# AS- 2

Q The cost of production of product X is rs 450 which includes per unit cost of raw material, labour and overheads of rs 250, rs 110, rs 90 respectively at the end of accounting year on 31.3.2020, the replacement cost of raw material is rs 210 per unit, there are 500 units at the end. Calculate as per AS 2 the value of closing stock of raw material when:

Case 1

Finished product is sold at rs 420 p.u.

Case 2

Finished product is sold at rs 490 p.u

Solution:

Case 1

Here, net realizable value of the product (i.e. Rs. 420) is less than its total cost (i.e. Rs. 450) and cost of raw material (i.e. Rs. 250) is more than the replacement cost (i.e. Rs. 210). In the situation, raw materials should be valued at replacement cost and the value of stock of raw materials would be: (500 units × Rs. 210 =) Rs. 1,05,000.

Case 2

Here, net realizable value of the product (i.e. Rs. 490) is more than its total cost (i.e. Rs. 450). the situation, raw materials should be valued at actual cost of materials and the value of stock of raw materials would be: (500 units × Rs. 250 =) Rs. 1,25,000

**Example 2**

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

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

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

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

## Illustration 1

*The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2016-17, the Historical Cost and Net Realisable Value of the items of closing stock are determined as follows:*

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





*What will be the value of closing stock?*

## Solution

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

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

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

## Illustration 2

*X Co. Limited purchased goods at the cost of ₹ 40 lakhs in October, 2016. Till March, 2017, 75% of the stocks were sold. The company wants to disclose closing stock at ₹ 10 lakhs. The expected sale value is ₹ 11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2017.*

## Solution

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realisable value.

In this case, the cost of inventory is ₹ 10 lakhs. The net realisable value is 11,00,000 × 90% = ₹ 9,90,000. So, the stock should be valued at ₹ 9,90,000.

**Example 4**

*The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:*

| | **Cost** | **Net Realisable Value** | **Inventory Value** |
|---|---|---|---|
| | ₹ | ₹ | ₹ |
| *Item 1* | *50,000* | *45,000* | *45,000* |
| *Item 2* | *20,000* | *24,000* | *20,000* |
| *Total* | *70,000* | *69,000* | *65,000* |

*Estimates of NRV should be based on evidence available at the time of estimation.*

Net realisable value is the estimated selling price in the ordinary course of

## Example 3

*A trader purchased certain articles for ₹ 85,000. He sold some of articles for ₹ 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was ₹ 15,000.*

*Cost of closing inventory is shown below:*

| | ₹ |
|---|---|
| *Sale value of opening stock and purchase (₹ 85,000 + ₹ 15,000) x 1.25* | *1,25,000* |
| *Sales* | *(1,05,000)* |





| | |
|---|---|
| *Sale value of unsold stock* | *20,000* |
| *Less: Gross Margin (₹ 20,000 / 1.25) x 0.25* | *(4,000)* |
| *Cost of inventory* | *16,000* |

### Estimates of Net Realisable Value

20,000*100/125=16000

16,000*25%= 4000

## Illustration 4

*You are required to value the inventory per kg of finished goods consisting of:*

| | *₹ per kg.* |
|---|---:|
| *Material cost* | *200* |
| *Direct labour* | *40* |
| *Direct variable overhead* | *20* |

*Fixed production charges for the year on normal working capacity of 2 lakh kgs is ₹ 20 lakhs. 4,000 kgs of finished goods are in stock at the year end.*

## Solution

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

Cost per kg. of finished goods:

| | | ₹ |
|---|---:|---:|
| Material Cost | | 200 |
| Direct Labour | 40 | |
| Direct Variable Production Overhead | 20 | |





| | | |
|---|---:|---:|
| Fixed Production Overhead $\left(\frac{20,00,000}{2,00,000}\right)$ | <u>10</u> | <u>70</u> |
| | | <u>270</u> |

Hence the value of 4,000 kgs. of finished goods = 4,000 kgs x ₹ 270 = ₹ 10,80,000

## Illustration 5

Hence the value of 4,000 kgs. of finished goods = 4,000 kgs x ₹ 270 = ₹ 10,80,000

## Illustration 5

*On 31st March 2017, a business firm finds that cost of a partly finished unit on that date is ₹ 530. The unit can be finished in 2017-18 by an additional expenditure of ₹ 310. The finished unit can be sold for ₹ 750 subject to payment of 4% brokerage on selling price. The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 2017 for preparation of final accounts.*

