

## **OVERVIEW OF ACCOUNTING STANDARDS**

### **LEARNING OUTCOMES**

**After studying this unit, you will be able to–**

- Understand the provisions of the specified Accounting Standards.
- Relate relevant Accounting Standards to various situations and apply them accordingly.
- Solve the practical problems based on application of Accounting Standards.

## UNIT OVERVIEW



### Practical Application of :

- AS 1 : Disclosure of Accounting Policies
- AS 2 : Valuation of Inventories
- AS 3 : Cash Flow Statements
- AS 10 : Property, Plant and Equipment
- AS 11 : The Effects of Changes in Foreign Exchange Rates
- AS 12 : Accounting for Government Grants
- AS 13 : Accounting for Investments
- AS 16 : Borrowing Costs

**Note:** The students are advised to refer the bare text of the above-mentioned Accounting Standards while studying this chapter.



## 2.1 DISCLOSURE OF ACCOUNTING POLICIES (AS 1)

### Introduction

Irrespective of extent of standardization, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.

Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

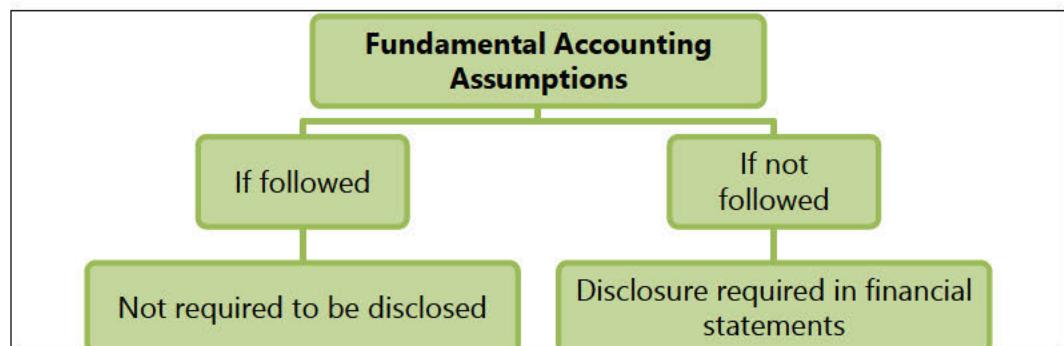
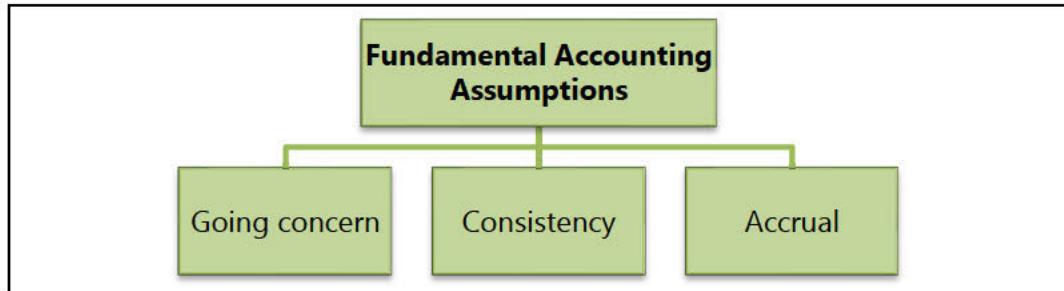
The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all

standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose significant accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

The standard applies to all enterprises.

### Fundamental Accounting Assumptions



**Going Concern:** The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither

there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

**Consistency:** The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

**Accrual basis of accounting:** Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain.

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 128(1)(iii) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

## **Accounting Policies**

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

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

<b>Items to be disclosed</b>	<b>Method of disclosure or valuation</b>
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method

This list is not exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

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

### **Selection of Accounting Policy**

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

**Prudence:** In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated.

### **Example 1**

*The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.*

*Suppose a trader has purchased 500 units of certain article @ ₹10 per unit. He sold 400 articles @ ₹15 per unit. If the net realisable value per unit of the unsold article is ₹15, the trader should value his stock at ₹10 per unit and thus ignoring the profit ₹500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is ₹8, the trader should value his stock at ₹8 per unit and thus recognising possible loss ₹200 that he may incur in next accounting period by selling 100 units of unsold articles.*

*Profit of the trader if net realisable value of unsold article is ₹15*

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹15) - (500 \times ₹10 - 100 \times ₹10) = ₹2,000$$

*Profit of the trader if net realisable value of unsold article is ₹8*

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹15) - (500 \times ₹10 - 100 \times ₹8) = ₹1,800$$

### **Example 2**

*Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.*

**Substance over form:** Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely by their legal form.

**Materiality:** Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

- (a) A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or ₹1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).
- (b) A company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the

number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

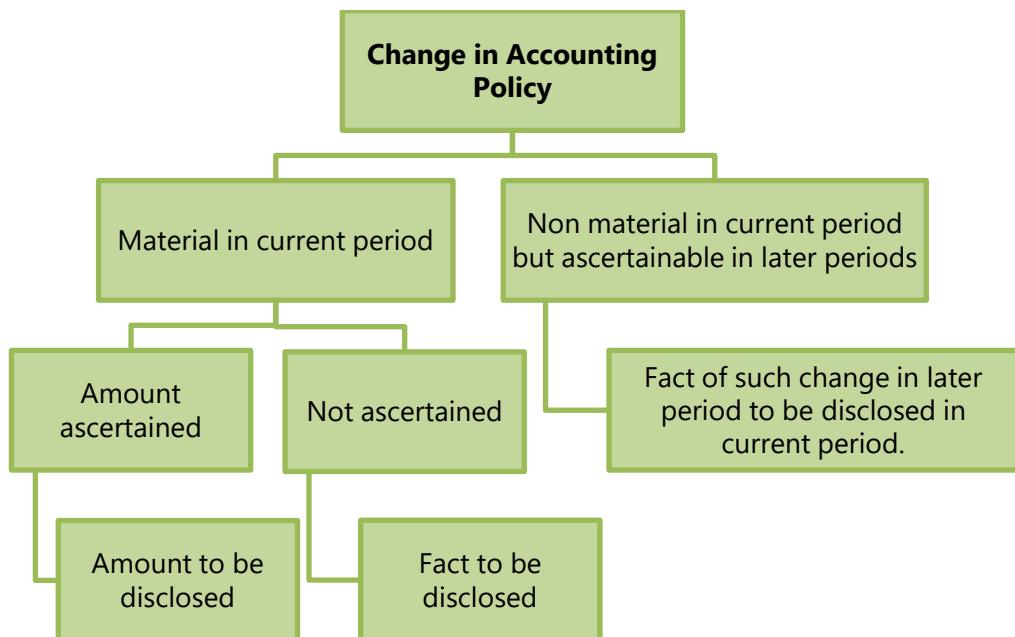
**Manner of disclosure:** All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

**Note:** Being a part of the financial statement, the opinion of auditors should cover the disclosures of accounting policies.

### Disclosure of Changes in Accounting Policies

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



### **Example 3**

*A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory by FIFO is ₹ 2 lakh and that by weighted average formula is ₹ 1.8 lakh, the change in accounting policy pulls down profit and value of inventory by ₹ 20,000. The company may disclose the change in accounting policy in the following manner:*

*'The company values its inventory at lower of cost or net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced profit and value of inventory by ₹ 20,000'.*

*A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.*

*The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 20X1-X2 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 20X1-X2 is not significant, the change in policy will not have any material effect on financial statements of 20X1-X2. Yet, the company must disclose the change in accounting policy in 20X1-X2 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 20X1-X2, then no disclosure in future years will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.*

### **Disclosure of deviations from fundamental accounting assumptions**

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed. The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods.

