to this aspect of the matter are similar to those discussed earlier in connection with the requirement relating to the disclosure of foreign currency expenditure. Since the Statement of Profit and Loss is prepared on an accrual basis, it may be suggested that foreign currency earnings should also be disclosed on a similar basis.

11.5.3 Since, foreign exchange earnings are to be disclosed on an accrual basis, the subsequent receipt of foreign exchange in a later year should be ignored, as otherwise the same earnings would be disclosed twice.

11.5.4 A further question which arises is whether the foreign exchange earnings should be disclosed gross of tax or whether they should be disclosed net of any tax deducted at source in the overseas country in which earnings have arisen. One way of looking at the matter is that the actual amount of earnings is the amount received after deduction of overseas tax at source, where such deduction is involved. On the other hand, the tax which is deducted at source in the overseas country is available by way of credit against the tax payable in that country. But for this credit, actual or constructive remittance may be involved from India to the overseas country for the purpose of meeting the tax liability in that country. It is, therefore, suggested that the more appropriate basis of disclosure would be gross of tax with a mention of the net of tax earnings and tax deducted at source. A further advantage of this method of disclosure is that the amount which is so disclosed would agree with the financial accounts, since, in the books of accounts kept in India, the gross amount of the foreign exchange earnings would be credited to revenue, while the tax deducted at source would be debited to an appropriate account relating to payment of taxes.

11.5.5 While the requirement relating to the disclosure of imports requires the “value of imports” to be disclosed, the disclosure of exports requires the “earnings from export of goods” to be disclosed. It would probably have been more consistent if the relevant clause had required the value of exports to be disclosed, rather than the earnings.

11.5.6 Considerations that apply in determining whether a purchase is an import by the company will also apply in determining whether sales is an export by the company. Any sales made direct by the company through an agent to any overseas buyer is an export by the company. However, goods sold to any canalizing agent like the State Trading Corporation for export is not the company’s export.

12 Multiple Activity Companies

Where a company has multiple activities e.g. both manufacturing and trading i.e. it falls under more than one category, it should comply with the various disclosure requirements relating to each of its classified activities. For instance, in respect of its manufacturing activities, such a company should comply with the requirements relating to a manufacturing company, whereas in respect of its trading or service activities, it should comply with the requirements relating to those categories of companies. However, in case of complexities in segregating the required information it would be sufficient compliance if the information is disclosed with respect to main activities with a suitable disclosure explaining the reasons thereof.

13 Consolidated Financial Statements

The Companies Act 2013 has mandated that the companies which have one or more subsidiaries / associates (which as per the Act includes joint ventures) are required to prepare Consolidated Financial Statements, except under certain circumstances exempted under the Act and Rules.

The companies are expected to prepare the standalone financial statements and in addition prepare the consolidated financial statements also.

Schedule III provides for general instructions in regard to the preparation of consolidated financial statements. This is a new addition brought in under Companies Act 2013.

13.1. General requirement

Where the company is required to prepare consolidated financial statements, the company shall *mutatis mutandis* follow the requirements of Schedule III for the standalone financial statements. This means that all the reporting requirements of the Schedule III need to be aggregated and reported for the group as a whole in the consolidated financial statements.

This would also indicate the need to obtain such information for all the subsidiaries / associates of the consolidated financial statements, including where such subsidiaries / associates are not audited under the Companies Act 2013.

However, due note has to be taken of the fact that the Schedule III itself states that the provisions of the schedule are to be followed *mutatis mutandis* to a consolidated financial statement. MCA has also clarified vide General Circular No. 39 / 2014 dated 14th October 2014 that Schedule III to the Act read with the applicable Accounting Standards does not envisage that a company while preparing its CFS merely repeats the disclosures made by it under stand-alone accounts being consolidated. Accordingly, the company would need to give all disclosures relevant for CFS only.

In this context, the requirements of Schedule III shall apply to a CFS, subject to the following exemptions / modifications based on the relevance to the CFS:

Schedule III Requirement	Applicability to CFS (if left blank, is applicable, as it is)
Share capital – authorized, issued, subscribed and paid up	It is adequate to present paid up capital and any calls in arrears Note: It has no relevance in the CFS context.
Capital reserve or goodwill arising on consolidation	Needs to be shown as a separate line item on the face of the Balance Sheet Note: IFRS / Ind AS does not require this to be stated separately. However, as per AS, differing treatment is

	given to goodwill arising on amalgamation and goodwill arising on consolidation and even SEBI format requires this to be separately disclosed.
(a) Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case. (b) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated (c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated (d) Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the Balance Sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested Note: This item is required to be disclosed even if it is exempted as per AS- 21 by keeping it here, as it is only reinforcing the regulatory requirement for reporting – what is required by	On all these items, disclosure can be limited to those which are material to the CFS; materiality could be considered at 10% of the respective balance sheet item

AS 21 cannot override regulatory requirements	
Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'	Separate notes should be given for such monies due outside the group in respect of entities which are consolidated.
Requirement to disclose excise duty separately	To be disclosed where such information is available for the entities consolidated. Note: Though AS 9 states excise to be shown separately, where subsidiaries are not disclosing it, it would not be practical and also no benefit is derived by disclosure of this.

