CHAPTER 1

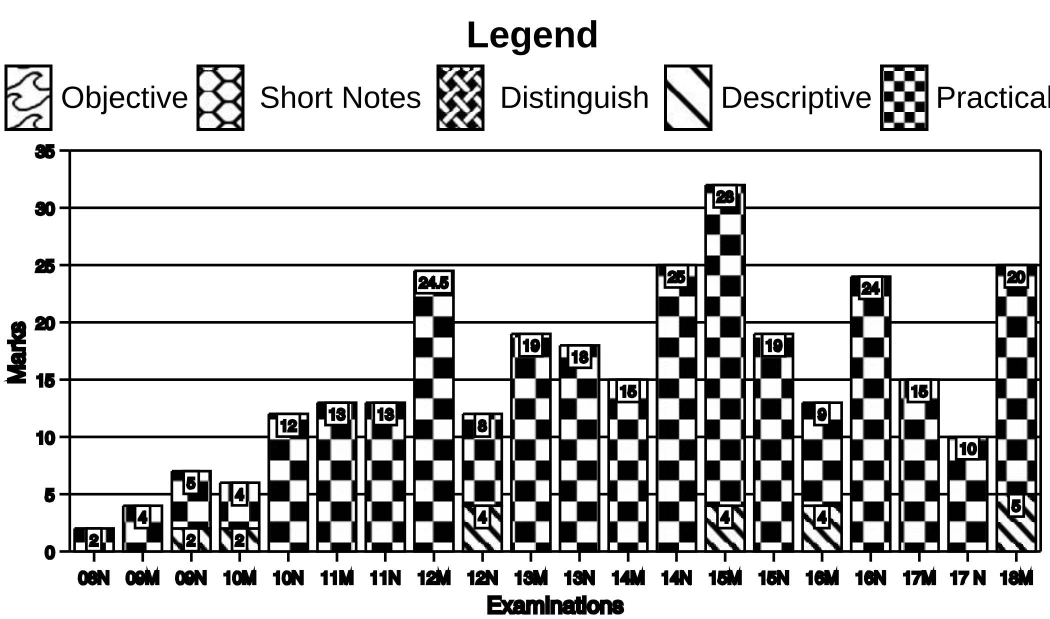
Application of Accounting Standards and Guidance Notes

This Chapter Covers: Study's Chapter: 1 and 2

Chapter Comprises: *☞ AS 7, AS 9, AS 14, AS 18, AS 19, AS 20, AS 24, AS 26, AS 29 ☞ Status of Guidance Notes ☞ Guidance Notes on Accounting Aspects ☞ An Overview of Guidance Notes.*

THE GRAPH .... ***Trend Analysis***

Marks of Objective, Short Notes, Distinguish Between, Descriptive & Practical Questions



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TIME MANAGER		. . . . ***Plan and Manage your Time***						
Time	***First In-depth learning***	***Instant Revision (in hours)***		***Periodic Revision (in hours)***				
	i.e..... .... Day 1	Next day i.e.... .... Day 2	After 7 days i.e. on .... Day 8	After 30 days i.e. on .... Day 30	After 60 days i.e. on .... Day 60	After 90 days i.e. on .... Day 90	Fix as per your need.	
1. Budgeted	16	4.00	3.12	2.20	1.35	1.35		
2. Actual								
3. Variance (1-2)								

QUICK LOOK	. . . . ***Weightage Analysis***	
Repeatedly Asked Questions	**Common Answered Questions**	**Must Try Question**

1 *AS - 7 Construction Contracts*

Q.1.1	**2009 - Nov [1] (viii)**	**Descriptive**
Explain contract costs as per Accounting Standard-7 related to 'Construction Contracts'. (2 marks) *[IPCC Gr. I]*		

Answer:

According to AS 7 "Construction Contracts (revised 2002)", contract cost should comprise:

1. Costs that relate directly to the specific contract;

2. Costs that are attributable to contract activity in general and can be allocated to the contract;
3. Other costs as are specifically chargeable to the customer under the terms of the contract.

Q.1.2	2010 - Nov [7] (c)	Practical

Answer the following :
An amount of ₹ 9,90,000 was incurred on a contract work upto 31-3-2010. Certificates have been received to date to the value of ₹ 12,00,000 against which ₹ 10,80,000 has been received in cash. The cost of work done but not certified amounted to ₹ 22,500. It is estimated that by spending an additional amount of ₹ 60,000 (including provision for contingencies) the work can be completed in all respects in another two months. The agreed contract price of work is ₹ 12,50,000. Compute a conservative estimate of the profit to be taken to the Profit and Loss Account as per AS-7. (4 marks)

Answer:

Computation of Estimated Profit as per AS 7

Particulars	**₹**
Expenditure incurred upto 31.3.2010	9,90,000
Estimated additional expenses (including provision for contingency)	60,000
Estimated cost (A)	10,50,000
Contract price (B)	12,50,000
Total estimated profit [(B-A)]	2,00,000
Percentage of completion (9,90,000/10,50,000) × 100	94.29%

Computation of estimate of the profit to be taken to Profit and Loss Account:

$$= \text{Total estimated profit} \times \frac{\textbf{Expenses incurred till 31.3.2010}}{\textbf{Total estimated cost}}$$

$$= 2,00,000 \times \frac{\mathbf{9,90,000}}{\mathbf{10,50,000}} = 1,88,571$$

Provision:

According to AS-7, 'Construction Contracts', 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 stage of completion of the contract activity at the reporting date.

Analysis and Conclusion:

Therefore estimated profit amounting ₹ 1,88,571 should be recognised as revenue in the statement of profit and loss.

Q.1.3	2011 - Nov [7] (d)	Practical

Answer the following:

From the following data, show. Profit and Loss A/c (Extract) as would appear in the books of a contractor following Accounting Standard -7:

	(₹ in lakhs)
Contract Price (fixed)	480.00
Cost incurred to date	300.00
Estimated cost to complete	200.00

(4 marks) *[IPCC Gr. I]*

Answer :

Calculation of Estimated Total Cost

Particulars	(₹ in lakhs)
Cost incurred to date	300
Estimate of cost completion	200
Estimated total cost in completing the contract	500

Percentage of completion (300/500) × 100 = 60%

Revenue recognised as a percentage to contract price

= 60% of ₹ 480 lakhs = ₹ 288 lakhs

As per para 35 of AS 7 'Construction Contracts', when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Accordingly, expenses to be recognized in the Profit and Loss Account will be

	(₹ in lakhs)
Total foreseeable loss (500 - 480)	20
Less: Loss for the current year (300 - 288)	(12)
Expected loss to be recognized immediately as per para 35 of AS 7	8

Profit and Loss A/c (An Extract)

	(₹ in lakhs)		(₹ in lakhs)
To Construction cost	300	By Contract price	288
To Estimated loss on completion of contract	8		
	?		?

Q.1.4	2012 - May [1] {C} (a), RTP	Practical

M/s Excellent Construction Company Limited undertook a contract to construct a building for ₹ 3 Crore on 1st September, 2011. On 31st March, 2012 the company found that it had already spent ₹ 1 Crore 80 Lakhs on the construction. Prudent estimate of additional cost for completion was ₹ 1 Crore 40 Lakhs. What amount should be charged, to revenue in the final accounts for the year ended on 31st March, 2012, as per the provisions of Accounting Standard 7 "Construction Contracts (Revised)"?

(5 marks) *[IPCC Gr. I]*

Answer:

Computation of Estimated Cost of Construction:

Particulars	₹ in crores
Cost of construction incurred till date	1.80
Add: Estimated future cost	1.40
Total estimated cost of construction	3.20

Percentage of completion of contract till date to total estimated cost of construction = ₹ (1.80/3.20) × 100 = 56.25%

Proportion of total contract price considered as revenue as per AS 7 (Revised)
= Contract price × percentage of completion
= ₹ 3 crores × 56.25% = ₹ 1.6875 crores

Q.1.5	2014 - May [1] {C} (d)	Practical

M/s. Highway Constructions undertook the construction of a highway on 01.04.2013. The contract was to be completed in 2 years. The contract price was estimated at ₹ 150 crores. Up to 31.03.2014 the company incurred ₹ 120 crores on the construction. The engineers involved in the project estimated that a further ₹ 45 crores would be incurred for completing the work.

What amount should be charged to revenue for the year 2013-14 as per the provisions of Accounting Standard 7 "Construction Contracts"? Show the extract of the Profit & Loss A/c in the books of M/s. Highway Constructions. (5 marks) *[IPCC Gr. I]*

Answer :

Statement showing the amount to be charged to Revenue as per AS 7

	₹ in crores
Cost of construction incurred upto 31.03.2014	120
Add: Estimated future cost	45
Total estimated cost of construction	165
Degree of completion (120/165x100)	72.73%
Revenue recognized (72.73% of 150)	109 (approx)
Total foreseeable loss (165 - 150)	15
Less: Loss for the current year (120-109)	11
Loss to be provided for	4

Profit and Loss Account (Extract)

	₹ in crores		₹ in crores
To Construction Costs	120	By Contract Price	109
To Provision for loss	4	By Net loss	15
	124		124

Q.1.6	2015 - May [1] {C} (b)	Practical

A construction contractor has a fixed price contract for ₹ 9,000 lacs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

(Amount ₹ in lacs)

	Year 1	Year 2	Year 3
Initial Amount for revenue agreed in contract	9,000	9,000	9,000
Variation in Revenue (+)	–	200	200
Contracts costs incurred up to the reporting date	2093	6168*	8100**
Estimated profit for whole contract	950	1,000	1,000

*Includes ₹ 100 lacs for standard materials stored at the site to be used in year 3 to complete the work.

**Excludes ₹ 100 lacs for standard material brought forward from year 2.

The variation in cost and revenue in year 2 has been approved by customer.

Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised). (5 marks) *[IPCC Gr. I]*

Answer:

The amounts of revenue, expenses and profit recognized in the statement of profit and loss in three years are shown below:

(Amount in ₹ lakhs)

	Upto the reporting date	**Recognized in prior years**	**Recognized in current year**
Year 1			
Revenue (9,000 x 26%)	2,340	–	2,340
Expenses (8,050 x 26%)	2,093	–	2,093
Profit	247	–	247
Year 2			
Revenue (9,200 x 74%)	6,808	2,340	4,468
Expenses (8,200 x 74%)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 100%)	9,200	6,808	2,392
Expenses (8,200 x 100%)	8,200	6,068	2,132
Profit	1,000	740	260

Working Note :

	Year 1	**Year 2**	**Year 3**
Revenue after consider variations	9,000	9,200	9,200
Less: Estimated profit for whole contract	950	1,000	1,000
Estimated total cost of the contract (A)	8,050	8,200	8,200
Actual cost incurred upto the reporting date (B)	2,093	6,068	8,200
		(6,168-100)	(8,100+100)
Degree of completion (B/A)	26%	74%	100%

Q.1.7	2016 - May [1] {C} (a), RTP	Practical

Uday Constructions undertake to construct a bridge for the Government of Uttar Pradesh. The construction commenced during the financial year ending 31.03.2016 and is likely to be completed by the next financial year. The contract is for a fixed price of ₹ 12 crores with an escalation clause. The costs to complete the whole contract are estimated at ₹ 9.50 crores of rupees. You are given the following information for the year ended 31.03.2016:

Cost incurred upto 31.03.2016 ₹ 4 crores

Cost estimated to complete the contract ₹ 6 crores

Escalation in cost by 5% and accordingly the contract price is increased by 5%.

You are required to ascertain the state of completion and state the revenue and profit to be recognized for the year as per AS-7.

(5 marks) *[IPCC Gr. I]*

Answer:

	₹ in crore
Cost of construction of bridge incurred 31.3.16	4.00
Add: Estimated future cost	6.00
Total estimated cost of construction	10.00
Contract Price (12 crore x 1.05)	12.60 crore

Stage of completion

Percentage of completion till date to total estimated cost of construction

= (4/10)×100

= 40%

Revenue and Profit to be recognized for the year ended 31st March, 2016 as per AS 7

Proportion of total contract value recognized as revenue = Contract price × percentage of completion
= ₹ 12.60 crore × 40% = ₹ 5.04 crore
Profit for the year ended 31st March, 2016 = ₹ 5.04 crore less ₹ 4 crore = 1.04 crore.

Q.1.8	2016 - Nov [1] {C} (a)	Practical
GTI Ltd. negotiates with Bharat Oil Corporation Ltd. (BOCL), for construction of "Retail Petrol and Diesel Outlet Stations". Based on proposals submitted to different Regional Offices of BOCL, the final approval for one outlet each in Region X, Region Y, Region Z is awarded to GTI Ltd. A single agreement is entered into between two. The agreement lays down values for each of the three outlets i.e. ₹ 102 Lakhs, ₹ 150 Lakhs, ₹ 130 Lakhs for Region X, Region Y, Region Z respectively. Agreement also lays down completion time for each Region. Comment whether GTI Ltd. will treat it as single contract or three separate contracts with reference to AS-7? (5 marks) *[IPCC Gr. I]*		

Answer:

Provision:

As per AS-7 'Construction Contracts' when a contract covers a number of assets, the construction of each asset should be treated as a separate contract when:

1. separate proposal have been submitted for each asset;
2. 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
3. the costs and revenues of each asset can be identified.

Analysis:

In the given case, GTI Ltd. negotiates with Bharat Oil Corporation Ltd.
Separate proposal is submitted for each construction, though a single agreement is entered between the two. Also values for each contract is defined separately such as ₹ 102 Lakhs, ₹ 150 Lakhs and ₹ 130 Lakhs for Region X, Region Y and Region Z respectively.

Conclusion:

Thus, GTI Ltd. is required to treat construction of each unit as a separate construction contract. Therefore, three separate contract accounts must be recorded and maintained in the books of GTI Ltd. For each contract principles of revenue and cost recognition must be applied separately and net income will be determined for each asset as per AS-7.

Q.1.9	2017 - May [1] {C} (c)	Practical

Akar Ltd. signed on 01/04/16, a construction contract for ₹ 1,50,00,000. Following particulars are extracted in respect of contract, for the period ending 31/03/17.