## Solution

**Valuation of unfinished unit**

| | ₹ |
|---|---|
| Net selling price | 750 |
| *Less*: Estimated cost of completion | (310) |
| | 440 |
| *Less*: Brokerage (4% of 750) | (30) |
| Net Realisable Value | 410 |
| Cost of inventory | 530 |
| Value of inventory (Lower of cost and net realisable value) | 410 |

## 12. Net Realisable Value (NRV)

| | ₹ |
|---|---|
| Estimated Selling Price in the ordinary course of business | XXX |
| *Less:* Cost of completion (applies if you are computing NRV of WIP) | (XX) |
| *Less:* Costs to make the sale (Applies to both WIP & FG) | (XX) |
| Net Realisable Value | XXX |

As we discussed in the beginning we need to compare the COST with NRV of the inventory and it will be carried at the lower of the above two items. For that purpose we should find out the NRV.

Let us understand how we determine the NRV of Finished Goods, WIP and Raw material separately.

**Net Realisable Value**

Finished Goods

| | ₹ |
|---|---|
| Expected SP | xxx |
| *Less:* Selling cost | (xx) |
| **NRV of FG** | xxx |

Work in progress

| | ₹ |
|---|---|
| Expected SP of FG | xxx |
| *Less:* Expected cost to complete | (xx) |
| *Less:* Selling cost | (xx) |
| **NRV of WIP** | xxx |

Raw material

NO need to determine NRV (See below)



### (1) NRV of work in progress

WIP is the one which is not completed or partially completed. Finding out expected selling price for WIP is not possible as nobody purchases the WIP product. It is meant to be converted into FG and to sell as FG. Hence we start computing the NRV of WIP with Expected selling price of FG and deduct the costs to be incurred to complete it as FG & Costs incurred to sell.

### (2) Raw material valuation

Strictly speaking, raw material valuation is NOT based on Cost (or) NRV whichever is less. Its valuation is fully based on the valuation of finished goods ***as the entity is purchasing raw material not to sell in the ordinary course of business as raw material BUT to use it for producing the finished goods. Intention is to sell FG and not RM.***

If the entity is able to sell the FG at cost or above cost, why should Inventory be written down, even if NRV of raw material is less than its COST? Just think before you look into the below diagram. RM is valued as discussed below.

**Raw material valuation**

FG is sold at cost or above cost → Value at COST only; No need to write down to NRV

FG is sold below cost → Value at Replacement cost

# AS- 9

QUESTION

X Limited has recognised Rs. 10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs. 50 lakhs held by it as at the end of the financial year 31st March, 2003. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2003. The dividend was proposed on 10th April, 2003 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard

ANSWER

Accounting Standard 9 on Revenue Recognition states that dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

In the given case, the dividend is proposed on 10th April, 2003, while it is declared on 15th June, 2003. Hence, the right to receive payment is established on 15th June, 2003. As per the above mentioned paragraphs, income from dividend on units of mutual funds should be recognised by X Ltd. in the financial year ended 31st March, 2004.

The recognition of Rs. 10 lakhs on accrual basis in the financial year 2002-2003 is not as perAS 9 'Revenue Recognition’

1. Y Ltd. used certain resources of X Ltd. In return X Ltd. receives Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respectively, from Y Ltd. during the year 2007 –2008. State on what basis X Ltd. should recognize their revenue, as per AS 9.
   Answer :
   As per AS 9 on 'Revenue Recognition', interest of Rs.10 lakhs received in the year 2007-2008 should be recognized on the time basis, whereas royalty of Rs. 15 lakhs received in the same year
   should be recognized on accrual basis as per the terms of relevant agreement.
2. M/s. Sea Ltd. recognized Rs. 5.00 lakhs, on accrual basis, income from dividend during the year 2010-11, on shares of the face value of Rs. 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.
   Answer :
   In the given case, 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 Rs. 5 lakhs, on accrual basis, in the financial year 2010-11 is not in accordance with AS 9.
3. The Board of Directors of X Ltd. decided on 31.3.2011 to increase sale price of certain items of goods sold retrospectively from 1st January, 2011. As a result of this decision the company has to receive ` 5 lakhs from its customers in respect of sales made from 1.1.2011 to 31.3.2011. But the Company's Accountant was reluctant to make-up his mind. You are asked to offer your suggestion.
   Answer :
   The additional revenue on account of increase in sales price with retrospective effect, as decided by Board of Directors of X Ltd., of ` 5 lakhs to be recognised as income for financial year 2010- 11, only if the company is able to assess the ultimate collection with reasonable certainty. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.
4. Sales include Rs. 200 lakhs representing royalty receivable for supply of know. How to a company in South-East Asia. As per agreement the amount is to be received in US Dollars. However, exchange permission was denied to the company in Southeast Asia for remitting the same.