(a) Payments to the auditor as (a) auditor, (b) for taxation matters, (c) for company law matters, (d) for management services, (e) for other services, (f) for reimbursement of expenses (b) In case of Companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities (c) Raw materials under broad heads (d) goods purchased under broad heads (e) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads (f) In the case of companies rendering or supplying services, gross income derived form services rendered or supplied under broad heads (g) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads	Not relevant at CFS level and hence, may be dispensed with
(h) In the case of other companies, gross income derived under broad heads (i) In the case of all concerns having works in progress,	Not relevant at CFS level and hence, may be dispensed with

works-in-progress under broad heads (j) Value of imports calculated on C.I.F basis by the company during the financial year in respect of (i) Raw materials (ii) Components and spare parts (iii) Capital goods (k) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters (l) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption	
(m) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related (n) Earnings in foreign exchange classified under the following heads, namely: (i) Export of goods calculated on F.O.B. basis (ii) Royalty, know-how, professional and	Not relevant at CFS level and hence, may be dispensed with

consultation fees (iii) Interest and dividend (iv) Other income, indicating the nature thereof	

13.2. Accounting Standards

The Consolidated Financial Statements shall also disclose the information as required under the various accounting standards applicable.

13.3. Minority Interest

Profit or loss attributable to "minority interest" shall be shown as an allocation for the period in the statement of profit and loss.

In the Balance Sheet, "minority interest" shall be presented within equity separately from equity of the owners of the parent.

13.4. Additional information on the entities included in the consolidated financial statements

Schedule III requires specific disclosure of additional information on the entities which are included in the consolidated financial statement in the following format.

Name of the entity in	**Net Assets i.e., total assets minus total liabilities**		**Share in profit or loss**	
	As % of Consolidated net assets	Amount	As % of Consolidated profit or loss	Amount
1	2	3	4	5
Parent Subsidiaries Indian				
1				
2				
3				
…				
…..				
Foreign				
1				
2				
3				
…				
…..				
Minority interest in all subsidiaries Associates (Investment as per equity method)				

Indian				
1				
2				
3				
…				
…				
Foreign				
1				
2				
3				
…				
…..				
Joint Ventures (as per proportionate consolidation/ Investment as per equity method)				
1				
2				
3				
…				
…..				
Foreign				
1				
2				
3				
…				
…..				
TOTAL				

In this context, it needs to be considered that in order to ensure that the total can be matched with the reported profits and net assets in the consolidated financial statements, the inter company eliminations needs to be adjusted to the respective entities which are part of the consolidated financial statements. This would require management to take judgements as to which entity the profit element and inter company balances are to be adjusted from in providing for an entity wise break up of net profits and net assets.

13.5. Entities not consolidated

Entities which are not covered in the consolidated financial statement, whether subsidiaries, associates or joint ventures are to be listed in the consolidated financial statement along with the reasons for not consolidating such entities. This requirement is also in line with the requirements of the accounting standard on consolidated financial statements.

13.6 Comparative figures

Schedule III states that except for the first financial statements prepared by a company after incorporation, presentation of comparative amounts is mandatory. Schedule III however, clarifies that in case of any conflict between Accounting Standards and Schedule III, Accounting Standards will prevail over the requirements of Schedule III. The transitional provisions of AS 21 exempt presentation of comparative numbers in the first set of consolidated financial statements prepared, even by an existing group. Hence, an existing group preparing consolidated financial statements for the first time under AS 21, need not present comparative information.

13.7 Definition of terms relevant for consolidation

The terms "Control", "Subsidiary" and "Associate" are defined very differently in the Companies Act as compared to definition in Accounting Standards. Rule 6 of the Companies (Accounts) Rules however states that consolidated financial statements shall be prepared in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. Accordingly, for removal of all doubts it is hereby clarified that for the purposes of preparing consolidated financial statements, the definitions of the above terms as given in Accounting Standards should be followed.

Note: Schedule III to the Companies Act, 2013 is annexed at the end of Module-I.