- Materials issued ₹ 75,00,000
- Labour charges paid ₹ 36,00,000
- Hire charges of plant ₹ 10,00,000
- Other contract cost incurred ₹ 15,00,000
- Out of material issued, material lying unused at the end of period is ₹ 4,00,000
- Labour charges of ₹ 2,00,000 are still outstanding on 31.3.17.
- It is estimated that by spending further ₹ 33,50,000 the work can be completed in all respect.

You are required to compute profit/loss to be taken to Profit and Loss Account and additional provision for foreseeable loss as per AS-7.

(5 marks) *[IPCC Gr. I]*

Answer:

Computation of Amount to be charged to P & L and additional Provision (As per AS-7)

Particulars		Amount (₹)
Cost of construction incurred upto 31.03.17 (W. N.-1)		1,34,00,000
Add:	Estimated Future cost	33,50,000
	Total Estimated cost of construction	1,67,50,000
	Degree of Completion $\left(\frac{1,34,00,000}{1,67,50,000} \times 100\right)$	80%

	Revenue Recognized (1,50,00,000 × 80%)	1,20,00,000
	Total Foreseeable loss (1,67,50,000 – 1,50,00,000)	17,50,000
Less:	Loss of Current Year (1,34,00,000 – 1,20,00,000)	(14,00,000)
	Additional Provision for Foreseeable loss	3,50,000

Working Note:

1. **Cost of Construction incurred upto 31.03.17**

Particulars	Amount (₹)	Amount (₹)
Material Issued	75,00,000	
(–) Unused Material	(4,00,000)	71,00,000
Labour Charges Paid	36,00,000	
+ Outstanding	2,00,000	38,00,000
Hire Charges of Plant		10,00,000
Other Contract Cost		15,00,000
		1,34,00,000

Q.1.10	2018 - May [1] {C} (a)	Practical

Sarita Construction Co. obtained a contract for construction of a dam. The following details are available in records of company for the year ended 31st March, 2018:

	₹ in lakhs
Total Contract Price	12,000
Work Certified	6,250
Work not certified	1,250
Estimated further cost to completion	8,750
Progress payment received	5,500
Progress payment to be received	1,500

Applying the provisions of Accounting Standard 7 "Accounting for Construction Contracts" you are required to compute:

(i) Profit/Loss for the year ended 31st March, 2018.
(ii) Contract work in progress as at end of financial year 2017-18.
(iii) Revenue to be recognized out of the total contract value.
(iv) Amount due from / to customers as at the year end. (5 marks)

Q.1.11	RTP	Practical

X Undertook a Contract for ₹ 15,00,000 on an arrangement that 80% of the value of work done as certified by the architect of the Contractee, should be paid immediately and that the remaining 20% be retained until the Contract was completed.

In Year 1, the amounts expended were ₹ 3,60,000, the work was certified for ₹ 3,00,000 and 80% of this was paid as agreed. It was estimated that future expenditure to complete the Contract would be ₹ 10,00,000.

In Year 2, the amounts expended were ₹ 4,75,000. Three-fourths of the Contract was certified as done by December 31st and 80% of this was received accordingly. It was estimated that future expenditure to complete the Contract would be ₹ 4,00,000.

In Year 3, the amounts expended were ₹ 3,10,000 and on June 30th the whole Contract was completed.

Show how Contract Revenue would be recognised in the P&L A/c each year.

Answer:

Particulars	Year 1	Year 2	Year 3
1. Contract Price	15,00,000	15,00,000	15,00,000
2. Cost Incurred till date	3,60,000	8,35,000	11,45,000
3. *Add:* Costs Expected	10,00,000	4,00,000	—
4. **Expected Total Contract Cost**	**13,60,000**	**12,35,000**	**11,45,000**
5. % of Completion	26.47%	67.61%	100%

$= \frac{\text{Cost Till Date}}{\text{Total Contract Costs}}$			
6. Total Contract Revenue	15,00,000	15,00,000	15,00,000
7. Contract Revenue to be recognised = Total Revenue × % of Completion	3,97,050	10,14,150	15,00,000
8. Contract Costs	3,60,000	8,35,000	11,45,000
9. **Profit**	**37,050**	**1,79,150**	**3,55,000**

Q.1.12	RTP	Practical

XYZ & Co. a Firm of Contractors, obtained a Contract for Construction of bridges across the river Revathi. The following details are available in the records kept for the year ending 31st March. (information in ₹ Lakhs)

Total Contract Price	1,000	Progress Payment Received	400
Costs incurred till date	605	Progress Payment to be Received	140
Estimated further Cost to Completion	495		

The Firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS - 7

Answer:

- Percentage of Completion = $\frac{\text{Cost Incurred Till Date}}{\text{Estimated Total Costs}} = \frac{₹605}{₹1,100} = 55\%$
- Total Expected Loss to be provided for, as per Para 35 = Contract Price (-) Total Costs = ₹ 100 Lakhs.

Contract Revenue as per Para 21 = 55% of ₹ 1,000 Lakhs = 550 Lakhs
Less: Contract Costs as per Para 21 = 605 Lakhs
Loss on Contract = 55 Lakhs
Less: Further provision required in respect of Expected Loss = 45 Lakhs (Bal. Figure)
Expected Loss recognised as per Para 35 = 100 Lakhs

Amount due from / to customers = Contract Costs + Recognised Profits (–) Recognised Losses (–) Progress Billings

= 605 + Nil (–) 100 (–) 540 = (35) Lakhs Amount Due to Customers.

This amount of ₹ 35 Lakhs will be shown in the Balance Sheet as a Liability.

Note: Progress Billings = Payments Received + Payments billed but not received.

Q.1.13	RTP	Practical
XYZ Construction Co. Ltd. undertook a contract on 1st January to construct a building for ₹ 80 Lakhs. The Company found on 31st March that it had already spent ₹ 58,50,000 on the construction. Prudent estimate of additional cost for completion was ₹ 31,50,000. What amount should be charged to Revenue and what amount of Contract Value to be recognized as Turnover in the accounts for the year ended 31st March as per provisions of AS-7?		

Answer:

Estimated Total Contract Costs = Cost till date + Further Costs = ₹ 58,50,000 + ₹ 31,50,000 = ₹ 90,00,000

Percentage of Completion = $\frac{\text{Cost Incurred Till Date}}{\text{Estimated Total Costs}} = \frac{₹58.50}{₹90.00}$ = 65%

Total Expected Loss to be provided for = Contract Price (–) Total Costs = ₹ 80 (–) ₹ 90 = ₹ 10,00,000.

Contract Revenue as per Para 21 = 60% of ₹ 80 Lakhs = ₹ 52,00,000 (Contract Revenue to be recognized)

- Percentage of completion = $\frac{\text{Cost Till Date}}{\text{Estimated Total Costs}} = \frac{300}{300+200}$ = 60%
- Total Expected Loss to be provided for, as per Para 35 = Contract Price - Total Costs = 480- 500 = ₹ 20 Lakhs.

Contract Revenue as per Para 21	=	60% of ₹ 480 Lakhs
	=	288 Lakhs (Contract Revenue to be recognized)
Less: Contract Costs as per Para 21	=	300 Lakhs (Contract Expenses to be recognized)
Loss on Contract	=	12 Lakhs
Less: Further provision required in respect of expected loss	=	8 Lakhs (Bal. Figure)

Expected Loss recognised as per Para 35 = 20 Lakhs (Loss on Contract to be recognized)

Q.1.14	RTP	Practical
XYZ Ltd. undertook a Contract for building a Crane for ₹ 10 Lakhs. As on 31st March of a financial year, it incurred a cost of ₹ 1.50 Lakhs and expects that ₹ 9 Lakhs more will be required for completing the crane. It has received so far ₹ 1.20 Lakhs as Progress Payment. Discuss the treatment of the above under AS-7.		

Answer:

- Percentage of Completion = $\frac{\text{Cost Incurred Till Date}}{\text{Estimated Total Costs}} = \frac{₹1.50}{₹10.50}$ = 14.29%
- Total Expected Loss to be provided for, as per Para 35 = Contract Price (–) Total Costs = ₹ 0.50 Lakhs.

Contract Revenue as per Para 21 = 14.29% of ₹ 10 Lakhs = 1.43 Lakhs

Less: Contract Costs = 1.50 Lakhs

Loss on Contract = 0.07 Lakhs

Less: Further provision required in respect of Expected Loss = 0.43 Lakhs (Bal. Figure)

Expected Loss recognised as per Para 35 = 0.50 Lakhs

Amount due from / to customers = Contract Costs + Recognised Profits (–) Recognised Losses (–) Progress Billings

= 1.50 + Nil (–) 0.50 (–) 1.20 = (0.20) Lakhs Amount Due to Customers.

This amount of ₹ 0.20 Lakhs will be shown in the Balance Sheet as a Liability.

2 AS - 9 Revenue Recognition

Q.2.1	2010 - May [1] (viii)	Descriptive

According to Accounting Standard-9, when revenue from sales should be recognised? (2 marks) *[IPCC Gr. I]*

Answer:

According to AS 9 'Revenue Recognition', revenue from sales should be recognised only when requirements as to performance are satisfied provided that at the time of performance it is not unreasonable to expect ultimate collection. These requirements can be given as follows:

(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.

Q.2.2	2008 - Nov [5] (iii)	Practical

Answer the following :
Y Ltd. used certain resources of X Ltd. In return X Ltd. receives ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respectively, from Y Ltd. during the year 2007-08. State on what basis X Ltd. should recognize their revenue, as per AS 9. (2 marks) *[IPCC Gr. I]*

Answer:

According to AS-9 on 'Revenue Recognition', interest of ₹ 10 lakhs received in the year 2007-08 should be recognized on the time proportion basis taking into account the amount outstanding and the rate applicable; whereas royalty of ₹ 15 lakhs received in the same year should be recognized on accrual basis as per the terms of relevant agreement.

Q.2.3	2011 - Nov [7] (b), RTP	Practical

Answer the following:
M/s. SEA Ltd. recognized ₹ 5.00 lakhs on accrual basis income from dividend during the year 2010-11, on shares of the face value of ₹ 25.00 lakhs held by it in Rock Ltd. as at 31st March, 2011. Rock Ltd. proposed dividend @ 20% on 10th April, 2011. However, dividend was declared on 30th June, 2011. Please state with reference to relevant Accounting Standard, whether the treatment accorded by SEA Ltd. is in order.

(4 marks) *[IPCC Gr. I]*

Answer:

Provision:

According to para 8.4 of AS 9 "Revenue Recognition", dividends from investments in shares are not recognized in the statement of Profit and Loss until the right to receive dividends is established.

Analysis and Conclusion:

In the given situation the dividend is proposed on 10th April, 2011, while it was declared on 30th June, 2011. Hence, the right to receive dividend is established on 30th June, 2011 only. Therefore, on applying the provisions stated in the standard, income from dividend on shares should be recognized by Sea Ltd. in the financial year 2011-2012 only.

Therefore, the recognition of income from dividend of ₹ 5 lakhs, on accrual basis, in the financial year 2010-11 is not in accordance with AS 9.

Q.2.4	2013 - May [7] (d)	Practical

Answer the following:

(d) M/s. Moon Ltd. sold goods worth ₹ 6,50,000 to Mr. Star. Mr. Star asked for a trade discount amounting to ₹ 53,000 and same was agreed to by M/s. Moon Ltd. The sales was effected and goods were dispatched. On receipt of goods, Mr. Star has found that goods worth ₹ 67,000 are defective. Mr. Star returned defective goods to M/s. Moon Ltd. and made payment due amounting to ₹ 5,30,000. The accountant of M/s. Moon Ltd. booked the sale for ₹ 5,30,000. Discuss the contention of the accountant with reference to Accounting Standard (AS) 9. (4 marks) *[IPCC Gr. I]*

Answer:

Provisions

- **As per AS-9, Revenue Recognition,** revenue is the gross inflow of cash, receivable or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods.
- However, trade discounts and volume rebates given in the ordinary course of business should be deducted in determining revenue.
- Revenue from sales should be recognized at the time of transfer of significant risks and rewards.
- If the delivery of the sales is not subject to approval from customers, then the transfer of significant risks and rewards would take place when the sale is affected and goods are dispatched.

Analysis and Conclusion:

- In the given case, if trade discounts allowed by M/s. Moon Ltd. are given in the ordinary course of business, M/s. Moon Ltd. should record the sales at ₹ 5,97,000 (i.e. ₹ 6,50,000 – ₹ 53,000) and goods returned worth ₹ 67,000 are to be recorded in the form of sales return.
- However, when trade discount allowed by M/s. Moon Ltd. is not in the ordinary course of business, M/s. Moon Ltd. should record the sales at gross value of ₹ 6,50,000. Discount of ₹ 53,000 in price and return of goods worth ₹ 67,000 are to be adjusted by suitable provisions.
- M/s Moon Ltd. might have sent the credit note of ₹ 1,20,000 to Mr. Star to account for these adjustments. In both the cases, the contention of the accountant to book the sales for ₹ 5,30,000 is not correct.

Q.2.5	2013 - Nov [1] {C} (c), RTP	Practical

A Ltd. entered into a contract with B Ltd. to despatch goods valuing ₹ 25,000 every month for 4 months upon receipt of entire payment. B Ltd. accordingly made the payment of ₹ 1,00,000 and A Ltd. started despatching the goods. In third month, due to a natural calamity, B Ltd. requested A Ltd. not to despatch goods until further notice though A Ltd. is holding the remaining goods worth ₹ 50,000 ready for despatch. A Ltd. accounted ₹ 50,000 as sales and transferred the balance to Advance Received against Sales. Comment upon the treatment of balance amount with reference to the provisions of Accounting Standard 9.

(5 marks) *[IPCC Gr. I]*

Answer:

Analysis:

According to AS-9, Revenue Recognition, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are 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.

Conclusion:

In the given problem transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. Also, the sale price has been recovered by the seller. Hence, the sale is complete but delivery has been postponed at buyer's request. A Ltd. should recognize the entire sale of ₹ 1,00,000 (₹ 25,000 x 4) and no part of the same is to be treated as Advance Receipt against Sales.