   Answer :
   As per AS-9 on Revenue Recognition, where the ability to assessthe ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g, for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognize revenue only when it reasonably certain that the ultimate collection will be made. Thus, Sale and other income' should be reduced by Rs.200 lakhs with equivalent Credit to Royalty receivable account.
5. Media advertising obtained advertisement right for one day world cup Cricket

Credit to Royalty receivable account.

To Do

5. Media advertising obtained advertisement right for one day world cup Cricket Tournament to be held in May/June 2010 for Rs. 250 lakhs. By 31 st March, 2010, they paid Rs. 150 lakhs to secure these advertisement rights. The balance Rs. 100 lakhs was paid in April 2010. By 31 st March, 2010, they processed advertisement for 70% of the available time For Rs. 350 lakhs. The advertiser paid 60% of amount by that date. The balance 40% was received in April 2010. The advertisement for balance

Media purchase- 250 (150+100)

70% @ 350 * paid 60% balance in April

30% @ 150 * paid full

500- cost 250
And profit 250

25% of add- may 2010. 250*25%=62.5
75% add - June 2010

30% time was procured in April 2010 for Rs. 150 lakhs. The advertiser paid the full amount while booking the advertisement. 25% of the advertisement time is expected to be available in May 2010 and balance 75% in June 2010. Calculate the profit/loss for the month of April, May, June 2010.

Answer :

As per AS-9. In a transaction involving the rendering of services, performance should be measured either under the com pleted service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

Further, appendix to AS-9 states that revenue from advertising should be recognized when the service is completed. In this case the service as regards Advertisement is deemed to be completed when the related advertisement appears before the public. As the 25% of the advertisement appeared in May 2010 and 75% in June 2010, therefore the revenue with 250 lakhs [ie., (350+150) (150+ 100)], should be apportioned in 25% and 75% ratio which will be 62.5 lakhs in May 2010 and 187.5 in June 2010.

# AS-26

20,00,000/10=200,000
2009-2010
2010-2011
2011-2012
2012-2013
2013-2014
2014-2015
—————- 6 years
2015-16
1 year total 7 yrs

### Illustration 1

*ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.2009. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.2016. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.2016.*

### Solution

**Journal Entry**

| | | ₹ | ₹ |
|---|---|---|---|
| Profit and Loss A/c (Prior period item) | Dr. | 12,00,000 | |
| Depreciation A/c | Dr. | 2,00,000 | |
| To Know-how A/c* | | | 14,00,000 |
| [Being depreciation of 7 years (out of which depreciation of 6 years charged as prior period item)] | | | |

### Illustration 2

*The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2015-2016, but*

* As per para 63 of AS 26 "Intangible Assets", there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.





*proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2016.*

*proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2016.*

**Solution**

In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus according to AS 26 'Intangible Assets', the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

**Illustration 3**

*A company with a turnover of ₹ 250 crores and an annual advertising budget of ₹ 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of ₹ 2 crore incurred on extensive special initial advertisement campaign for the new product.*

*Is the procedure adopted by the company correct?*

**Solution**

According to AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

AS 26 mentions that expenditure on advertising and promotional activities should be recognised as an expense when incurred.

In the given case, advertisement expenditure of ₹ 2 crores 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 ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

# AS-10 PPE

**Question 10**

*Entity A has a policy of not providing for depreciation on PPE capitalised in the year until the following year, but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?*

**Solution**

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use.

**Question 11**

*Entity A purchased an asset on 1st January 2013 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.*

*On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.*

*Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.*

**Solution**

The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e (1,00,000/10 years).

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.

The remaining useful life is 4 years.

The company should amend the annual provision for depreciation to charge the unamortised cost over the revised remaining life of four years.

Consequently, it should charge depreciation for the next 4 years at ₹ 15,000 per annum i.e. (60,000/4 years).

**Note:** Depreciation is recognised even if the Fair value of the Asset exceeds its Carrying Amount. Repair and maintenance of an asset do not negate the need to depreciate it.

Q. 1

A company has purchased plant and machinery in the year 2001-2002 for `45 lakhs. A balance of `5 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2004-2005. The company treated it as income and credited to profit and loss account during 2004-2005. Whether accounting treatment of the company is correct. If not, state with reasons.

**Solution**:

As per AS 10 the cost of fixed assets may undergo changes subsequent to its acquisition or construction on account of exchange fluctuation, price adjustments, changes in duties or similar factors. The treatment done by the company is not correct. `5 lakhs should be deducted from the cost of fixed assets.