### **Illustration 1**

*In the books of M/s Prashant Ltd., closing inventory as on 31.03.20X2 amounts to ₹ 1,63,000 (on the basis of FIFO method).*

*The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 20X1-X2. On the basis of weighted average method, closing inventory as on 31.03.20X2 amounts to ₹ 1,47,000. Realisable value of the inventory as on 31.03.20X2 amounts to ₹ 1,95,000.*

*Discuss disclosure requirement of change in accounting policy as per AS-1.*

### **Solution**

As per AS 1 "Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Thus Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 201X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by ₹ 16,000.

### **Illustration 2**

*Jagannath Ltd. had made a rights issue of shares in 20X2. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31<sup>st</sup> March, 20X2. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:*

- (i) *Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).*
- (ii) *Not to provide for "after sales expenses" during the warranty period. Till the*

*last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹600 crores.*

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

*As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 20X1-20X2.*

### **Solution**

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

### **Notes on Accounts:**

- (i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.
- (ii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.
- (iii) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

### **Illustration 3**

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

### **Solution**

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

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

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



## 2.2 VALUATION OF INVENTORY [AS 2 (REVISED)]

### Introduction

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

### Inventories

AS 2 (Revised) defines inventories as assets held

- for sale in the ordinary course of business, or
- in the process of production for such sale, or
- for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment meeting the definition of Property, plant and equipment.

Inventories encompass goods purchased and held for resale, for example merchandise (goods) purchased by a retailer and held for resale, or land and other property held for resale. Inventories also include finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10 (Revised), *Property, Plant and Equipment*. Such items are accounted for in accordance with Accounting Standard (AS) (Revised) 10, *Property, Plant and Equipment*.

Following are excluded from the scope of AS 2 (Revised).

- (a) Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site should however be covered by AS 2 (Revised).
- (b) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is

inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.

- (c) Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 (Revised) as well. The current Indian practice is however to value them at lower of cost and fair value.
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

The types of inventories are related to the nature of business. The inventories of a trading concern consist primarily of products purchased for resale in their existing form. It may also have an inventory of supplies such as wrapping paper, cartons, and stationery. The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), parts and factory supplies, work-in-process (partially completed products in the factory) and, of course, finished products.

At the year end every business entity needs to ascertain the closing balance of Inventory which comprise of Inventory of raw material, work-in-progress, finished goods and miscellaneous items. The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period.

Since inventories are assets, and assets are resources expected to generate future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs incurred in bringing the assets to their present (i) location of the inventory, e.g. freight incurred to carry the materials to factory and (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock. The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and

therefore should not be included in inventory costs unless those costs are necessary in production process prior to a further production stage.

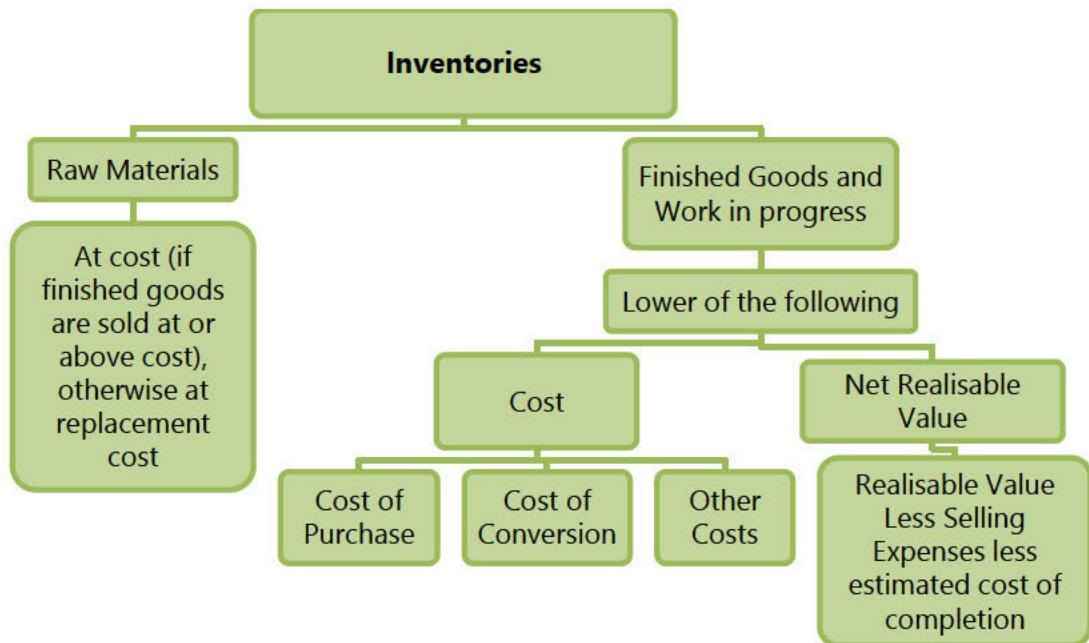
The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence higher is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, inventory is valued at lower of cost and net realisable value. The standard specifies (i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit and Loss statement in such way that their impact on current profit/loss can be perceived.

Part I of Schedule III to the Companies Act, 2013 prescribes that valuation method should be disclosed for inventory held by companies.

### **Measurement of Inventories**

Inventories should be valued at lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.



### Example 1

Cost of a partly finished unit at the end of 20X1-X2 is ₹ 150. The unit can be finished next year by a further expenditure of ₹ 100. The finished unit can be sold at ₹ 250, subject to payment of 4% brokerage on selling price. Assume that the partly finished unit cannot be sold in semi-finished form and its NRV is zero without processing it further. The value of inventory will be determined as below:

	₹
Net selling price	250
Less: Estimated cost of completion	(100)
	150
Less: Brokerage (4% of 250)	(10)
Net Realisable Value	140
Cost of inventory	150
Value of inventory (Lower of cost and net realisable value)	140

### Costs of inventory

Costs of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

## **Costs of purchase**

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

## **Costs of Conversion**

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable that are incurred in converting raw material to finished goods.

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects to achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

## **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 than actually

*earned. Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production ( $90,000 \times 18$ ) ₹ 16.2 lacs and rest ₹ 1.8 lacs should be transferred to Profit & Loss Account.*

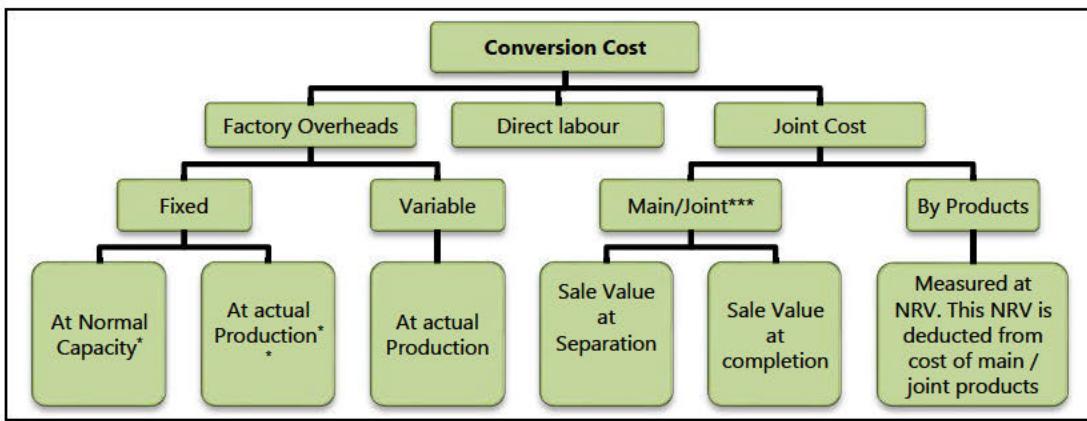
**Case 3:** Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at ₹ 18 each for fixed overhead purpose, we will be adding 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 ( $1.2 \text{ lacs} \times 15$ ) ₹ 18 lacs.