Q.2.6	2014 - Nov [1] {C} (b)	Practical

Sarita Publications publishes a monthly magazine on the 15th of every month. It sells advertising space in the magazine to advertisers on the terms of 80% sale value payable in advance and the balance within 30 days of the release of the publication. The sale of space for the March 2014 issue was made in February 2014. The magazine was published on its scheduled date. It received ₹ 2,40,000 on 10.3.2014 and ₹ 60,000 on 10.4.2014 for the March 2014 issue.
Discuss in the context of AS 9 the amount of revenue to be recognized and the treatment of the amount received from advertisers for the year ending 31.3.2014. What will be the treatment if the publication is delayed till 2.4.2014? (5 marks) *[IPCC Gr. I]*

Answer:

According to AS-9, 'Revenue Recognition', 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 as the service is performed, whichever relates the revenue to the work accomplished.

In this case, income accrues when the related advertisement appears before public.

The advertisement service would be considered as performed on the day the advertisement is seen by public and hence revenue is recognized on that date, so in this case, it is 15.03.2014, the date of publication of the magazine.

Therefore, ₹ 3,00,000 (₹ 2,40,000 + ₹ 60,000) is recognized as income in March, 2014. The terms of payment are not relevant for considering the date on which revenue is to be recognized. ₹ 60,000 is treated as amount due from advertisers as on 31.03.2014 and ₹ 2,40,000 will be treated as payment received against the sale.

Whereas, if the publication is delayed till 02.04.2014 revenue recognition will also be delayed till the advertisements get published in the magazine. In such case revenue of ₹ 3,00,000 will be recognized for the year ended 31.03.2015 after the magazine is published on 02.04.2014. The amount received from sale of advertising space on 10.03.2014 of ₹ 2,40,000 will be considered as an advance from advertisers as on 31.03.2014.

Q.2.7	2015 - May [7] (c)	Practical

Answer the following:
Given the following information of M/s. Paper Products Ltd.

(i) Goods of ₹ 60,000 were sold on 20-3-2015 but at the request of the buyer these were delivered on 10-4-2015.

(ii) On 15-1-2015 goods of ₹ 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-2015.

(iii) ₹ 1,20,000 worth of goods were sold on approval basis on 1-12-2014. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-2015 and no approval or disapproval received for the remaining goods till 31-3-2015.

(iv) Apart from the above, the company has made cash sales of ₹ 7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

You are required to advise the accountant of M/s. Paper Products Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS-9 and also determine the total revenue to be recognized for the year ending 31-3-2015. (4 marks) *[IPCC Gr. I]*

Answer:

(i) As per AS-9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(a) 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

(b) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In this transaction, the buyer sold goods of ₹ 60,000 on 20-3-2015 but at the request of the buyer these were delivered on 10-4-2015.

As per AS-9, goods sold by company the right becomes to revenue recognised whether, the actual physical delivery of goods taken place or not. So here ₹ 60,000 of revenue is to be recognised as Sales in Trading A/c.

(ii) **As per AS-9,** if the goods are sent on consignment basis and if the agent sells them to third party then only the revenue is recognised by consignor.

- So here, goods of ₹ 1,50,000 sent on consignment and only 80% goods were sold. Thus, sales recorded will be only ₹ 1,20,000 in Trading A/c as per AS-9.

(iii) **As per AS-9,** revenue should be recognised on sale on approval basis as follows:

- Revenue shall be recognised if the buyer formally accepted the goods.
- Revenue shall also be recognised if the period of rejection has elapsed or where no time has been fixed or a reasonable time has elapsed.
- Here, total goods worth ₹ 1,20,000 are sold to customers on 1-12-2014, on approval period of 3 months. Buyer sent approval for 75% goods up to 31-1-2015 and no approval or disapproval received for the remaining goods till 31-3-2015. As the approval time is elapsed on 31-3-2015, so all the goods sold on' 1-12-2014 is to be considered as sales.
- So, ₹ 1,20,000 to be shown in Trading P&L A/c as sales as on 31-3-2015.

(iv) Apart, from above the company has made cash sales of ₹ 7,80,000 (gross). Trade discount of 5% allowed on cash sales, so sale is to be recorded as 7,80,000 – 39,000 = ₹ 7,41,000.

* **Calculation for total revenue to be recognised for the year ending 31-3-2015**

Particulars	Amount (₹)
(i) Sale as on 20-3-2015	60,000
(ii) Sale on consignment basis on 15-2-2015	1,20,000
(iii) Sale on approval basis on 1-12-2014	1,20,000
(iv) Sale (Cash) after discount	7,41,000
Total revenue recognized	10,41,000

Q.2.8	2015 - Nov [1] {C} (a)	Practical

M/s Umang Ltd. sold goods through its agent. As per terms of sales, consideration is payable within one month. In the event of delay in payment, interest is chargeable @ 12% p.a. from the agent. The company has not realized interest from the agent in the past. For the year ended 31st March, 2015 interest due from agent (because of delay in payment) amounts to ₹ 1,72,000. The accountant of M/s Umang Ltd. booked ₹ 1,72,000 as interest income in the year ended 31st March, 2015. Discuss the contention of the accountant with reference to Accounting Standard-9. (5 marks) *[IPCC Gr. I]*

Answer:

As per AS-9 "Revenue Recognition", where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of rising any claim, the revenue recognition is postponed to the extent of uncertainty. In such cases, the revenue is recognised only when it is reasonably certain that the ultimate collection will be made.

So in this case M/s Umang Ltd. never realised interest for the delayed payments made by the agents. Hence, it has to recognize the interest only if the ultimate collection is certain. The interest income of ₹ 1,72,000 is not be recognised in the year ended 31st March, 2015.

So the contention of the accountant is wrong. It should not recognize it as interest income in the books of account for year ended 31st March, 2015.

Q.2.9	2016 - Nov [1] {C} (d)	Practical

A manufacturing company has the following stages of production and sale in manufacturing Fine paper rolls:

Date	Activity	Costs to Date (₹)	Net Realizable Value (₹)
15.1.16	Raw material	1,00,000	80,000
20.1.16	Pulp (WIP 1)	1,20,000	1,20,000
27.1.16	Rough & thick paper (WIP 2)	1,50,000	1,80,000
15.2.16	Fine Paper Rolls	1,80,000	3,50,000
20.2.16	Ready for sale	1,80,000	3,50,000
15.3.16	Sale agreed and invoice raised	2,00,000	3,50,000
02.4.16	Delivered and paid for	2,00,000	3,50,000

Explain the stage on which you think revenue will be generated and state how much would be net profit for year ending 31-3-16 on this product according to AS-9. (5 marks) *[IPCC Gr. I]*

Answer:

Provision:

As per AS-9 'Revenue Recognition' revenue in terms of sales could be recognised only when ownership has been passed by the seller to the buyer and there is no uncertainty regarding collection of consideration (sale proceeds) and it is reasonable to expect ultimate collection at the time of performance. Thus, sales will be recognized only when following two conditions are satisfied:

(i) The sale value is fixed and determinable.

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

Analysis:

In the given situation, company has sold goods and raised invoice on 15.3.16 and goods are ready for delivery. In that case company is entitled to recognise sale for the year ended 31.3.2016, provided delay in delivery is due to buyer's request.

Calculation of NP is as under:

Sale price	₹ 3,50,000
Less: Cost	₹ (1,80,000)
∴ Gross profit	₹ 1,70,000
Less: Expenses	₹ (20,000)
Thus, Net profit	₹ 1,50,000

Q.2.10	**2017 - May [1] {C} (d)**	**Practical**

Raj Ltd. entered into an agreement with Heena Ltd. to dispatch goods valuing ₹ 5,00,000 every month for next 6 months on receipt of entire payment. Heena Ltd. accordingly made the entire payment of ₹ 30,00,000 and Raj Ltd. started dispatching the goods. In fourth month, due to fire in premise of Heena Ltd., Heena Ltd. requested to Raj Ltd. not to dispatch goods untill further notice. Due to this, Raj Ltd. is holding the remaining goods worth ₹ 15,00,000 ready for dispatch. Raj Ltd. accounted ₹ 15,00,000 as sales and transferred the balance to Advance received against Sales account.

Comment upon the above treatment by Raj Ltd. with reference to the provision of AS-9. (5 marks) *[IPCC Gr. I]*

Answer:

As per AS-9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

1. The seller of goods has transferred to the buyer the property in the goods for 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

2. No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

   In the given case, transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. Also, the sale price has been recovered by the seller. Hence, the sale is complete but delivery has been postponed at buyer's request. Raj Ltd. should recognize the entire sale of ₹ 30,00,000 (₹ 5,00,000 × 6) and no part of the same is to be treated as Advance Receipt against Sales.

Q.2.11	**2017 - Nov [1] {C} (c)**	**Practical**

Fashion Limited is engaged in manufacturing of readymade garments. They provide you the following information on 31st March, 2017:

(i) On 15th January, 2017 garments worth ₹ 4,00,000 were sent to Anand on consignment basis of which 25% garments unsold were lying with Anand as on 31st March, 2017.

(ii) Garments worth ₹ 1,95,000 were sold to Shine boutique on 25th March, 2017 but at the request of Shine Boutique, these were delivered on 15th April, 2017.

(iii) On 1st November, 2016 garments worth ₹ 2,50,000 were sold on approval basis. The period of approval was 4 months after which they were considered sold. Buyer sent approval for 75% goods up to 31st December, 2016 and no approval or disapproval received for the remaining goods till 31st March, 2017.

You are required to advise the accountant of Fashion Limited, the amount to be recognised as revenue in above cases in the context of AS 9.

(5 marks) *[IPCC Gr. I]*

Answer:

(i) As per As 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are 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.

Situation: Consignment Sales**.**

Amount to be recognised as Revenue: ₹ 4,00,000 × 75% = ₹ 3,00,000

Reason: Revenue on Consignment Sales is recognised only when goods are sold by the agent to a third party. Since 25% is unsold, 75% would have been sold.

Note: Cost of Inventory 25% should also be accounted for.

(ii) **Situation:** Delay in delivery at Buyer's request.

Amount to be recognised as Revenue: ₹ 1,95,000

Reason: Revenue should be recognised notwithstanding that physically delivery has not been completed so long as there is expectation that delivery will be made.

(iii) **Situation:** Sales on approval basis.

Amount to be recognised as Revenue: ₹ 2,50,000

Reason:

- **For 75% approved:** Revenue should be recognised since the buyer has formally accepted the goods.
- **For 25%:** Revenue should be recognised as time period for rejection has elapsed.

3 *AS - 14 Accounting for Amalgamations*

Q.3.1	2013 - Nov [1] {C} (d), RTP	Practical

A Ltd. is amalgamating with B Ltd. They are undecided on the method of accounting to be followed. You are required to advice the management of B Ltd. on the method of accounting that can be adopted under AS-14.

(5 marks) *[IPCC Gr. I]*

Answer :

- An amalgamation may be either – an amalgamation in the nature of merger, or an amalgamation in the nature of purchase.
- The selection of method of accounting for amalgamation (pooling of interests or purchase method) is to be judged after considering the intentions of the both the companies.
- If genuine pooling of all assets, liabilities, shareholders' interest is intended; separate businesses of both the companies are continued and their amalgamation scheme satisfies all the conditions necessary for merger as specified in AS-14 Accounting for Amalgamations, pooling of interests method is adopted.
- If B Ltd. or A Ltd. wants to acquire the other company, then purchase method needs to be adopted. In that case, the shareholders of the acquired company don't continue to have proportional share in equity of the combined company and the business of the acquired company is not intended to be continued.
- 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.
- Thus choice of accounting method depends on the fact whether B Ltd. wants to continue its business or not.

Q.3.2	**2016 - May [7] (a)**	**Practical**

Answer the followings:

(a) Anjana Ltd., is absorbed by Sanjana Ltd., the consideration being the takeover of liabilities, the payment of cost of absorption not exceeding ₹ 10,000 (actual cost ₹ 9,000) the payment of the 9% debentures of ₹ 50,000 at a premium of 20% in 8% debentures issued at a premium of 25% at face value and the payment of ₹ 15 per share in cash and allotment of three 11% preference share of ₹ 10 each at a discount of 10% and four equity share of ₹ 10 each at a premium of 20% fully paid for every five shares in Anjana Ltd. The number of share of the vendor company are 1,50,000 of ₹ 10 each fully paid.
Calculate purchase consideration as per Accounting Standard– 14.
(4 marks) *[IPCC Gr. I]*

Answer :

Calculation of Purchase Consideration:

As per AS - 14

Amount to be paid in Cash (1,50,000 × ₹ 15)	₹ 22,50,000
equity shares 4 : 5 @ ₹ 10 + 20% premium	
∴ $\frac{1,50,000}{5} \times 4 \times 12$	₹ 14,40,000
Preference shares 3 : 5 @ ₹ 9	
∴ $\frac{1,50,000}{5} \times 3 \times 9$	₹ 8,10,000
Total purchase consideration	₹ **45,00,000**

Note:

1. Amount paid debenture holders will not be included in calculation of purchase consideration.

4 AS - 18 Related Party Disclosures

Q.4.1	2007 - Nov [5] (b)	Practical

P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P. Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS-18 on Related Party Disclosures? (4 marks) *[CA Final Gr. I]*

Answer :

Para 10 of AS 18 'Related Party Disclosures', defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/ or operating decisions.

Here, Control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and Significant Influence is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

Present Case:

P Ltd. has direct economic interest in R Ltd. to the extent of 14%, and through Q Ltd. in which it is the majority shareholders, it has further control of 12% in R Ltd. (60% of Q Ltd.'s 20%). These two taken together (14% + 12%) make the total control of 26% .

Thus it is clear that control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, as per para 12 of AS 18, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd. As R Ltd. is a listed company and regularly supplies goods to P Ltd. Therefore, related party disclosure, as per AS 18 is required.

Q.4.2	**2012 - Nov [7] (b)**	**Practical**

Answer the following:
P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.
How would you assess the situation from the view point of AS-18 on related party disclosures ? (4 marks) *[CA Final - I]*

Answer :

- P Ltd. has direct economic interest in R Ltd. to the extent of 14%, and through Q Ltd. (in which it is the majority shareholders) it has further control of 12% in R Ltd. (60% of Q Ltd.'s 20%). These two taken together (14% + 12%) make the total control of 26%.
- AS 18 'Related Party Disclosures', defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and / or operating decisions.
- Since, P Ltd. has total control of 26% (directly and indirectly by Q Ltd.) in R Ltd. which is less than half of the voting power of R Ltd., P Ltd. is said to have significant influence over R Ltd. Also it is given in the question that R Ltd. is a listed company and regularly supplies goods to P Ltd.
- Hence, related party disclosure, as per AS 18, is required by R Ltd. in its financial statements, in respect of goods supplied to P Ltd.