### **Joint or By-Products**

In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example, value of by products, scraps and wastes are usually not material. These are therefore valued at net realisable value. The cost of main product is then valued as joint cost minus net realisable value of by-products, scraps or wastes.

### **Other Costs**

- (a) These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost.
- (b) Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory. Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine.
- (c) The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.
- (d) Exchange differences are not taken in inventory costs.



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

\*\* When actual production is higher than normal capacity.

\*\*\* Allocation at reasonable and consistent basis.

### **Exclusions from the cost of inventories**

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- Abnormal amounts of wasted materials, labour, or other production costs;
- Storage costs, unless the production process requires such storage;
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- Selling and distribution costs.

### **Cost Formula**

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible. In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

## **Other techniques of cost measurement**

- (a) Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.
- (b) In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.

### **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 $(₹85,000 + ₹15,000) \times 1.25$	1,25,000
Sales	(1,05,000)
Sale value of unsold stock	20,000
Less: Gross Margin $(₹20,000 / 1.25) \times 0.25$	(4,000)
Cost of inventory	16,000

## **Estimates of Net Realisable Value**

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

## Comparison of Cost and Net Realisable Value

The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items.

### Example 4

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

	<b>Cost</b>	<b>Net Realisable Value</b>	<b>Inventory Value</b>
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 business less the estimated costs of completion and the estimated costs necessary to make the sale. AS 2 (Revised) also provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

### NRV of materials held for use or disposal

Materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

### Review of net realisable value at each balance sheet date

An assessment is made of net realisable value as at each balance sheet date.

### Disclosures

The financial statements should disclose:

- The accounting policies adopted in measuring inventories, including the cost formula used; and

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

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

- (1) raw materials and components,
- (2) work in progress,
- (3) finished goods,
- (4) Stock-in-trade (in respect of goods acquired for trading),
- (5) stores and spares,
- (6) loose tools, and
- (7) Others (specify nature).

### **Illustration 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 20X1-X2, the Historical Cost and Net Realisable Value of the items of closing stock are determined as follows:

<b>Items</b>	<b>Historical Cost (₹ in lakhs)</b>	<b>Net Realisable Value (₹ in lakhs)</b>
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.

<b>Items</b>	<b>Historical Cost (₹ in lakhs)</b>	<b>Net Realisable Value (₹ in lakhs)</b>	<b>Valuation of closing stock (₹ in lakhs)</b>
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, 20X1. Till March, 20X2, 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 31.3.20X2.*

### 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  $11,00,000 \times 90\% = ₹ 9,90,000$ . So, the stock should be valued at ₹ 9,90,000.

### Illustration 3

*In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on stock at the year end. State with reference to Accounting Standard, how will you value the inventories in this case?*

### Solution

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

In this case, normal waste is 250 MT and abnormal waste is 50 MT. The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste ( $50 \text{ MT} \times ₹ 1,052.6315 = ₹ 52,632$ ) will be charged to the profit and loss statement.

$$\text{Cost per MT (Normal Quantity of 4,750 MT)} = 50,00,000 / 4,750 = ₹ 1,052.6315$$

$$\text{Total value of inventory} = 4,700 \text{ MT} \times ₹ 1,052.6315 = ₹ 49,47,368.$$

#### **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



## **2.3 CASH FLOW STATEMENT (AS 3)**

#### **Introduction**

This Standard is mandatory for the enterprises, which fall in the category of level I, at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements. Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for

the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

**Note:**

Under Section 129 of the Companies Act, 2013, the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement. As per the Amendment, under Chapter I, clause (40) of section 2, an exemption has been provided vide Notification dated 13th June, 2017 under Section 462 of the Companies Act 2013 to a startup private company besides one person company, small company and dormant company. As per the amendment, a startup private company is not required to include the cash flow statement in the financial statements.

Thus the financial statements, with respect to one person company, small company, dormant company and private company (if such a private company is a start-up), may not include the cash flow statement.

**Objective**

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

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

## **Meaning of the term cash and cash equivalents for cash flow statements**

Cash and cash equivalents for the purpose of cash flow statement consists of the following:

- (a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and
- (b) Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk of change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

**Note:** For the purpose of cash flow statement, 'cash and cash equivalent' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks etc. and investments regarded as cash equivalents. For this reason, the AS 3 requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.

## **Meaning of the term cash flow**

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. *For example suppose an enterprise has a bank balance of USD 10,000, stated in books at ₹ 4,90,000 using the rate of exchange ₹ 49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is ₹ 50/USD, the bank balance will be restated at ₹ 5,00,000 on the balance sheet date. The increase is however not a cash flow because neither there is any cash inflow nor there is any cash outflow.*

## **Types of cash flow**

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications of each cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e. operating cash flows, investing cash flows and financing cash flows. Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

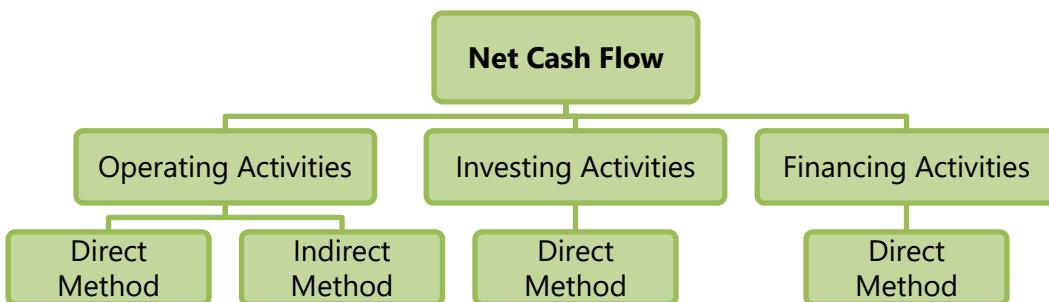
The operating cash flows are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to / recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares, payment of dividends and payment of interests (other than interests paid by financial institutions).

## **Identifying type of cash flows**

### **Classification of Cash Flows**



Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.

#### **Loans/Advances given and Interests earned**

- (a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.
- (c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.
- (d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.
- (e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.
- (f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

#### **Loans/Advances taken and interests paid**

- (a) Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances taken and interests paid on them are financing cash flows

for non-financial enterprises.

- (c) Loans and advances taken from subsidiaries and interests paid on them are financing cash flows for all enterprises.
- (d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.
- (e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.
- (f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

### **Investments made and dividends earned**

- (a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.
- (c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

### **Dividends Paid**

Dividends paid are financing cash outflows for all enterprises.