5 *AS - 19 Leases*

Q.5.1	2012 - Nov [3] (b)	Descriptive
Define the term Finance Lease. State any three situations when a lease would be classified as finance lease. (4 marks)		

Answer :

As per AS 19 'Leases', a finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

As per para 8 of the standard, classification of lease into a finance lease or an operating lease depends on the substance of the transaction rather than its form. Three situations which would normally lead to a lease being classified as a finance lease are:

(i) The lessor transfers ownership of the asset to the lessee by the end of the lease term;

(ii) 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;

(iii) The lease term is for the major part of the economic life of the asset even if title is not transferred.

Other situations when a lease would be classified as finance lease

(i) 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 as set; and

(ii) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(iii) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee,

(iv) gains or losses from the fluctuation in the fair value of the residual fall to the lessee, and

(v) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Q.5.2	**2015 - May [7] (d)**	**Descriptive**
Answer the following: State any four situations when a lease would be classified as Finance Lease. (4 marks)		

Answer :

Situation when a lease would be classified as finance lease:

Finance Lease is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

As per AS 19, in following situations, the lease transactions would be classified as Finance lease:

1. When there is transfer of ownership in finance lease of the asset to the lessee by the end of the lease term.

2. When option to purchase the asset is available to the lessee, at a price which is 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.
3. When lease term is for the major part of the economic life of the asset even if title is not transferred.
4. When present value of minimum lease payment at the inception of the lease amounts to atleast substantially all of fair value of leased asset (i.e. PV of MLP = Fair value approx.)

Q.5.3	**2010 - May [6] (c)**	**Practical**

B & P Ltd. availed a lease from N & L Ltd. The conditions of the lease terms are as under:

(i) Lease period is 3 years, in the beginning of the year 2009, for equipment costing ₹ 10,00,000 and has an expected useful life of 5 year

(ii) The Fair market value is also ₹ 10,00,000.

(iii) The property reverts back to the lessor on termination of the lease.

(iv) The unguaranteed value is estimated at ₹ 1,00,000 at the end of the year 2011.

(v) 3 equal annual payments are made at the end of each year.
Consider IRR = 10%

The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513.

The present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868.

State whether the lease constitute finance lease and also calculate unearned Finance income. (4 marks)

Answer :

(i) **Computation of annual lease payment to the lessor**

Particulars	₹
Cost of equipment	10,00,000
Unguaranteed residual value	1,00,000

Present value of residual value after third year @ 10% (₹1,00,000 × 0.7513)	75,130
Fair value to be recovered from lease payments (₹ 10,00,000 – ₹ 75,130)	9,24,870
Present value of annuity for three years is 2.4868 Annual lease payment = ₹ 9,24,870/2.4868	3,71,911.70

The present value of lease payment i.e. ₹ 9,24,870 equals 92.48% of the fair market value i.e., 10,00,000. As the present value of minimum lease payments substantially covers the initial fair value of the leased asset and lease term (i.e.3 years) covers the major part of the life of asset (i.e. 5 years). Therefore, it constitutes a finance lease.

(ii) **Computation of Unearned Finance Income**

Particulars	₹
Total lease payments (₹ 3,71,911.70 × 3)	11,15,735
Add : Unguaranteed residual value	1,00,000
Gross investment in the lease	12,15,735
Less : Present value of investment (lease payments and residual value) (₹ 75,130 + ₹ 9,24,870)	(10,00,000)
Unearned finance income	2,15,735

Q.5.4	**2011 - May [6] (a)**	**Practical**

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000. The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However Lessor Ltd., estimates that the residual value of the machinery will be only ₹ 15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year. (8 marks)

Answer :

Provision:

According to AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Value of machinery:

In the given question, fair value of the machinery is ₹ 7,00,000 and the net present value of minimum lease payments is ₹ 6,99,054 (Note 1). As the present value of the machine is less than the fair value of the machine, the machine will be recorded at value of ₹ 6,99,054.

Computation of finance charges for each year

Year	Finance charge ₹	Payment ₹	Reduction in outstanding liability ₹	Outstanding liability ₹
1st year beginning	—	—	—	6,99,054
End of 1st year	1,04,858	3,00,000	1,95,142	5,03,912
End of 2nd year	75,587	3,00,000	2,24,413	2,79,499
End of 3rd year	41,925	3,00,000	2,58,075	21,424 **(Note 2)**

**Note 1 : ***Present value of minimum lease payments :

Annual lease rental x PV factor + Present value of guaranteed residual value

= ₹ 3,00,000 x (0.869 + 0.756 + 0.657) + ₹ 22,000 x (0.657)

= ₹ 6,84,600 + ₹ 14,454 = ₹ 6,99,054.

Note 2 : The difference between this figure and guaranteed residual value (₹ 22,000) is due to approximation in computing the interest rate implicit in the lease.

Q.5.5	**2011 - Nov [1] {C} (b), RTP**	**Practical**

Answer the following:

An equipment having expected useful life of 5 years, is leased for 3 years. Both the cost and the fair value of the equipment are ₹ 6,00,000. The amount will be paid in 3 equal instalments and at the termination of lease, lessor will get back the equipment. The unguaranteed residual value at the end of 3 years is ₹ 60,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 3rd year at 10% IRR is 2.4868. The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is 0.7513. State with reason whether the lease constitutes finance lease and also compute the unearned finance income. (5 marks)

Answer :

(i) **Determination of Nature of Lease:**

Present value of residual value at the end of 3rd year= ₹ 60,000 × 0.7513 = ₹ 45,078

Present value of lease payments= ₹ 6,00,000 – ₹ 45,078 = ₹ 5,54,922

The percentage of present value of lease payments to fair value of the equipment is (₹ 5,54,922 / ₹ 6,00,000) × 100 = 92.487%

Since, it substantially covers the major portion of the lease payments, the lease constitutes a finance lease.

Assumption:

It is assumed that the fair value of the leased equipments is equal to the present value of minimum lease payments.

(ii) **Calculation of Unearned Finance Income:**

Annual lease payment = ₹ 5,54,922 / 2.4868 = ₹ 2,23,147 (approx)

Gross investment in the lease = Total minimum lease payment + unguaranteed residual value

= (₹ 2,23,147 × 3) + ₹ 60,000 = ₹ 6,69,441 + ₹ 60,000 = ₹ 7,29,441

Unearned finance income = Gross investment – Present value of minimum lease payments and unguaranteed residual value

= ₹ 7,29,441 – ₹ 6,00,000 = ₹ 1,29,441

Q.5.6	2012 - May [7] (d)	Practical

Answer the following:

X Ltd. sold JCB Machine having WDV of ₹ 50 Lakhs to Y Ltd. for ₹ 60 Lakhs and the same JCB was leased back by Y Ltd. to X Ltd. The lease is operating lease.

Comment according to relevant Accounting Standard if

(i) Sale price of ₹ 60 Lakhs is equal to fair value.
(ii) Fair value is ₹ 50 Lakhs and sale price is ₹ 45 Lakhs.
(iii) Fair value is ₹ 55 Lakhs and sale price is ₹ 62 Lakhs.
(iv) Fair value is ₹ 45 Lakhs and sale price is ₹ 48 Lakhs. (4 marks)

Answer :

According to AS 19, following will be the treatment in the given situations:

(i) If the sales price of ₹ 60 lakhs is equal to fair value, X Ltd. should immediately recognize the profit of ₹ 10 lakhs (i.e. 60 - 50) in its books.

(ii) If the fair value of leased JCB machine is ₹ 50 lakhs & sales price is ₹ 45 lakhs, then loss of ₹ 5 lakhs (50 - 45) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payments.

(iii) If the fair value is ₹ 55 lakhs & sales price is ₹ 62 lakhs, profit of ₹ 5 lakhs (55 - 50) to be immediately recognized by X Ltd. in its books and balance profit of ₹ 7 lakhs (62 - 55) is to be amortised/deferred over lease period.

(iv) If the fair value is ₹ 45 lakhs & sales price is ₹ 48 lakhs, then the loss of ₹ 5 lakhs (50-45) to be immediately recognized by X Ltd. in its books and profit of ₹ 3 lakhs (48 - 45) should be amortised/deferred over lease period.

Q.5.7	2012 - Nov [7] (a)	Practical

Answer the following :
Annual lease rent = ₹ 40,000 at the end of each year
Lease period = 5 years
Guaranteed residual value = ₹ 14,000
Fair value at the inception (beginning) of lease = ₹ 1,50,000
Interest rate implicit on lease is 12.6%. The present value factors at 12.6% are 0.89, 0.79, 0.7, 0.622, 0.552 at the end of first, second, third, fourth and fifth year respectively.
Show the Journal entry to record the asset taken on finance lease in the books of the lessee. (4 marks)

Answer :

In the books of Lessee
Journal entry

Particulars		₹	₹
Asset A/c To Lessor (Being recognition of finance lease as an asset and a liability)	Dr.	1,49,888	1,49,888

Working Notes:

Year	Lease Payments ₹	Discounting Factor (12.6%)	Present Value ₹
1	40,000	0.89	35,600
2	40,000	0.79	31,600
3	40,000	0.70	28,000
4	40,000	0.622	24,880
5	40,000	0.552	22,080
5	14,000 (GRV)	0.552	7,728
			1,49,888

Q.5.8	2013 - Nov [7] (a)	Practical

Answer the following:
Classify the following into either operating or finance lease :

(i) Lessee has option to purchase the asset at lower than fair value, at the end of lease term;

(ii) Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;

(iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;

(iv) Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y". (4 marks)

Answer :

(i) Finance lease if it becomes certain at the inception of lease itself that the option will be exercised.

(ii) It will be classified as finance lease since a substantial portion of the life of the asset is covered by the lease term.

(iii) Since the asset is procured only for the use of lessee, it is a finance lease.

(iv) Where X = 4, or where X substantially equals 4, it is a finance lease.

Q.5.9	**2014 - May [1] {C} (c)**	**Practical**

Answer the following:
What do you understand by the term "Interest rate implicit on lease"?
Calculate the interest rate implicit on lease from the following details:

Annual Lease Rent	: ₹ 80,000 at the end of each year
Lease Period	: 5 Years
Guaranteed Residual Value	: ₹ 40,000
Unguaranteed Residual Value	: ₹ 24,000
Fair Value at the inception of the lease	: ₹ 3,20,000

Discounted rates for the first 5 years are as below:

At 10%	0.909,	0.826,	0.751,	0.683,	0.621,
At 14%	0.877,	0.769,	0.675,	0.592,	0.519,

(5 marks)

Answer :

According to AS 19 'Leases' the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Present value at discount rate of 10%

Year	Lease Payments (₹)	Disc. Factor(10%)	Present Value (₹)
1	80,000	0.909	72,720
2	80,000	0.826	66,080
3	80,000	0.751	60,080
4	80,000	0.683	54,640
5	80,000	0.621	49,680
5	40,000	0.621	24,840
5	24,000	0.621	14,904
	Total		**3,42,944**

Present value at discount rate of 14%

Year	Lease Payments (₹)	Disc. Factor(14%)	Present Value (₹)
1	80,000	0.877	70,160
2	80,000	0.769	61,520
3	80,000	0.675	54,000
4	80,000	0.592	47,360
5	80,000	0.519	41,520
5	40,000	0.519	20,760
5	24,000	0.519	12,456
	Total		**3,07,776**

Interest Rate Implicit on Lease $=10\% + \frac{14\% - 10\%}{3,42,944 - 3,07,776} \times (3,42,944 - 3,20,000) = 10\% + 2.609\% = 12.609\%$ or say 12.61%

Q.5.10	2014 - Nov [1] {C} (a)	Practical

Answer the following:
A machine having expected useful life of 6 years, is leased for 4 years. Both the cost and the fair value of the machinery are ₹ 7,00,000. The amount will be paid in 4 equal instalments and at the termination of lease, lessor will get back the machinery. The unguaranteed residual value at the end of the 4th year is ₹ 70,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 4th year at 10% IRR is 3.169. The present value of ₹ 1 due at the end of 4th year at 10% rate of interest is 0.683.
State with reasons whether the lease constitutes finance lease and also compute the unearned finance income. (5 marks)

Answer :

(i) The lease term is 66.67% of asset's useful life. Also present value of lease payments is around 93% of the fair value, constituting substantial portion of the fair value.
Therefore, the lease is a finance lease on the basis of calculation below:
(a) **Present value of Unguaranteed Residual Value (UGRV):**
= 70,000 × 0.683 = ₹ 47,810
(b) **Present value of Lease Payments (PV of MLP):**
= 7,00,000 - 47,810 = ₹ 6,52,190
(c) **% of PV of MLP to fair value:**
$= \frac{6,52,190}{7,00,000} \times 100 = 93.17\%$
Since it substantially covers the major portion of lease payment and life of the asset, the lease constitutes a financial lease.

(ii) **Computation of Unearned Finance Income:**
Annual Lease Payments $= \frac{\text{PV of Lease Payments}}{\text{Annuity factor for 3 years at 20\%}}$

$= \frac{6,52,190}{3.169}$ = ₹ 2,05,803 p.a.

		₹
Total lease rentals for the lease period		
= 2,05,803 p.a.× 4 years	=	8,23,212
+ Residual value	=	70,000
Gross investment in lease	=	8,93,212
(-) P.V. of MLP & UGRV = (6,52,190 + 47,810)	=	(7,00,000)
Unearned Finance Income	=	1,93,212

Q.5.11	**2015 - Nov [1] {C} (b)**	**Practical**

Answer the following:
Aksat International Limited has given a machinery on lease for 36 months and its useful life is 60 months. Cost and fair market value of the machinery is ₹ 5,00,000. The amount will be paid in 3 equal annual installments and the lessee will return the machinery to lessor at termination of lease. The unguaranteed residual value at the end of 3 years is ₹ 50,000. IRR of investment is 10% and present value of annuity factor of ₹ 1 due at the end of 3 years at 10% IRR is 2.4868 and present value of ₹ 1 due at the end of 3rd year at 10% IRR is 0.7513.
You are required to comment with reason whether the lease constitute finance lease or operating lease. If it is finance lease, calculate unearned finance income. (5 marks)

Answer :

Determination of Nature of Lease

Present value of unguaranteed residual value at the end of 3rd year
= ₹ 50,000 x 0.7513
= ₹ 37,565

Present value of lease payments = ₹ 5,00,000 – ₹ 37,565
= ₹ 4,62,435

The percentage of present value of lease payments to fair value of the equipment is (₹ 4,62,435/ ₹ 5,00,000) x 100 = 92.487%.