### **Income Tax**

- (a) Tax paid on operating income is operating cash outflows for all enterprises
- (b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.
- (c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

### **Insurance claims received**

- (a) Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.
- (b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

AS 3 requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.

### **Reporting Cash Flows from Operating Activities**

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

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

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

Below is the format for Cash Flow Statement (Illustrative):

#### **Cash Flow Statement of X Ltd. for the year ended March 31, 20X1 (Direct Method)**

<b>Particulars</b>	<b>₹</b>	<b>₹</b>
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
Cash received from sale of services	xxx	xxx
Less: Payment for Cash Purchases		
Payment to Trade payables	xxx	
Payment for Operating Expenses	xxx	
e.g. power, rent, electricity		
Payment for wages & salaries	xxx	
Payment for Income Tax	xxx	xxx
		xxx

Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

**Cash Flow Statement of X Ltd. for the year ended March 31, 20X1**  
**(Indirect Method)**

Particulars	₹	₹
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	
Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	
Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

#### **Profit or loss on disposal of fixed assets**

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

#### **Fundamental techniques of cash flow preparation**

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

## **Reporting Cash Flows on Net Basis**

AS 3 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. For example, if an enterprise pays ₹ 50,000 in acquisition of machinery and realises ₹ 10,000 on disposal of furniture, it is not right to show net cash outflow of ₹ 40,000. The exceptions to this rule are stated below.

Cash flows from the following operating, investing or financing activities may be reported on a net basis.

- (a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.
- (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

AS 3 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

- (a) Cash flows on acceptance and repayment of fixed deposits with a fixed maturity date
- (b) Cash flows on placement and withdrawal deposits from other financial enterprises
- (c) Cash flows on advances/loans given to customers and repayments received therefrom.

## **Interest and Dividends**

Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

## **Non-Cash transactions**

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial

statements in a way that provides all the relevant information about these investing and financing activities.

### **Business Purchase**

The aggregate cash flows arising from acquisitions and disposals of subsidiaries or other business units should be presented separately and classified as cash flow from investing activities.

- (a) The cash flows from disposal and acquisition should not be netted off.
- (b) An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
  - (i) The total purchase or disposal consideration; and
  - (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

### **Treatment of current assets and liabilities taken over on business purchase**

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

### **Exchange gains and losses**

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

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

difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement.

## **Disclosures**

AS 3 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

AS 3 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise together with a commentary by management. Such information may include:

- (a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

## **Illustration 1**

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

- (a) *Purchase of Machinery.*
- (b) *Proceeds from issuance of equity share capital*
- (c) *Cash Sales.*
- (d) *Proceeds from long-term borrowings.*
- (e) *Cheques collected from Trade receivables.*
- (f) *Cash receipts from Trade receivables.*
- (g) *Trading Commission received.*
- (h) *Purchase of investment.*
- (i) *Redemption of Preference Shares.*
- (j) *Cash Purchases.*

- (k) *Proceeds from sale of investment*
- (l) *Purchase of goodwill.*
- (m) *Cash paid to suppliers.*
- (n) *Interim Dividend paid on equity shares.*
- (o) *Wages and salaries paid.*
- (p) *Proceed from sale of patents.*
- (q) *Interest received on debentures held as investment.*
- (r) *Interest paid on Long-term borrowings.*
- (s) *Office and Administration Expenses paid*
- (t) *Manufacturing Overheads paid.*
- (u) *Dividend received on shares held as investments.*
- (v) *Rent Received on property held as investment.*
- (w) *Selling and distribution expense paid.*
- (x) *Income tax paid*
- (y) *Dividend paid on Preference shares.*
- (z) *Underwritings Commission paid.*
- (aa) *Rent paid.*
- (bb) *Brokerage paid on purchase of investments.*
- (cc) *Bank Overdraft*
- (dd) *Cash Credit*
- (ee) *Short-term Deposits*
- (ff) *Highly liquid Marketable Securities (without risk of change in value)*
- (gg) *Refund of Income Tax received.*

### **Solution**

- (a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.
- (b) Investing Activities: a, h, k, l, p, q, u, v, bb & ee.
- (c) Financing Activities: b, d, i, n, r, y, z, cc & dd.
- (d) Cash Equivalent: ff.

## **Illustration 2**

*X Ltd. purchased debentures of ₹ 10 lacs of Y Ltd., which are redeemable within three months. How will you show this item as per AS 3 while preparing cash flow statement for the year ended on 31<sup>st</sup> March, 20X1?*

### **Solution**

As per AS 3 on 'Cash flow Statement', cash and cash equivalents consists of cash in hand, balance with banks and short-term, highly liquid investments\*. If investment, of ₹ 10 lacs, made in debentures is for short-term period then it is an item of 'cash equivalents'.

However, if investment of ₹ 10 lacs made in debentures is for long-term period then as per AS 3, it should be shown as cash flow from investing activities.

## **Illustration 3**

*Classify the following activities as per AS 3 Cash Flow Statement:*

- (i) *Interest paid by financial enterprise*
- (ii) *Tax deducted at source on interest received from subsidiary company*
- (iii) *Deposit with Bank for a term of two years*
- (iv) *Insurance claim received towards loss of machinery by fire*
- (v) *Bad debts written off*

### **Solution**

- (i) Interest paid by financial enterprise  
Cash flows from operating activities
- (ii) TDS on interest received from subsidiary company  
Cash flows from investing activities
- (iii) Deposit with bank for a term of two years  
Cash flows from investing activities

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\* As per AS 3, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say three months or less from the date of acquisition and is subject to insignificant risk of change in value.

- (iv) Insurance claim received against loss of fixed asset by fire  
 Extraordinary item to be shown as a separate heading under 'Cash flow from investing activities'
- (v) Bad debts written off  
 It is a non-cash item which is adjusted from net profit/loss under indirect method, to arrive at net cash flow from operating activity.

#### **Illustration 4**

Following is the cash flow abstract of Alpha Ltd. for the year ended 31<sup>st</sup> March, 20X1:

**Cash Flow (Abstract)**

<b>Inflows</b>	₹	<b>Outflows</b>	₹
<i>Opening balance:</i>			
<i>Cash</i>	10,000	<i>Payment for Account Payables</i>	90,000
<i>Bank</i>	70,000	<i>Salaries and wages</i>	25,000
<i>Share capital – shares issued</i>	5,00,000	<i>Payment of overheads</i>	15,000
<i>Collection on account of Trade Receivables</i>	3,50,000	<i>Property, plant and equipment acquired</i>	4,00,000
		<i>Debentures redeemed</i>	50,000
<i>Sale of Property, plant and equipment</i>	70,000	<i>Bank loan repaid</i>	2,50,000
		<i>Taxation</i>	55,000
		<i>Dividends</i>	1,00,000
		<i>Closing balance:</i>	
		<i>Cash</i>	5,000
		<i>bank</i>	10,000
	10,00,000		10,00,000
			0

Prepare Cash Flow Statement for the year ended 31<sup>st</sup> March, 20X1 in accordance with Accounting standard 3.