Since, lease payments substantially covers the major portion of the fair value; the lease constitutes a finance lease.

Calculation of Unearned Finance Income

Annual lease payment = ₹ 4,62,435/ 2.4868 = ₹ 1,85,956 (approx.)

Gross investment in the lease = Total minimum lease payments + unguaranteed residual value
= (₹ 1,85,956 × 3) + ₹ 50,000
= ₹ 5,57,868 + ₹ 50,000
= ₹ 6,07,868

Unearned finance income = Gross investment - Present value of minimum lease payments and unguaranteed residual value
= ₹ 6,07,868 – ₹ 5,00,000
= ₹ 1,07,868

Q.5.12	2018 - May [1] {C} (d)	Practical

A Ltd. sold JCB having WDV of ₹ 20 lakhs to B Ltd. for ₹ 24 lakhs and the same JCB was leased back by B Ltd. to A Ltd. The lease is operating lease. In context of Accounting Standard 19 "Leases" explain the accounting treatment of profit or loss in the books of A Ltd. if

(i) Sale price of ₹ 24 lakhs is equal to fair value.
(ii) Fair value is ₹ 20 lakhs and sale price is ₹ 24 lakhs
(iii) Fair value is ₹ 22 lakhs and sale price is ₹ 25 lakhs.
(iv) Fair value is ₹ 25 lakhs and sale price is ₹ 18 lakhs
(v) Fair value is ₹ 18 lakhs and sale price is ₹ 19 lakhs. (5 marks)

Q.5.13	RTP	Practical

XYZ Ltd. has taken an asset on lease from ABC Ltd. for a period of 3 years. Annual Lease Rentals are ₹ 6 Lakhs payable at the end of every year. The Residual Value guaranteed by XYZ is ₹ 2 Lakhs whereas ABC expects the estimated salvage value to be ₹ 5 Lakhs at the end of the lease term. If the Fair Value of the asset at the lease inception is ₹ 15 Lakhs and the interest rate implicit in the lease is 12%, compute the Net

Investment in the Lease from the viewpoint of ABC Ltd. and the annual Finance Income.

Answer:

1.	Minimum Lease Payments (MLP)	= ₹ 6 Lakhs × 3 years	= ₹ 18,00,000
2.	Guaranteed Residual Value (GRV)		₹ 2,00,000 Given
3.	MLP from the viewpoint of the Lessor (XYZ)	= MLP as above + GRV	= ₹ 20,00,000
4.	Unguaranteed Residual Value (URV)	= Total Residual Value - GRV	= ₹ 3,00,000
5.	Gross Investment in the Lease	MLP for Lessor + URV	= ₹ 23,00,000
6.	PV of MLP, GRV and URV	As per computation below	₹ 17,97,040
7.	Unearned Finance Income	(5) - (6)	₹ 5,02,960
8.	Net Investment in the Lease	(5) - (7)	₹ 17,97,040

Note: PV of Gross Investment in the Lease is computed as under:

PV of MLP = ₹ 6,00,000 × PVF at 12% for 3 years = ₹ 6,00,000 × (0.8929 + 0.7972 + 0.7118) =	₹ 14,41,140
PV of (GRV + URV) = ₹ 5,00,000 × PVF at 12% for year 3 = ₹ 5,00,000 × 0.7118 =	₹ 3,55,900
Total of the above	**₹ 17,97,040**

Recognition of Finance Income by Lessor

Year	Net Investment in the Lease = Receivable	Finance Income at 12% on NI	Total Lease Payments received from Lessee	Balance Reduction in Receivable (i.e. Principal)
(1)	(2)	(3) = (2) × 12%	(4)	(5) = (4) - (3)
1	₹ 17,97,040	₹17,97,040 × 12% = ₹ 2,15,645	₹ 6,00,000	₹ 6,00,000 - ₹ 2,15,645 = ₹ 3,84,355
2.	₹ 17,97,040 - ₹ 3,84,355 = ₹ 14,12,685	₹ 14,12,685 × 12% = ₹ 1,69,522	₹ 6,00,000	₹ 6,00,000 - ₹ 1,69,522 = ₹ 4,30,478
3.	₹ 14,12,685 - ₹ 4,30,478 = ₹ 9,82,207	₹ 9,82,207 × 12% = ₹ 1,17,865	₹ 6,00,000	₹ 6,00,000 - ₹ 1,17,865 = ₹ 4,82,135
3 (end)	₹ 9,82,207 - ₹ 4,82,135 = ₹ 5,00,072	Nil	(GRV + URV) ₹ 5,00,000	Nil (difference ₹ 72 due to R/Off)

Q.5.14	RTP	Practical

ABC Silk Mills leased its looms to XYZ Looms Ltd. for a period of five years from 1st April, 2016, for a lumpsum lease of ₹ 10,50,000 payable in full in advance. The Lessor agreed to incur the expenditure for Repairs and Maintenance of the looms which were as under: Financial Year 2016-2017 ₹ 4,700, Financial Year 2017-2018 ₹ 5,200.

WDV of the Looms on 01.04.2016 was ₹ 4,60,000 and depreciation at 33 1/3% was to be charged.

Pass Journal Entries in the books of the Lessor. Show relevant entries in the P & L A/c and the Balance Sheet for the year 2016-2017, if the Lessor closes its account on 31st March every year.

Answer :

1. Journal Entries in the Books of the Lessee

Date	Particulars	Dr. (₹)	Cr. (₹)
1st April 2016	Bank A/c Dr. To Lease Rent Advance A/c (Being Lease Rent for 5 years received in advance.)	10,50,000	 10,50,000
31st March 2017	Repairs and Maintenance A/c Dr. To Bank A/c (Being Maintenance Expenses Incurred for the year)	4,700	 4,700
31st March 2017	Lease Rent Advance A/c Dr. To Lease Rental Income A/c (Being Lease Rental Income recognised for year 1)	2,10,000	 2,10,000
31st March 2017	Depreciation A/c Dr. To Plant and Machinery A/c (Being Depreciation at 33.33% on WDV of Asset) (4,60,000 × 33.33% for Year 1)	1,53,333	 1,53,333
31st March 2017	Profit and Loss A/c Dr. To Depreciation A/c To Repairs and Maintenance A/c (Being Depreciation and R & M Expense for the year transferred to P&L Account)	1,58,033	 1,53,333 4,700
31st March 2017	Lease Rent Income A/c Dr. To Profit and Loss A/c (Being Lease Rental Income for the year transferred to P&L Account)	2,10,000	 2,10,000

2. Profit and Loss A/c (extract)

Particulars	₹	Particulars	₹
To Depreciation A/c To Repairs and Maintenance A/c	1,53,333 4,700	By Lease Rental Income A/c	2,10,000

3. Balance Sheet (extract)

Liabilities	₹	Assets		₹
Lease Rent in Advance (10,50,000 - 2,10,000)	8,40,000	Loom: WDV at beginning:	4,60,000	
Repairs and maintenance A/c	4,700	Less: Depreciation	1,53,333	3,06,667

Q.5.15	RTP	Practical

Lease Ltd. has an asset of ₹ 1 Lakh, which it depreciates at 10% on SLM method. At the end of the 5th year, it sells the asset at ₹ 60,000 (Fair Value) and leases it back for the remaining useful life of 5 years. Lessee Ltd. agrees to pay at the end of each of the 5 years, a Lease Rental of ₹ 15,000 and guarantees a Residual Value of ₹ 6,000 at the end of the lease term. Lessee's Incremental borrowing rate is 10%. The PV of ₹ 1 at 10% at the end of 5th year is 0.62, and annuity is 3.79. Advice on accounting in the books of both the Lessor and Lessee Ltd.

Answer :

A. In the books of the Lessee:

1. Since SLM depreciation is 10%, useful life is taken as 10 years. Since the lease period covers the balance useful life of the asset, it is a Finance Lease.
2. PV of MLP & GRV = (3.79 × 15,000) + (0.62 × 6,000) = ₹ 60,570.
3. The asset should be capitalized at - (a) Fair Value ₹ 60,000, or (b) PV of MLP & GRV ₹ 60,570, whichever is lower. Hence, Cost of Asset in Lessor's Books = ₹ 60,000.
4. Depreciation to be charged for the next 5 years

$$= \frac{\textbf{Cost less Residual Value}}{\textbf{Useful Life}} = \frac{₹60,000 - ₹6,000}{5} = ₹\ 10,800 \text{ p.a.}$$

5. Profit on Sale and Lease Back = Revised Book Value - Old Book Value = ₹ 60,000 - ₹ 50,000 = ₹ 10,000 p.a.
   This Profit will be credited to P & L A/c in the next 5 years, in proportion to the depreciation charge. In this case, ₹ 2,000 p.a. will be credited to the P & L A/c over the next 5 years. (Since Depreciation is constant on SLM basis)
6. Interest Charge to be debited in P & L A/c is determined as under:

Year	Opening Balance	Interest at 10% on Opening Balance	Lease Payment	Balance Principal repaid	Closing Balance
1	60,000	6,000	15,000	9,000	51,000
2	51,000	5,100	15,000	9,900	41,100
3	41,100	4,110	15,000	10,590	30,510
4	30,510	3,051	15,000	12,949	17,561
5	17,561	1,756	15,000	13,244	4,317

Note: Difference between ₹ 4,317 and GRV ₹ 6,000 is due to approximation in using 10% as IRR.

B. In the books of the Lessor: The Lessor makes an investment of ₹ 60,000 in respect of which he receives ₹ 75,000 (at ₹ 15,000 p.a.) over the next 5 years and also a Residual Vlaue of ₹ 6,000. This gives him an IRR of 9.98%, which will be recognized as follows:

Year	Opg. Bal. of Principal Outstanding	MLPs	Finance Income at 9.98%	Principal repaid during the year
1	60,000	15,000	5,988	9,012
2	50,988	15,000	5,089	9,911
3	41,077	15,000	4,099	10,901

4	30,176	15,000	3,012	11,988
5	18,188	21,000	1,812	18,188
	Total		**20,000**	**60,000**

Note: The Principal Outstanding will appear as a Recoverable Amount (Asset) in the Balance Sheet of the Lessor.

6 AS - 20 Earnings Per Share

Q.6.1	2007 - Nov [6] (f)	Practical

Answer the following:

(f) From the following information relating to Y Ltd. Calculate Earnings Per Share (EPS):

	₹ in Crores
Profit before VRS Payments but after depreciation	75.00
Depreciation	10.00
VRS payments	32.10
Provision for taxation	10.00
Fringe benefit tax	5.00
Paid up Share Capital (Shares of ₹ 10 each fully Paid)	93.00

(4 marks)

Answer :

Profit before tax	75,00,00,000
Less : VRS payment	10,00,00,000
Provision for tax	32,10,00,000
Fringe benefit tax	5,00,00,000
Earning available to shareholders	27,90,00,000
No. of shares	9,30,00,000

∴ E.P.S. (27,90,00,000 ÷ 9,30,00,000) ₹ 3/-per share

Q.6.2	2009 - May [6] (d)	Practical

Answer the following:
From the following information relating to X Ltd. calculate Diluted earning per share as per AS-20:

Net profit for the current year	₹ 2,00,00,000
Number of equity shares outstanding	40,00,000
Basic earning per share	₹ 5.00
Number of 11% convertible debentures of ₹ 100 each	50,000
Each debenture is convertible into 8 equity shares.	
Interest expense for the current year	₹ 5,50,000
Tax saving relating to interest expense (30%)	₹ 1,65,000

(4 marks)

Answer :

Adjusted Net profit for the current year

= 2,00,00,000 + 5,50,000 – 1,65,000 = ₹ 2,03,85,000

Number of equity shares resulting from conversion of debentures

= 50,000 × 8 = 4,00,000 equity shares

Total number of equity shares resulting from conversion of debentures

= 40,00,000 + 4,00,000 = 44,00,000 shares

Diluted Earnings per share $= \frac{₹\ 2,03,85,000}{44,00,000}$

= ₹ 4.63 (Approximately)

Q.6.3	2009 - Nov [6] (b) (ii), RTP	Practical

Answer the following :
Compute Basic earning per share from the following information :

Date	Particulars	No. of Shares
1st April, 08	Balance at the beginning of the year	1,500
1st August, 08	Issue of shares for cash	600
31st March, 09	Buy back of shares	500

Net profit for the year ended 31st March, 2009 was ₹ 2,75,000.

(5 marks)

Answer :

Computation of weighted average number of shares outstanding during the period:

Date	No. of equity shares	Period outstanding	Weights (months)	Weighted average number of shares
(1)	(2)	(3)	(4)	(5) = (2) × (4)
1st April, 2008	1,500 (Opening)	12 months	12/12	1,500
1st August, 2008	600 (Additional issue)	8 months	8/12	400
31st March, 2009	500 (Buy back)	0 months	0/12	–
Total				1900

Basic Earnings Per Share =

$$\frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$$

$$= \frac{₹\ 2{,}75{,}000}{1{,}900} = ₹\ 144.74$$

Q.6.4	2010 - Nov [7] (b)	Practical

Answer the following :
Ram Ltd. had 12,00,000 equity shares on April, 1, 2009. The company earned a profit of ₹ 30,00,000 during the year 2009-10. The average fair value per share during 2009-10 was ₹ 25. The company has given share option to its employees of 2,00,000 equity shares at option price of ₹ 15. Calculate basic E.P.S. and diluted E.P.S. (4 marks)

Answer :

Computation of Earnings Per Share

	Earnings	**Share**	**Earnings Per Share**
Net Profit for the year 2009-10	30,00,000		
Weighted average number of shares outstanding during the year 2009-10		12,00,000	
Basic Earning Per Share = $\frac{30,00,000}{12,00,000}$			2.50
Number of shares under option		2,00,000	
Number of shares that would have been issued at fair value (As indicated in Working Note) 2,00,000 × $\frac{15}{25}$		(1,20,000)	
Diluted Earnings Per Share $\left[\frac{30,00,000}{12,80,000}\right]$	30,00,000	12,80,000	2.34

Working Note:

The earnings have not increased as the total number of shares has been increased only by the number of shares (80,000) deemed for the purpose of the computation to have been issued for no consideration.