### Solution

#### Cash Flow Statement for the year ended 31.3.20X1

	₹	₹
<b>Cash flow from operating activities</b>		
Cash received on account of trade receivables	3,50,000	
Cash paid on account of trade payables	(90,000)	
Cash paid to employees (salaries and wages)	(25,000)	
Other cash payments (overheads)	(15,000)	
Cash generated from operations	2,20,000	
Income tax paid	(55,000)	
Net cash generated from operating activities		1,65,000
<b>Cash flow from investing activities</b>		
Payment for purchase of Property, plant and equipment	(4,00,000)	
Proceeds from sale of Property, plant and equipment	70,000	
Net cash used in investment activities		(3,30,000)
<b>Cash flow from financing activities</b>		
Proceeds from issue of share capital	5,00,000	
Bank loan repaid	(2,50,000)	
Debentures redeemed	(50,000)	
Dividends paid	(1,00,000)	
Net cash used in financing activities		1,00,000
Net decrease in cash and cash equivalents		(65,000)
Cash and cash equivalents at the beginning of the year		80,000
Cash and cash equivalents at the end of the year		15,000

### Illustration 5

Prepare Cash Flow from Investing Activities of M/s. Creative Furnishings Limited for the year ended 31-3-20X1.

<b>Particulars</b>	₹
Plant acquired by the issue of 8% Debentures	1,56,000
Claim received for loss of plant in fire	49,600
Unsecured loans given to subsidiaries	4,85,000

<i>Interest on loan received from subsidiary companies</i>	82,500
<i>Pre-acquisition dividend received on investment made</i>	62,400
<i>Debenture interest paid</i>	1,16,000
<i>Term loan repaid</i>	4,25,000
<i>Interest received on investment</i>	68,000
<i>(TDS of ₹ 8,200 was deducted on the above interest)</i>	
<i>Book value of plant sold (loss incurred ₹ 9,600)</i>	84,000

### Solution

#### **Cash Flow Statement from Investing Activities of M/s Creative Furnishings Limited for the year ended 31-03-20X1**

<b><i>Cash generated from investing activities</i></b>	<b>₹</b>	<b>₹</b>
Interest on loan received	82,500	
Pre-acquisition dividend received on investment made	62,400	
Unsecured loans given to subsidiaries	(4,85,000)	
Interest received on investments (gross value)	76,200	
TDS deducted on interest	(8,200)	
Sale of plant	<u>74,400</u>	
Cash used in investing activities (before extra ordinary item)		(1,97,700)
Extraordinary claim received for loss of plant		<u>49,600</u>
Net cash used in investing activities (after extra ordinary item)		<u>(1,48,100)</u>

#### **Note:**

1. Debenture interest paid and Term Loan repaid are financing activities and therefore not considered for preparing cash flow from investing activities.
2. Plant acquired by issue of 8% debentures does not amount to cash outflow, hence also not considered in the above cash flow statement.

**Note:** For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 4.

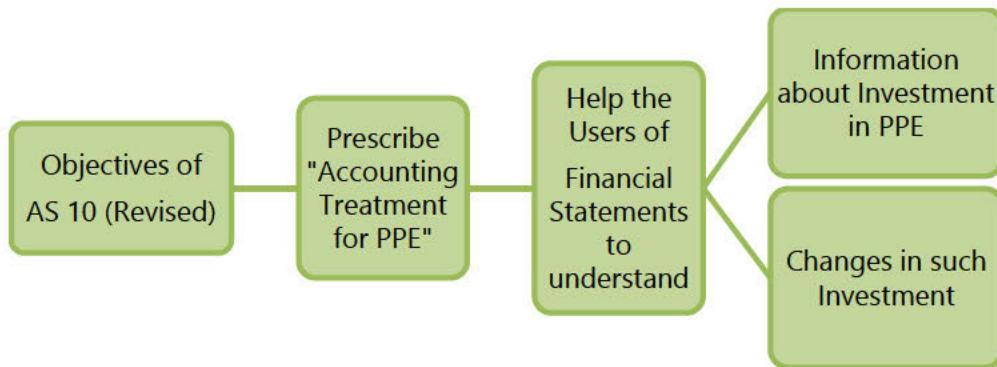
**Reference:** The students are advised to refer the full text of AS 3 "Cash Flow Statement."



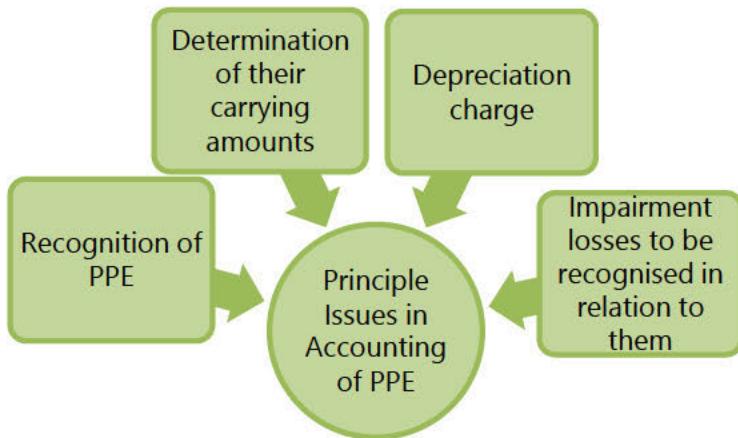
## 2.4 AS 10 (REVISED): PROPERTY, PLANT AND EQUIPMENT

### Introduction

The objective of this Standard is to prescribe accounting treatment for Property, Plant and Equipment (PPE).



The principal issues in Accounting for PPE are:



### Scope of the Standard

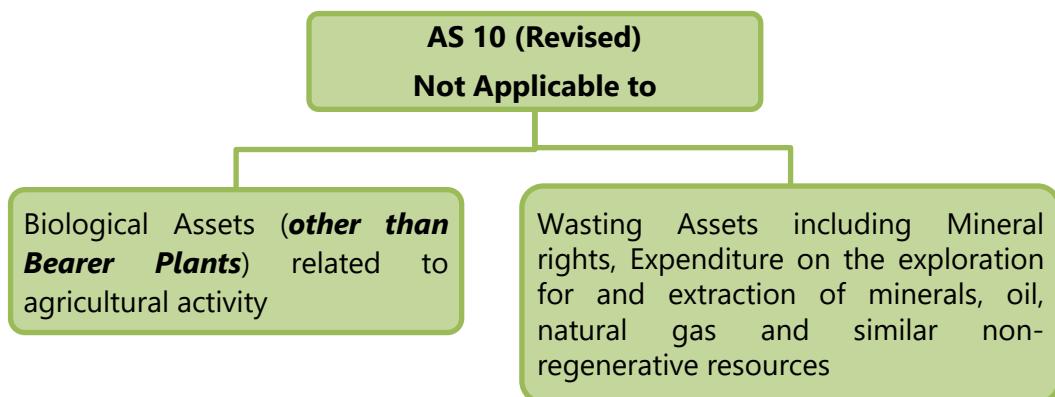
As a general principle, AS 10 (Revised) should be applied in accounting for PPE.