Q.6.5	**2011 - May [1] {C} (a)**	**Practical**

Answer the following:

The following information is available for Raja Ltd. for the accounting year 2009-10 and 2010-11.

Net Profit :	Year 2009 -10	₹	25,00,000
	Year 2010 -11	₹	40,00,000

No. of shares outstanding prior to right issue 12,00,000 shares.

Right issue : One new share for each three outstanding i.e. 4,00,000 shares

: Right issue Price ₹ 22

: Last date of exercise rights 30-6-2010

Fair rate of one equity share immediately prior to exercise of rights on 30-6-2010 = ₹ 28

You are required to compute the basic earnings per share for the years 2009-10 and 201-11 (5 marks)

Answer:

Calculation of basic earnings per share (EPS)

Particulars	Year 2009-10 (₹)	Year 2010-11 (₹)
EPS for the year 2009-10 as (original) $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}} = \frac{₹\ 25,00,000}{12,00,000}$	2.08	
EPS for the year 2009-10 restated for rights issue $= \frac{₹\ 25,00,000}{12,00,000 \times 1.06}$ * (Ref. Note)	1.97 (approx)	
EPS for the year 2010-11 including effects of right issue $= \frac{40,00,000}{\left(12,00,000 \times 1.06 \times \frac{3}{12}\right) + \left(16,00,000 \times \frac{9}{12}\right)}$		2.64 (approx)

Note : * The number of equity shares to be used in calculating basic earnings per share for periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the adjustment factor. The adjustment factor has been calculated as in Working Note 2.

Working Notes :

1. Calculation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights + Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + Number of shares issued in the exercise}}$$

$$= \frac{(₹28 \times 12,00,000) + (₹22 \times 4,00,000)}{12,00,000 + 4,00,000} = ₹\ 26.50$$

2. Calculation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - right value per share}}$$

$$= \frac{₹\ 28}{₹\ 26.5} = 1.06\ (\qquad .)$$

Q.6.6	2012 - May [1] {C} (d) (i)	Practical

Answer the following:

Explain the concept of 'Weighted average number of equity shares outstanding during the period'.

State how would you compute, based on AS-20, the weighted average number of equity shares in the following case:

		No. of Shares
1st April, 2011	Balance of Equity Shares	4,80,000
31st August, 2011	Equity shares issued for cash	3,60,000
1st February, 2012	Equity shares bought back	1,80,000
31st March, 2012	Balance of equity shares	6,60,000

($2\frac{1}{2}$ marks)

Answer :

(a) Provision:

According to Para 16 of AS 20, the weighted average number of equity shares outstanding during the period reflects the fact that the amount at any time. Hence, for the purpose of calculating basic or diluted earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

(b) Weighted average number of equity shares

Period		**Weighted shares**
1st April, 2011 to 31st August, 2011	4,80,000 shares x 5/12	2,00,000 shares
1st September, 2011 to 31st January, 2012	8,40,000 shares x 5/12	3,50,000 shares
1st February, 2012 to 31st March, 2012	6,60,000 shares x 2/12	1,10,000 shares
		6,60,000 shares

Q.6.7	**2013 - May [1] {C} (a)**	**Practical**

Answer the following:

(a) Net profit for the year 2012 : ₹ 24,00,000

Weighted average number of equity shares outstanding during the year 2012: 10,00,000

Average Fair value of one equity share during the year 2012 : ₹ 25.00

Weighted average number of shares under option during the year 2012: 2,00,000

Exercise price for shares under option during the year 2012 : ₹ 20.00

Compute Basic and Diluted earning per share. (5 marks)

Answer :

Calculation of earnings per share

Particulars	Earnings (₹)	Shares	Earnings per share
Net profit for the year 2012	24,00,000		
Weighted average number of shares outstanding during the year 2012		10,00,000	
Basic earnings per share			₹ 2.40
Number of shares under option		2,00,000	
Number of shares that would have been issued at fair value: (2,00,000 × 20.00)/25.00 (Note)		(1,60,000)	
Diluted earnings per share	24,00,000	10,40,000	₹ 2.31

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (40,000) deemed for the purpose of computation to have been issued for no consideration.

Q.6.8	2014 - May [1] {C} (d), RTP	Practical

Answer the following:
The following information is available for AB Ltd. for the accounting year 2012-13 and 2013-14 :

Net profit for		₹
Year	2012-13	22,00,000
Year	2013-14	30,00,000

No. of shares outstanding prior to right issue 10,00,000 shares.

Right issue : One new share for each five shares Outstanding i.e. 2,00,000 shares.
: Right Issue price ₹ 25
: Last date to exercise right 31st July, 2013

Fair value of one equity share immediately prior to exercise of rights on 31.07.2013 is ₹ 32.

You are required to compute

(i) Basic earnings per share for the year 2012-13.

(ii) Restated basic earnings per share for the year 2012-13 for right issue.

(iii) Basic earnings per share for the year 2013-14. (5 marks)

Answer :

(i) Computation of Basic Earning per share for 2012-13.

$$= \frac{\text{Net profit for the year attributable to equity shareholders}}{\text{No. of Equity shares outstanding during the year}}$$

$$= \frac{22,00,000}{10,00,000} = ₹\ 2.20$$

(ii) Restated basic earnings per share for the year 2012-13 for right issue

$$\frac{\text{Net profit for the year attributable to equity shareholders}}{\text{Weighted average no. of Equity shares outstanding prior to right issue} \times \text{Adjustment factor}}$$

$$= \frac{22,00,000}{10,00,000 \times 1.04} \text{ (w.n. 2)}$$

$$= \frac{22,00,000}{10,40,000}$$

= ₹ 2.12

(iii) Computation of basic Earning per share for year 2013-14

$$= \frac{\text{Net profit for the year attributable to equity shareholders}}{\text{Weighted average no. of Equity shares outstanding during the year}}$$

$$= \frac{30,00,000}{\left(10,00,000 \times 1.04 \times \frac{4}{12}\right) + 12,00,000 \times \frac{8}{12}}$$

$$= \frac{30,00,000}{3,46,667 + 8,00,000}$$

$$= \frac{30,00,000}{11,46,667}$$

= ₹ 2.62

Working Notes :

1. Computation of Theoretical Ex-Rights price.

$$= \frac{\text{Fair value of all o/s shares immediately prior to exercise of right + Total amount received exercise}}{\text{No. of shares o/s prior to exercise + no. of shares issued in exercise}}$$

$$= \frac{(32 \times 10,00,000) + (25 \times 2,00,000)}{10,00,000 + 2,00,000}$$

$$= \frac{3,20,00,000 + 50,00,000}{12,00,000}$$

= ₹ 30.833

2. Computation of adjusted factor

$$= \frac{\text{Fair value per share prior to exercise price}}{\text{Theoritical ex-right value per share}}$$

$$= \frac{32}{30.833} = 1.04 \text{ (approx.)}$$

Q.6.9	2015 - May [1] {C} (d)	Practical

Answer the following:

M/s. A Ltd. had 8,00,000 Equity Shares outstanding on 1st April, 2013. The Company earned a profit of ₹ 20,00,000 during the year 2013 - 14. The average fair value per share during 2013 - 14 was ₹ 40. The Company has given Share Option to its employees of 1,00,000 Equity Shares at option price of ₹ 20.

Calculate Basic EPS and Diluted EPS. (5 marks)

Answer :

(i) **Calculation for Basic EPS:**

Basic EPS =

$$\frac{\text{Net Profit/Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average No. of equity shares outstanding during the period}}$$

$$= \frac{₹ 20,00,000}{8,00,000}$$

Basic EPS = ₹ 2.5

(ii) **Calculation for Diluted EPS:**

Diluted EPS =

$$\frac{\text{Adjusted NP or loss for the period attributable to Equity Shareholders}}{\text{Adjusted weighted average no. of equity shares outstanding during the period}}$$

$$= \frac{₹\ 20{,}00{,}000}{8{,}00{,}000 + \times \frac{40-20}{40}}$$

$$= \frac{₹20{,}00{,}000}{8{,}00{,}000 + 50{,}000}$$

Diluted EPS = ₹ 2.35

Q.6.10	2015 - Nov [7] (a)	Practical

Answer the following:

What do you mean by "Weighted average number of equity shares outstanding during the period" and why is it required to be calculated? Compute weighted average number of equity shares in the following case:

		No. of shares
1st April, 2014	Balance of Equity Shares	5,00,000
30th June, 2014	Equity Shares issued for cash	1,00,000
15th January, 2015	Equity Shares bought back	50,000
31st March, 2015	Balance of Equity Shares	5,50,000

(4 marks)

Answer :

Weighted average number of equity shares outstanding at the end of the year is the shares as adjusted by the number of equity shares bought back or issued during the period as multiplied by the time weighting factor. 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 periods a reasonable approximation of the weighted average is adequate in many circumstances.

Calculation weighted average no. of shares:

$$= \left(5,00,000 \times \frac{3}{12}\right) + \left(6,00,000 \times \frac{6.5}{12}\right) + \left(5,50,000 \times \frac{2.5}{12}\right)$$

= 1,25,000 + 3,25,000 + 1,14,583

= weighted average No. of shares = 5,64,583

Q.6.11	2016 - Nov [1] {C} (a)	Practical

Answer the following question:

"While calculating diluted EPS, effect is given to all dilutive potential equity shares that were outstanding during the period." Explain this statement in the light of relevant AS.

Also calculate the diluted EPS from the following information:

Net Profit for the current year (After Tax)	₹ 1,00,00,000
No. of Equity shares outstanding	10,00,000
No. of 10% Fully Convertible Debentures of ₹ 100 each (Each Debentures is compulsorily & fully convertible into 10 equity shares)	1,00,000
Debenture interest expense for the current year	₹ 5,00,000
Assume applicable Income Tax rate @ 30%	(5 marks)

Answer :

According to AS 20 '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 for calculation of diluted earnings per share. Hence, "in calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period."

Calculation of Diluted Earnings per Share =

$$\frac{\textbf{Adjusted net profit for the current year}}{\textbf{Weighted average number of equity shares}}$$

Particulars	Net profit for the period attributable to Equity Shareholders	Weighted Average no. of Equity Shareholders
For Basic EPS	1,00,00,000	10,00,000
Add: Adjustment for Dilution	3,50,000 (W.N.1)	5,00,000 (W.N.1)
∴ Adjusted EPS	**1,03,50,000**	**15,00,000**

∴ Basic EPS $= \dfrac{1,00,00,000}{10,00,000}$ = ₹ 10

∴ Diluted EPS $= \dfrac{1,03,50,000}{15,00,000}$ = ₹ 6.90 per share

Working Note:

1. Tax adjusted interest on 10% Convertible Debentures
   = Interest × (100% – Tax Rate)
   = 5,00,000 × (100% – 30%)
   = 3,50,000
2. 1,00,000 × 10 × $\dfrac{6}{12}$ = 5,00,000

Assumption:

Annual Interest on Debentures
= 10% × ₹ 100 × 1,00,000 Debentures
= ₹ 10,00,000 Equity Shares

But interest expense for the current year is given as ₹ 5,00,000

Hence: It can be implied that debentures are issued during the year. Period = 6 months (By comparing Annual Interest Rate @ 10% on ₹ 10,00,000 with given interest expense of ₹ 5,00,000)

Q.6.12	2018 - May [1] {C} (b)	Practical

As at 1st April, 2016 a company had 6,00,000 equity shares of ₹ 10 each (₹ 5 paid up by all shareholders). On 1st September, 2016 the remaining ₹ 5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 2017 was ₹ 21,96,000 after considering dividend on preference shares and dividend distribution tax on such dividend totalling to ₹ 3,40,000.
Compute Basic EPS for the year ended 31st March, 2017 as per Accounting Standard 20 "Earnings Per Share". (5 marks)

Q.6.13	RTP	Practical

XYZ Ltd. is engaged in manufacturing Industrial Packaging Equipment. As per the terms of an agreement entered into with its Debentureholders, the Company is required to appropriate adequate portion of its Profits to a Specific Reserve over the period of maturity of the Debentures such that at the redemption date, the Reserve constitutes at least half the value of such Debentures. As such, appropriations are not available for distribution to the Equity Shareholders. Kashyapa Ltd. has excluded this from the Numerator, in the Computation of Basic EPS. Is this treatment correct?

Answer :

1. **AS - 20 Principle:** Para 11 states that "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".
2. **Analysis:** With an emphasis on the phrase "attributable to Equity Shareholders", it may be construed that amounts appropriated to Mandatory Reserves as described in this case, though not available for distribution as dividend, are still attributable to Equity Shareholders.

3. **Conclusion:** So, the appropriation made to a Mandatory Reserve created for the redemption of Debentures would be included in the Net Profit attributable to Equity Shareholders for the computation of Basic EPS. The treatment given by the Company is not correct.

Q.6.14	**RTP**	**Practical**
From the following information, calculate Earnings Per Share (EPS), (₹ in Crores)		

Profit before VRS Payment but after depreciation	75.00	Provision for Taxation	10.00
Depreciation	10.00	Fringe Benefit Tax	5.00
VRS payments	32.10	Paid Up Share Capital (Shares of ₹ 10 each fully paid)	93.00

Answer :

Particulars		₹ in Crores
Profit after depreciation but before VRS Payment		75.00
Less: Depreciation - already adjusted, hence no adjustment required.	—	
VRS Payments - all items are considered in determining Profit/Loss	32.10	
Provision for Taxation	10.00	
Fringe Benefit Tax	5.00	47.10
Net Profit available for Equity Shareholders		27.90
Number of Equity Shares		9.30 Crores
EPS = $\frac{\textbf{Net Profit}}{\textbf{No. of shares}} = \frac{\textbf{27.90}}{\textbf{9.30}}$ = ₹ 3 per Share.		

Q.6.15	RTP	Practical

XYZ Ltd. has the following different classes of Equity Shares of ₹ 10 each, outstanding as at 31st March, having disproportionate rights with respect to voting and dividends:

Number of Shares	Rights as to Share in Net Profit to the extent of Capital
1,00,000 "A" Class Equity Shares	Proportionate to Capital
30,000 "B" Class Equity Shares	In the proportion of 3:2 with respect to "A" Class Shares
30,000 "C" Class Equity Shares	In the proportion of 5:2 with respect to "A" Class Shares
40,000 "D" Class Equity Shares	In the proportion of 3:1 with respect to "A" Class Shares

Profit for the year ended 31st March was ₹ 8,00,000. The Company believes that Net Profit is to be allocated to the Shares in the ratio or 2:3:5:6 as derived from their rights to Share Net Profit. The Company has calculated the Basic EPS in the following manner. You are required to confirm whether this calculation is correct.