#### Exception:

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

**Example:** AS 19<sup>1</sup> on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

This Standard does not apply to:



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

**Clarifications:**

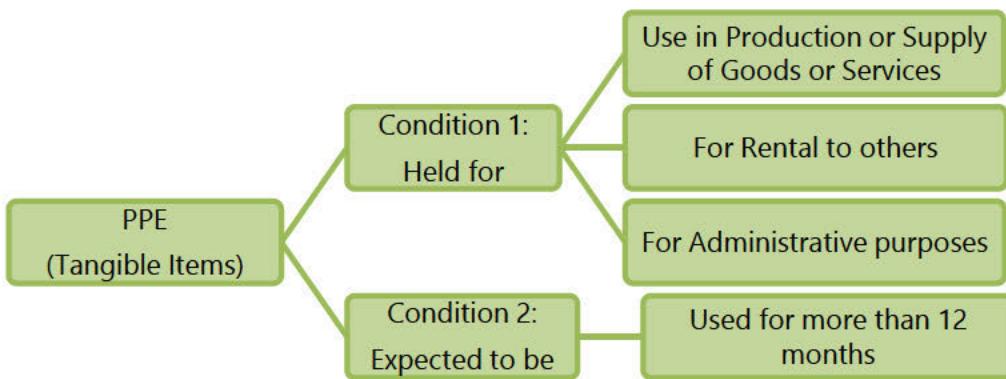
1. AS 10 (Revised) applies to PPE used to develop or maintain the assets described above.
2. Investment property (defined in AS 13 (Revised)), should be accounted for only in accordance with the Cost model prescribed in this standard.

**DEFINITION OF PROPERTY, PLANT AND EQUIPMENT(PPE)**

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

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<sup>1</sup> The students may note that AS 19 on Leases is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.



**Note:** Intangible items are covered under AS 26.

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

- Selling and distribution
- Finance and accounting
- Personnel and other functions of an Enterprise.

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

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

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

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

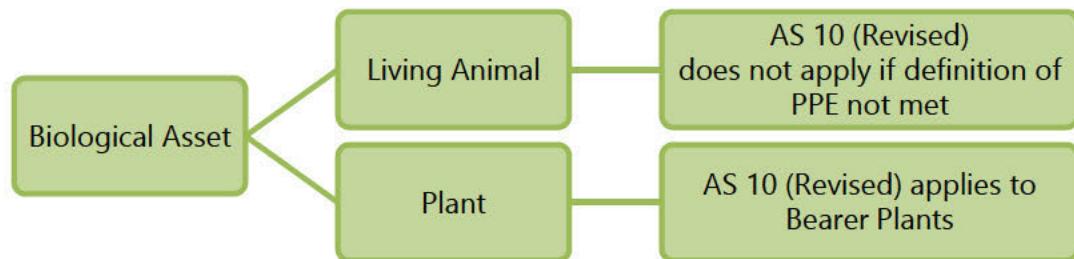
*The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28 (Impairment of Assets)<sup>2</sup>.*

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<sup>2</sup> The students may note that AS 28 on Impairment of Assets is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.

## OTHER DEFINITIONS

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



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

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

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

The following are not Bearer Plants:

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

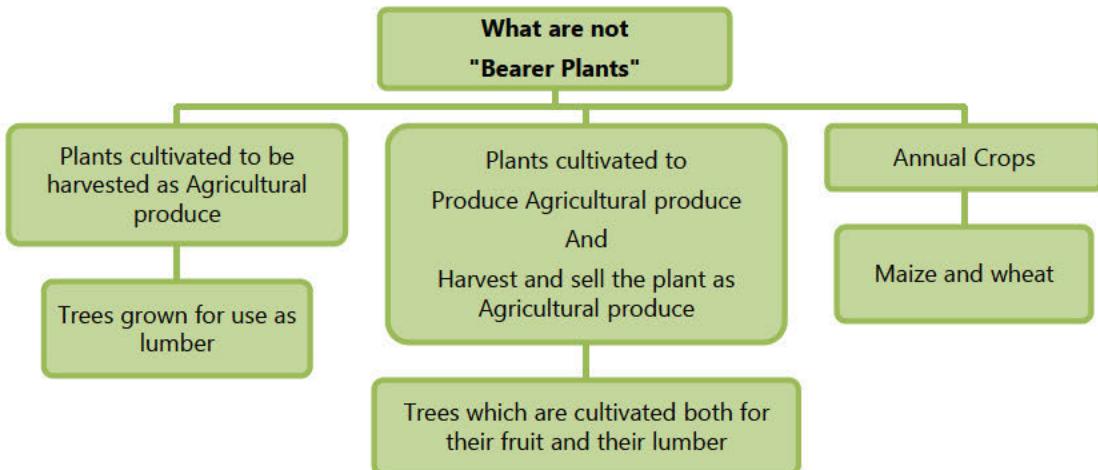
**Example:** Trees grown for use as lumber

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

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

(c) Annual crops

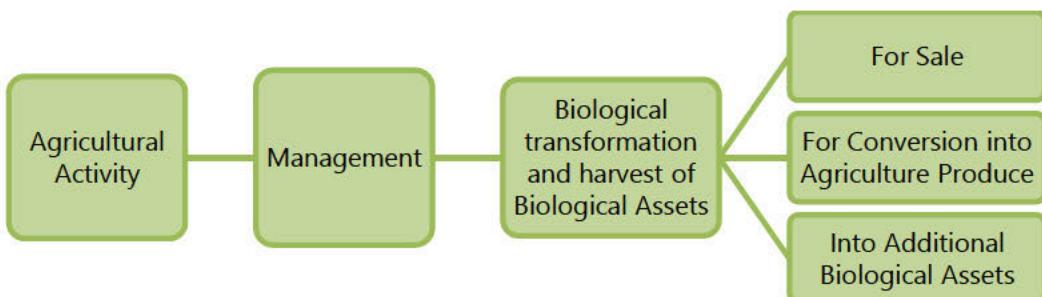
**Example:** Maize and wheat



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

**3. Agricultural Activity:** Is the management by an Enterprise of:

- o Biological transformation; and
- o Harvest of Biological Assets
  - For sale, Or
  - For conversion into Agricultural Produce, Or
  - Into additional Biological Assets



### Recognition Criteria for PPE

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

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

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

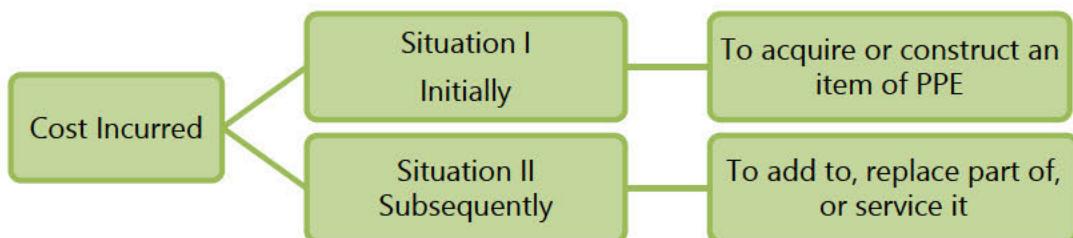
Notes:

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

### **When do we apply the above criteria for Recognition?**

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

These costs include costs incurred:



### **Treatment of Spare Parts, Stand by Equipment and Servicing Equipment**

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

- Recognised as PPE as per AS 10 (Revised)

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

- Such items are classified as Inventory as per AS 2 (Revised)

### **Illustration 1 (Capitalising the cost of “Remodelling” a Supermarket)**

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

## **Solution**

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

## **TREATMENT OF SUBSEQUENT COSTS**

### **Cost of day-to-day servicing**

#### **Meaning**

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

#### **Accounting Treatment:**

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

### **Replacement of Parts of PPE**

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

#### **Examples**

1. *A furnace may require relining after a specified number of hours of use.*
2. *Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.*
3. *Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.*
4. *Replacing the interior walls of a building, or to make a non-recurring replacement.*