Class	Apportionment of Net Profit	No. of Shares	Basic EPS
Class A	₹ 8,00,000 × 2/16 =₹ 1,00,000	1,00,000	₹ 1.00
Class B	₹ 8,00,000 × 3/16 =₹ 1,50,000	30,000	₹ 5.00
Class C	₹ 8,00,000 × 5/16 =₹ 2,50,000	30,000	₹ 8.33
Class D	₹ 8,00,000 × 6/16 =₹ 3,00,000	40,000	₹ 7.50

Answer :

As per Para 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”. In the instant case, Net Profit should first be apportioned to various classes of Equity Shares in accordance with their Dividend Rights in the following manner:

Class (1)	No. of Shares (2)	Ratio of rights in Profit (3)	Adjusted Number of Shares (4)	Apportioned Profit (in the ratio of adjusted number of Shares) (5)	Basic EPS (6) = (5) ÷ (2)
A	1,00,000	1:1	$1,00,000 \times \frac{1}{1} = 1,00,000$	$8,00,000 \times \frac{100}{340} =$ ₹ 2,35,294	₹ 2.35
B	30,000	3:2	$30,000 \times \frac{3}{2} = 45,000$	$8,00,000 \times \frac{45}{340} =$ ₹ 1,05,882	₹ 3.53
C	30,000	5:2	$30,000 \times \frac{5}{2} = 75,000$	$8,00,000 \times \frac{75}{340} =$ ₹ 1,76,471	₹ 5.88
D	40,000	3:1	$40,000 \times \frac{3}{1} = 1,20,000$	$8,00,000 \times \frac{120}{340} =$ ₹ 2,82,353	₹ 7.06
		Total	**3,40,000**	**₹ 8,00,000**	

Conclusion: The Company’s EPS computation is not correct. The amounts presented above should be considered.

Q.6.16	RTP	Practical

From the information given below, calculate the Diluted EPS of XYZ Ltd.:
Profit available for appropriation = ₹ 3750 Crores.
Equity Shares (of ₹ 10 each fully paid) outstanding as at beginning of year = 250 Crores.
No. of Loan Bonds convertible into 100 Equity Shares of ₹ 10 each for each Loan Bond = 5.25 Lakhs.
No. of Equity Shares likely to arise on conversion of Series III Debentures = 3.90 Lakhs.
Interest on Loan Bonds and Series III Debentures = ₹ 50 Crores, Tax Rate = 40%.
Potential Equity Shares on account of Stock Options = 1.15 Crores.

Answer :

1. Computation of Number of Equity Shares after conversion

	Number of Equity Shares at the beginning of the year	2,50,00,00,000
Add:	Potential Equity Shares on Conversion of Bonds (5,25,000 × 100)	5,25,00,000
Add:	Potential Equity Shares on Conversion of Series III Debentures	3,90,000
Add:	Potential Equity Shares towards Stock Options (Profit Adjustment not required for Options)	1,15,00,000
	Number of Equity Shares Outstanding during the year	**2,56,43,90,000**

2. Computation of Basic and Diluted EPS

Particulars	For Basic EPS	Adjustment for Dilution	For Adjusted EPS
(1)	**(2)**	**(3)**	**(4) = (2) + (3)**
1. Net Profit for the period attributable to Equity Shareholders	Given ₹ 3,750 Crores	(Note) ₹ 30 Crores	₹ 3,780 Crores

2. Weighted Avg. No. of Equity Shares	2,50,00,00,000	6,43,90,000	2,56,43,90,000
3. EPS = 1 ÷ 2	Basic EPS = ₹ 15.00		Diluted EPS = ₹ 14.74

Note: Tax Adjusted Interest on Convertible Debentures
= Interest × (100% - Tax Rate)
= ₹ 50 Crores × (100% - 40%) = ₹ 30 Crores.

Q.6.17	RTP	Practical

Calculate Basic and Diluted EPS of Marthanda Ltd. if:
Equity Shares (₹ 10 each) as at the beginning of the financial year - 50,00,000 Shares,
Net Profit after Tax for the year - ₹ 2,00,00,000,
Issue of Shares for Cash on 1st July - 10,00,000 Shares (₹ 10 each)
Issue of Bonus Shares on 1st October = 1:5 as at the beginning of year, i.e. 10,00,000 Shares.
Convertible Debentures outstanding at beginning of the year = 10% Debentures for ₹ 1,00,00,000.
Company's Tax Rate is 40%.

Answer :

1. Weighted Average Number of Equity Shares

Date	No. of Equity Shares	Period Outstanding (upto 31st Dec.)	Time Weighting Factor	Weighted Average Number of Shares
(1)	(2)	(3)	(4)	(5) = (2) × (4)
1st Apr.	50,00,000	12 months	12/12	50,00,000
1st July	10,00,000	9 months	9/12	7,50,000

1st Oct.	(deemed as from the previous reporting period) 10,00,000	12 months	12/12	10,00,000
Weighted Average Number of Equity Shares Outstanding during the period.				67,50,000

2. Computation of Basic and Diluted EPS

Particulars	For Basic EPS	Adjustment for Dilution	For Adjusted EPS
(1)	**(2)**	**(3)**	**(4) = (2) + (3)**
1. Net Profit for the period attributable to Equity Shareholders	Given ₹ 2,00,00,000	(Note) ₹6,00,000	₹ 2,06,00,000
2. Weighted Avg. No. of Equity Shares	(WN 1) 67,50,000	1,00,00,000 ÷ 10 = 10,00,000	77,50,000
3. EPS = 1 ÷ 2	Basic EPS = ₹ 2.96		Diluted EPS = ₹ 2.66

Note: Tax Adjusted Interest on Convertible Debentures = Interest × (100% - Tax Rate) = (₹ 1,00,00,000 × 10%) × (100% - 40%) = ₹ 6,00,000.

7 *AS - 24 Discontinuing Operations*

Q.7.1	**2009 - Nov [6] (c), RTP**	**Descriptive**
Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS-24, but that might do so in combination with other circumstances. (4 marks) *[CA Final - I]*		

Answer :

Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operation. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

1. Closing of a facility to achieve productivity improvement or any other cost saving.
2. Gradual/Evolutionary phasing out any product line or service or class.
3. Discontinuing several products, within an ongoing line of business.
4. Changing of location of production or marketing activities for a particular business line.

Q.7.2	2013 - Nov [7] (c)	Practical

Qu Ltd. is in the business of manufacture of Passenger cars and commercial vehicles. The company is working on a strategic plan to shift from the Passenger car segment over the coming 5 years. However no specific plans have been drawn up for sale of neither the division nor its assets. As part of its plan it will reduce the production of passenger cars by 20% annually. It also plans to commence another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner.

(i) You are required to comment if mere gradual phasing out in itself can be considered as a 'Discontinuing Operation' within the meaning of AS 24.

(ii) If the company passes a resolution to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS 24 ?

(iii) Would your answer to the above be different if the company resolves to sell the assets of the Passenger Car Division in a phased but time bound manner? (4 marks) *[CA Final - I]*

Answer :

Mere gradual phasing is not considered as discontinuing operation as defined under para 3 of AS 24, ‘ Discontinuing Operation’.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

(i) Gradual or evolutionary phasing out of a product line or class of service.

(ii) Shifting of some production or marketing activities for a particular line of business from one location to another and

(iii) Closing of a facility to achieve productivity improvements or other cost savings.

A Reportable business segment or geographical segment as defined in AS-17, would normally satisfy criteria (b) of the definition.

In view of the above the answers are:

(i) No. The companies strategic plan has no final approval from the board through a resolution and no specific time bound activities like shifting of Assets and employees and above all the new segment commercial vehicle production line and factory has started.

(ii) No. The resolution is salient about stoppage of the Car segment in definite time period. Though, some assets sales and transfer proposal was passed through a resolution to the new factory, closure road map and new segment starting road map is missing. Hence, AS-24 will not be applicable.

(iii) Yes. Phased and time bound programme resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and clear road map. Hence, this action will attract AS-24 compliance.

8 AS - 26 Intangible Assets

Q.8.1	2010 - Nov [7] (e)	Practical

Answer the following :
M Ltd. launched a project for producing product A in Nov. 2008. The company incurred ₹ 30 lakhs towards Research and Development expenses upto 31st March 2010. Due to unfavourable market conditions the management feels that it is not possible to manufacture and sold the product in the market for next so many years.
The management hence wants to defer the expenditure write off to future years. Advise the company as per the applicable Accounting Standard.
(4 marks)

Answer :

Provision:

As per AS - 26, expenditure on research should be recognised as an expense when it is incurred.

An intangible asset arising from development (or from the development phase of an internal project) should be recognized if and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard.

An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to the provisions of AS 26.

Analysis and Conclusion:

The management cannot defer the expenditure write off to future years and the company is required to expense the entire amount of 30 lakhs in the Profit and Loss account of the year ended 31st March, 2010.

Q.8.2	2012 - May [1] {C} (a)	Practical

Answer the following:

(a) A company had deferred research and development cost of ₹ 450 Lakhs. Sales expected in the subsequent years are as under:

Years	**Sales (₹ in Lakhs)**
1	1200
2	900
3	600
4	300

You are asked to suggest how should research and development cost be charged to Profit and Loss Account assuming entire cost of ₹ 450 Lakhs is development cost. If at the end of 3rd year, it is felt that no further benefit will accrue in the 4th year, how the unamortized expenditure would be dealt with in the accounts of the Company?

(5 marks)

Answer :

(i) Research and development cost based on sales (assumed that entire cost of ₹ 450 lakhs is development cost) is allocated as follows :

Year	Research and Development cost allocation
	(₹ in lakhs)
1st	$\frac{450}{3,000} \times 1,200 = 180$
2nd	$\frac{450}{3,000} \times 900 = 135$
3rd	$\frac{450}{3,000} \times 600 = 90$
4th	$\frac{450}{3,000} \times 300 = 45$

(ii) If at the end of the 3rd year, the conditions do not justify that further benefit will accrue in the 4th year, then the company has to charge the unamortised amount i.e. remaining ₹ 135 lakhs [450 - (180 + 135)] as revenue expense in 3rd year.

Q.8.3	2013 - May [1] {C} (d)	Practical

Answer the following:
An enterprise acquired patent right for ₹ 400 lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under :

Year	Estimated Future Cash Flows (₹ in lakhs)
1	200
2	200
3	200
4	100
5	100

After 3rd year, it was ascertained that the patent would have an estimated balance future life of 3 years and the estimated cash flow after 5th year is expected to be ₹ 50 lakhs each year. Determine the amortization under Accounting Standard 26. (5 marks)

Answer :

Amortization of cost of patent as per AS 26

Year	Estimated future cash flow (₹ in lakhs)	Amortization Ratio	Amortized Amount (₹ in lakhs)
1	200	.25	100
2	200	.25	100
3	200	.25	100
4	100	.40 (Revised)	40
5	100	.40 (Revised)	40
6	50	.20 (Revised)	20

			<u>400</u>

1. In the first three years, the patent cost will be amortised in the ratio of estimated future cash flows i.e. (200: 200: 200: 100: 100).
2. The unamortized portion of the patent after third year will be ₹ 100 (400-300) which will be amortised in the ratio of revised estimated future cash flows (100:100:50) in the fourth, fifth and sixth year.

Q.8.4	2013 - Nov [7] (b)	Practical

Answer the following:
Plymouth Ltd. is engaged in research on a new process design for its product. It had incurred ₹ 10 lakhs on research during first 5 months of the financial year 2012-13. The development of the process began on 1st September, 2012 and upto 31st March, 2013, a sum of ₹ 8 lakhs was incurred as Development Phase Expenditure, which meets assets recognition criteria.
From 1st April, 2013, the Company has implemented the new process design and it is likely that this will result in after tax saving of ₹ 2 lakhs per annum for next five years.
The cost of capital is 10%. The present value of annuity factor of ₹ 1 for 5 years @ 10% is 3.7908.
Decide the treatment of Research and Development Cost of the project as per AS-26. (4 marks)

Answer :

Research Expenditure: According to AS 26 'Intangible Assets', the expenditure on research of new process design for its product ₹ 10 lakhs should be charged to "Profit and Loss Account in the year in which it is incurred". It is presumed that the entire expenditure is incurred in the financial year 2012-13. Hence, it should be written off as an expense in that year itself.

Cost of internally generated intangible asset: it is given that development phase expenditure amounting ₹ 8 lakhs incurred upto 31st March, 2013 meets asset recognition criteria. As per AS 26, for measurement of such internally generated intangible asset, fair value can be estimated by discounting estimated future net cash flows.

Savings (after tax) from implementation of new design for next 5 years	₹ 2 lakhs p.a.
Company's cost of capital	10%
Annuity factor @ 10% for 5 years	3.7908
Present value of net cash flows (₹ 2 lakhs x 3.7908)	₹ 7.582 lakhs

The cost of an internally generated intangible asset would be lower of cost value ₹ 8 lakhs or present value of future net cash flows ₹ 7.582 lakhs.
Hence, cost of an internally generated intangible asset will be 7.582 lakhs.
The difference of ₹ 0.418 lakhs (i.e. ₹ 8 lakhs – ₹ 7.582 lakhs) will be amortized by Plymouth for the financial year 2012-13.
Amortisation: The company can amortise ₹ 7.582 lakhs over a period of five years by charging ₹ 1.5164 lakhs per annum from the financial year 2013-2014 onwards.

Q.8.5	2014 - Nov [1] {C} (b)	Practical

Answer the following:
A company is showing an intangible asset at ₹ 88 lakhs as on 01.04.2013. This asset was acquired for ₹ 120 lakhs on 01.04.2009 and the same was available for use from that date. The company has been following the policy of amortization of the intangible assets over a period of 15 years on straight line basis. Comment on the accounting treatment of the above with reference to the relevant Accounting Standard. (5 marks)

Answer :

- **According to AS 26 'Intangible Assets',** the depreciable amount of an intangible asset should be allocated on 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 10 years from the date when the asset is available for use.
- Company has been following the policy of amortisation of the intangible asset over a period of 15 years on straight line basis. The period of 15

years is more than the maximum period of 10 years specified as per AS 26.