#### **Accounting Treatment**

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

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

## **Regular Major Inspections - Accounting Treatment**

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

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

### **Illustration 2**

*What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed?*

### **Solution**

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

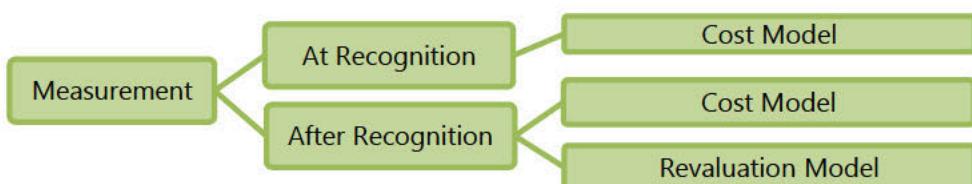
### **Illustration 3**

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

### **Solution**

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

## **Measurement of PPE**

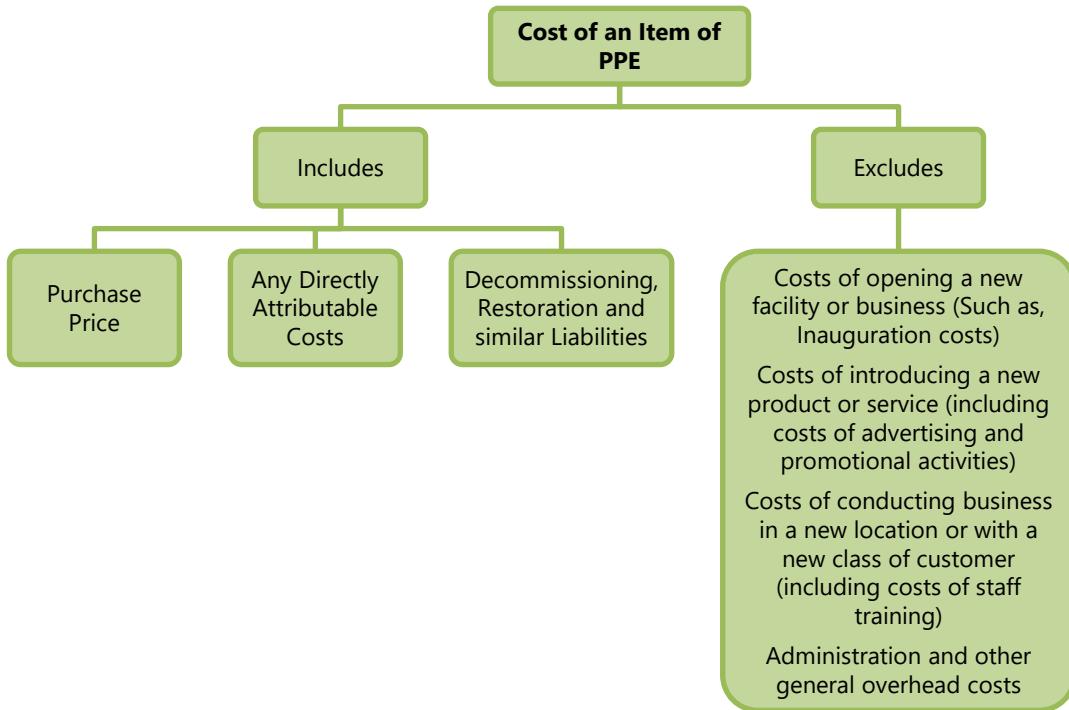


### **Measurement at Recognition**

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

What are the elements of Cost?

Cost of an item of PPE comprises:



**Let us understand the above in detail.**

**A. Purchase Price:**

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

**B. Directly Attributable Costs:**

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

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

1. Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.

2. Initial operating losses, such as those incurred while demand for the output of an item builds up. And
3. Costs of relocating or reorganising part or all of the operations of an enterprise.

**Examples of directly attributable costs are:**

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs
4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

**Examples of costs that are not costs of an item of property, plant and equipment are:**

- (a) costs of opening a new facility or business, such as, inauguration costs
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities)
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training)
- (d) administration and other general overhead costs

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

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

#### **Illustration 4**

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

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

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

#### **Solution**

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

#### **Illustration 5**

*Omega Ltd. contracted with a supplier to purchase machinery which is to be installed in its one department in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 1,40,000. These activities were supervised by a technician during the entire period, who is employed for this purpose of ₹ 45,000 per month. The machine was purchased at ₹ 1,58,00,000 and ₹ 50,000 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of ₹ 30,000 to supervise machinery installation at the factory site. You are required to ascertain the amount at which the Machinery should be capitalized.*

#### **Solution**

Particulars		₹
Purchase Price	Given	1,58,00,000
Add: Site Preparation Cost	Given	1,40,000
Technician's Salary	Specific/Attributable overheads	1,35,000

	for 3 months (45,000 x3)	
Initial Delivery Cost	Transportation	50,000
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Machinery		1,61,55,000

### Illustration 6 (Capitalisation of directly attributable costs)

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

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

### Solution

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

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

### Illustration 7 (Operating costs incurred in the start-up period)

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

## **Solution**

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

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

### **C. Decommissioning, Restoration and similar Liabilities:**

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

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

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

## **COST OF A SELF-CONSTRUCTED ASSET**

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

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. Therefore, any internal profits are eliminated in arriving at such costs.
2. Cost of abnormal amounts of wasted material, labour, or other resources incurred in self constructing an asset is not included in the cost of the asset.
3. AS 16 on Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of PPE.
4. Bearer plants are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.

## **MEASUREMENT OF COST**

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

### **A. If payment is deferred beyond normal credit terms:**

Total payment *minus* Cash price equivalent

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

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

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

- (a) Exchange transaction lacks commercial substance; Or
- (b) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

*Note:*

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.
2. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.
3. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:
  - (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
  - (b) the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;
  - (c) and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the enterprise-specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result of these analyses may be clear without an enterprise having to perform detailed calculations.

### **Illustration 8 (Consideration received comprising a combination of non-monetary and monetary assets)**

*Entity A exchanges land with a book value of ₹ 10,00,000 for cash of ₹ 20,00,000 and plant and machinery valued at ₹ 25,00,000. What will be the measurement cost of the assets received. (Consider that the transaction has commercial substance)?*

#### **Solution**

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

### **Illustration 9 (Exchange of assets that lack commercial substance)**

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

#### **Solution**

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

#### **C. PPE purchased for a Consolidated Price:**

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

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

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

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

## **E. Government Grant related to PPE:**

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

### **Measurement after Recognition**

An enterprise should choose

- Either Cost model,
- Or Revaluation model

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

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

### **Examples of separate classes:**

- |                            |                        |
|----------------------------|------------------------|
| (a) Land                   | (b) Land and Buildings |
| (c) Machinery              | (d) Ships              |
| (e) Aircraft               | (f) Motor Vehicles     |
| (g) Furniture and Fixtures | (h) Office Equipment   |
| (j) Bearer plants          |                        |

### **Cost Model**

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

Cost- Any Accumulated Depreciation- Any Accumulated Impairment losses

### **Revaluation Model**

After recognition as an asset, an item of PPE whose fair value can be measured reliably should be carried at a revalued amount.