- According to the above, the company would be required to restate the carrying amount of intangible asset as on 01.04.2013 at ₹ 72 lakhs i.e. ₹ 120 lakhs less 48 lakhs

$$\left(\frac{₹\,120}{10} \times 4 \quad = 48\right)$$

- Difference of ₹ 16 Lakhs (i.e. ₹ 88 lakhs – ₹ 72 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of ₹ 72 lakhs will be amortised over remaining 6 years by amortising ₹ 12 lakhs per year.

Q.8.6	2015 - May [1] {C} (b)	Practical

Answer the following:

M/s. Mahesh Ltd. is developing a new production process. During the Financial Year ended 31st March, 2013, the total expenditure incurred on the process was ₹ 60 Lakhs. The production process met the criteria for recognition as an intangible asset on 1st December, 2012. Expenditure incurred till this date was ₹ 32 Lakhs.

Further expenditure incurred on the process for the Financial Year ending 31st March, 2014 was ₹ 90 Lakhs. As on 31.03.2014, the recoverable amount of know-how embodied in the process is estimated to be ₹ 82 Lakhs. This includes estimates of future cash outflows and inflows.

You are required to work out:

(i) What is the expenditure to be charged to Profit & Loss Account for the year ended 31st March, 2013?

(ii) What is the carrying amount of the intangible asset as on 31st March, 2013?

(iii) What is the expenditure to be charged to Profit & Loss Account for the year ended 31st March, 2014?

(iv) What is the carrying amount of the intangible asset as on 31st March, 2014? (5 marks)

Answer :

As per AS-26, the amount charged and recognised are as follows:

(i) **The expenditure to be charged to Profit & Loss A/c for year ended 31st March, 2013:**

- ₹ 32 lakhs will be recognised as an Expense because the recognition criteria were not met until 1st December, 2012.
  This expenditure will not form part of the cost of the production process recognised in the Balance Sheet.

(ii) **The carrying amount of the asset as on 31st March, 2013:**

- The production process will be recognised (i.e. carrying amount) as an intangible asset at a cost of ₹ 28 lakhs (i.e. expenditure incurred since the date the recognition criteria were met, i.e. total during 2012-13 ₹ 60 lakhs -Expenses incurred upto 1st December, 2012 ₹ 32 lakhs).

(iii) **The expenditure to be charged to Profit & Loss A/c for year ended 31st March, 2014:**

		₹
• Book Value on 31/03/14		
Carrying Amount on 31/03/13 + Exp. in 2013-14	=	28 + 90 lakhs
	=	118 lakhs
Less: Recoverable Amount	=	(82 lakhs)
Impairment loss to be charged to Profit & Loss A/c	=	₹ 36 lakhs

(iv) **The Carrying Amount of asset as on 31st March, 2014:**

- The production process will be shown at book value ₹ 118 lakhs or, recoverable amount ₹ 82 lakhs, whichever is less, hence carrying amount is ₹ 82 lakhs.

Q.8.7	2016 - Nov [1] {C} (d)	Practical

Answer the following question:
A Company with a turnover of ₹ 375 crores and an annual advertising budget of ₹ 3 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 37.5 crores from the new product. The Company had debited to its Profit and Loss Account the total expenditure of ₹ 3 crores incurred on extensive special initial advertisement campaign for the new product.
Is the procedure adopted by the Company correct? (5 marks)

Answer :
Provision:
According to para 55 and 56 of AS 26 "Intangible Assets", "expenditure on an intangible items should be recognised as an expense when it is incurred, unless it forms part of the cost of an Intangible Asset.
Analysis:
In the given case, advertisement expenditure of 3 crore had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 37.5 crores. Here, no intangible asset or other asset is acquired or created that can be recognised.
Conclusion:
Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 3 crore to the Profit and Loss Account of the year is correct.

Q.8.8	2017 - May [1] {C} (a)	Practical

Answer the following question:
Fast Ltd. acquired a patent at a cost of ₹ 40,00,000 for a period of five years and its product life-cycle is also five years. The company capitalized the cost and started amortizing the asset at ₹ 5,00,000 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 are expected to be ₹ 18,00,000, ₹ 23,00,000, ₹ 22,00,000, ₹ 20,00,000 and ₹ 17,00,000. Find out the amortization cost of the patent for each of the years. (5 marks)

Answer :

As per AS-26, "Intangible Assets", Fast Ltd. amortized ₹ 5,00,000 per annum for the first two years i.e., ₹ 10,00,000. 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 amortization may be found as follow:

Year	Net Cash flows (₹)	Amortization Ratio	Amortization Amt. (₹)
1	—	—	5,00,000
2	—	—	5,00,000
3	18,00,000	18%	5,40,000
4	23,00,000	23%	6,90,000
5	22,00,000	22%	6,60,000
6	20,00,000	20%	6,00,000
7	17,00,000	17%	5,10,000
Total	1,00,00,000	100%	40,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 30,00,000 has been amortized in the ratio of net cash flows arising from the product of Fast Ltd.

Note: The answer has been given on the basis that the patent is renewable and Fast Ltd. got it renewed after expiry of five years.

Q.8.9	2018 - May [1] {C} (c)	Practical

A company acquired a patent at a cost of ₹ 160 lakhs for a period of 5 years and the product life cycle is also 5 years. The company capitalized the cost and started amortising the asset at ₹ 16 lakhs per year based on the economic benefits derived from the product manufactured under the patent. After 2 years it was found that the product life cycle may continue for another 5 years from then (the patent is renewable and the company can get it renewed after 5 years). The net cash flows from the product during these 5 years were expected to be ₹ 50 lakhs, ₹ 30 lakhs, ₹ 60 lakhs, ₹ 70 lakhs and ₹ 40 lakhs. Find out the amortization cost of the patent for each of the years. (5 marks)

9 *AS - 29 Provisions, Contingent Liabilities and Contingent Assets*

Q.9.1	2016 - May [7] (b)	Descriptive

Answer the following:
With reference to AS 29 "Provisions, Contingent Liabilities and Contingent Assets", define:

(i) A Provision
(ii) A Liability
(iii) A Contingent Asset
(iv) Present Obligation (4 marks)

Answer :

(i) **A Provision:**
A Provision is a liability, which can be measured only by using a substantial degree of estimation.

(ii) **A Liability:**
A Liability is an obligation which the enterprise has to pay to some parties based on some contractual or any other trading arrangements within some specified or reasonable time period. So that it is considered as amount payable.

(iii) **A Contingent Asset:**
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.

(iv) **Present Obligation:**
Present Obligation is an obligation of outflow of resources that is probable and reliable. It is estimated that amount is payable in present situation.

Q.9.2	**2012 - May [7] (c), RTP**	**Practical**
Answer the following : An airline is required by law to overhaul its aircraft once in every five years. The Pacific Airlines which operates aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29. (4 marks)		

Answer :

A provision should be recognised only when an enterprise has a present obligation as a result of a past event. In the given case, there is no present obligation, therefore no provision is recognised as per AS 29.

- The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts.
- Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts.

- Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft.
- However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime.
- A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

Q.9.3	**2012 - Nov [7] (c)**	**Practical**

Answer the following:
A company is in a dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of ₹ 900 lakhs. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal the same in the annual accounts of the company? (4 marks)

Answer :

Provision:

As per AS 29, (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', 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.

Analysis and Conclusion:

In the given situation, since, the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be no outflow of the resources. The company will disclose the same as contingent liability by way of the following note:

"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 ₹ 900 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company."

Q.9.4	2013 - May [1] {C} (c)	Practical

Answer the following:

An engineering goods company provides after sales warranty for 2 years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period :

Less than 1 year : 2% provision

More than 1 year : 3% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
19th January, 2011	40,000
29th January, 2012	25,000
15th October, 2012	90,000

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2012 and 31st March, 2013. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2013. (5 marks)

Answer:

Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31st March, 2012	= ₹ 40,000 x .02 + ₹ 25,000 x .03
	= ₹ 800 + ₹ 750
	= ₹ 1,550
As at 31st March, 2013	= ₹ 25,000 x .02 + ₹ 90,000 x .03
	= ₹ 500 + ₹ 2,700 = ₹ 3,200

Amount debited to Profit and Loss Account for year ended 31st March, 2013

Particulars	₹
Balance of provision required as on 31.03.2013	3,200
Less: Opening Balance as on 1.4.2012	(1,550)
Amount debited to profit and loss account	1,650

Note: No provision will be computed on 31st March, 2013 in respect of sales amounting ₹ 40,000 made on 19th January, 2011 as the warranty period of 2 years has already expired.

Q.9.5	**2014 - Nov [1] {C} (d)**	**Practical**

Answer the following:
WZW Ltd. is in dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of ₹ 1,000 Lakhs. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal the same in the Annual Accounts of the company? (5 marks)

Answer :

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a provision should be recognised when:

(i) An enterprise has a present obligation as a result of past event;

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(iii) A reliable estimate can be made of the amount of the obligation.

- If such conditions are not met, no provision should be recognised.
- A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. The possibility of an outflow of resources embodying economic benefits is remote in the given situation, since the directors of the company are of the opinion that the claim can be successfully resisted by the company. Therefore, the company shall not disclose the same as contingent liability.

- Where as the following note in this regard may be given in annual accounts:

"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 ₹ 1,000 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company".

Q.9.6	2015 - May [1] {C} (a)	Practical

Answer the following:

M/s. Shishir Ltd., a public Sector Company, provides consultancy and engineering services to its clients. In the year 2014-15, the Government set up a commission to decide about the pay revision. The pay will be revised with respect from 1 - 1 - 2012 based on the recommendations of the commission. The company makes the provision of ₹ 1,250 lakhs for pay revision in the financial year 2014 - 15 on the estimated basis as the report of the commission is yet to come. As per the contracts with client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts:

"Salaries and benefits include the provision of ₹ 1,250 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made."

The Accountant feels that the company should also book/recognize the income by ₹ 1,250 lakhs in Profit & Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit.

Comment on the opinion of the Accountant with reference to relevant Accounting Standards. (5 marks)

Answer :

As per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized 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 recognized for the reimbursement should not exceed the amount of the provision.

Thus, 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.

Present Case: The provision of salary to employees of ₹ 1,250 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 1,250 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be matched with the reimbursable asset to be claimed from the client. It appears that the whole amount of ₹ 1,250 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding recognition of income of ₹ 1,250 lakhs is not as per AS 29 and also the concept of prudence will not be followed if ₹ 1,250 lakhs is simultaneously recognized as income. ₹ 1,250 lakhs is not the revenue at present but only reimbursement of claim for which an asset is created. However, the accountant is correct to the extent as that non- recognition of ₹ 1,250 lakhs as income will result in the understatement of profit. To avoid this, in the statement of profit and loss, expense relating to provision may be presented net of the amount recognized for reimbursement.

Q.9.7	2016 - Nov [7] (b)	Practical

M/s. XYZ Ltd. is in a dispute with a competitor company. The dispute is regarding alleged infringement of Copyrights. The competitor has filed a suit in the court of law seeking damages of ₹ 200 Lakhs.

The Directors are of the view that the claim can be successfully resisted by the Company.

How would the matter be dealt in the annual accounts of the Company in the light of AS-29? Explain in brief giving reasons for your answer.

(4 marks)

Answer :

Provision:

As per para 14 of AS 29, 'provisions,' Contingent Liabilities and Contingent Assets' a provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;
(b) a reliable estimate can be made of the amount of the obligation;
(c) it is probable that the outflow of resources embodying economic benefits will be required to settle the obligation.

If these conditions are not met, no provision should be recognised.

Analysis & Conclusion:

In the given situation, since the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be not outflow of the resources. The company will disclose the same as contingent liability by way of the following note:

"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 ₹ 200 lakhs.

However, the directors are of the opinion that the claim can be successfully resisted by the company".

Q.9.8	2017 - Nov [1] (b)	Practical

Legal department of XYZ Limited provides that as on 31st March, 2017, there were 25 law suits pending which have not been settled till the approval of accounts by the Board of Directors. The possible outcome of suits are follows:

Particulars	Probability	Loss (₹)
In respect of Seven cases (Win)	100%	
Next Twelve cases (Win)	60%	
Loss (Low damages)	30%	1,50,000
Loss (High damages)	10%	2,50,000
Remaining Six cases (Win)	50%	
Loss (Low damages)	35%	1,25,000
Loss (High damages)	15%	3,00,000

Outcome of each case is to be taken as a separate one. Ascertain the amount of contingent loss to be reported in the Financial Statement.

(5 marks)

Answer :

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 first 7 cases is 100%.

The probability of winning next twelve cases is 60% and for remaining six cases is 50%.

In other word, probability of losing the cases is 40% and 50% respectively. According to AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the probability or possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore, disclosure by way of note of contingent liability amount may be calculated as under:

Expected loss in next twelve cases

= [₹ 1,50,000 × 30% + ₹ 2,50,000 × 10%] × 12
= [45,000 + 25,000] × 12
= 70,000 × 12
= ₹ 8,40,000

Expected loss in remaining six cases

= [₹ 1,25,000 × 35% + ₹ 3,00,000 × 15%] × 6
= [43,750 + 45,000] × 6
= 88,750 × 6
= 5,32,500

Total contingent liability = 8,40,000 + 5,32,500 = ₹ 13,72,500

Expected loss in next twelve cases

= ₹ 2,50,000 × 12 cases
= ₹ 30,00,000

Expected loss in remaining six cases

= ₹ 3,00,000 × 6 cases
= ₹ 18,00,000

Total = ₹ 30,00,000 + ₹ 18,00,000
= ₹ 48,00,000

Disclosure:

(a) Disclosure of contingent liability on the basis of maximum loss at ₹ 48,00,000 will be highly unrealistic since it does not recognize the probability of winning some cases and paying low damages in some cases.

(b) It will be advisable to disclose the overall expected loss of ₹ 13,72,500 as contingent liability not provided for in the accounts.

10 *Guidance Notes*

Q.10.1	2018 - May [6] (c)	Descriptive

Answer the following:

(c) How is Minimum Alternative Tax (MAT) to be presented in the financial statements? (5 marks)