Fair value at the date of the revaluation	—
Less: Any subsequent accumulated depreciation	(—)
Less: Any subsequent accumulated impairment losses	(—)
Carrying value	==

### **Revaluation for entire class of PPE**

If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued.

## **Reason**

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the Financial Statements that are a mixture of costs and values as at different dates.

### **Illustration 10 (Revaluation on a class by class basis)**

*Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 (Revised) to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.*

*State whether this is acceptable under AS 10 (Revised) or not with reasons?*

## **Solution**

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. AS 10 (Revised) permits assets to be revalued on a class by class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement.

However, all properties within the class of office buildings must be carried at revalued amount.

## **Frequency of Revaluations**

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using Fair value at the Balance Sheet date.

The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.

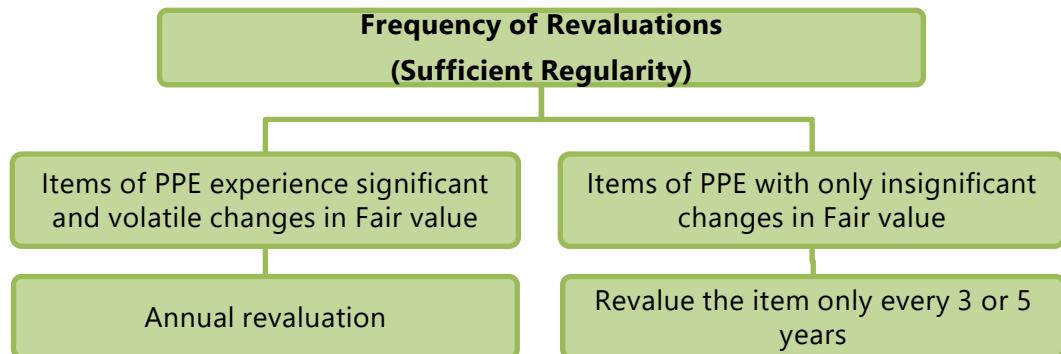
When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

- A.** Items of PPE experience significant and volatile changes in Fair value

Annual revaluation should be done.

- B. Items of PPE with only insignificant changes in Fair value

Revaluation should be done at an interval of 3 or 5 years.



## Determination of Fair Value

Fair value of items of PPE is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.

If there is no market-based evidence of fair value because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach.

### Example

Based on

- *Discounted cash flow projections, Or*
- *A depreciated replacement cost approach*

Which aims at making a **realistic estimate of the current cost** of acquiring or constructing an item that has the same service potential as the existing item.

## Accounting Treatment of Revaluations

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount.

At the date of the revaluation, the asset is treated in one of the following ways:

- A. Technique 1: Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

### **Gross carrying amount**

- May be restated by reference to observable market data, or
- May be restated proportionately to the change in the carrying amount.

### **Accumulated depreciation at the date of the revaluation is**

- Adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses

### **Case Study on Technique I**

PPE is revalued to ₹ 1,500 consisting of ₹ 2,500 Gross cost and ₹ 1,000 Depreciation based on observable market data.

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/ Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500	600	900
PPE after revaluation	2,500	1,000	1,500

The increase on revaluation is ₹ 900 (i.e., ₹ 1,500 – ₹ 600).

### **B. Technique 2: Accumulated depreciation is eliminated against the Gross Carrying amount of the asset**

### **Case Study on Technique II**

(Taking the information given in the above Example)

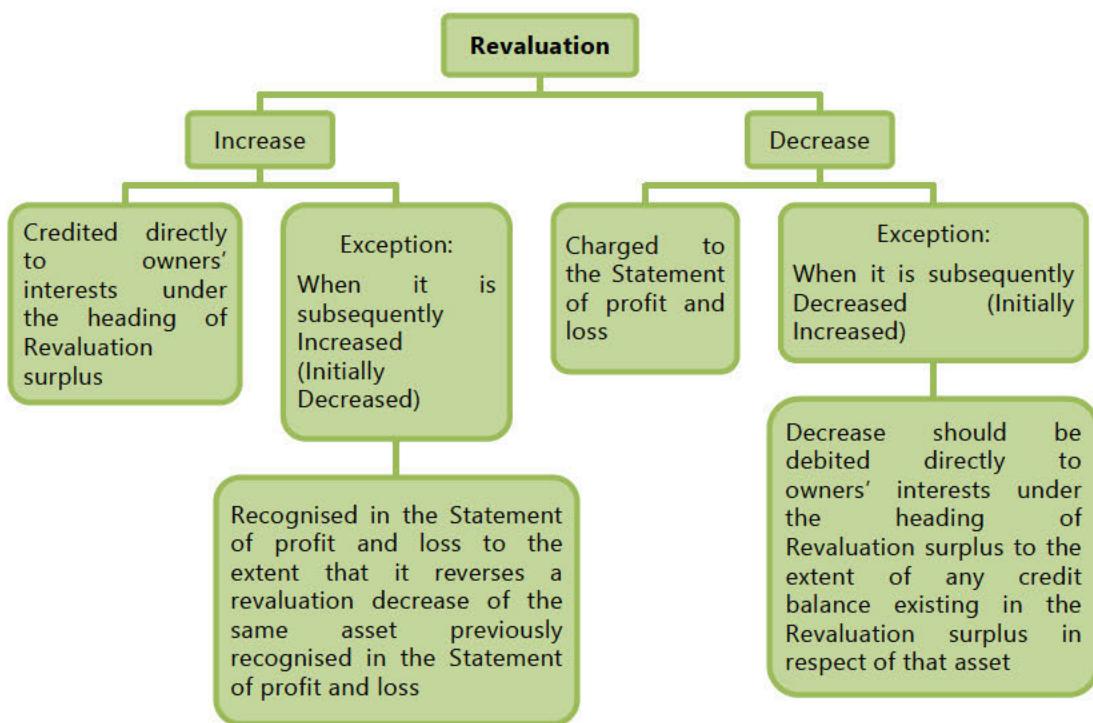
Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600

PPE after revaluation	1,500		1,500
Revaluation gain	500	400	

The increase on revaluation is ₹ 900 (i.e., ₹ 500 + ₹ 400).

### Revaluation – Increase or Decrease



### Treatment of Revaluation Surplus

The revaluation surplus included in owners' interests in respect of an item of PPE may be transferred to the Revenue Reserves when the asset is derecognised.

**Case I:** When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

**Case II:** Some of the surplus may be transferred as the asset is used by an enterprise:

In such a case, the amount of the surplus transferred would be:

Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

**Transfers from Revaluation Surplus to the Revenue Reserves are not made through the Statement of Profit and Loss.**

## **Depreciation**

### **Component Method of Depreciation:**

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately.

**Example:** It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

Is Grouping of Components possible?

**Yes.**

A significant part of an item of PPE may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

## **Accounting Treatment**

Depreciation charge for each period should be recognised in the Statement of Profit and Loss unless it is included in the carrying amount of another asset.

## **Examples on Exception**

AS 2 (Revised): Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories as per AS 2 (Revised).

AS 26: Depreciation of PPE used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26 on Intangible Assets.

## **Depreciable Amount and Depreciation Period**

### **What is “Depreciable Amount”?**

Depreciable amount is:

Cost of an asset (or other amount substituted for cost i.e. revalued amount) - Residual value

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

### **Illustration 11**

*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. Thus, the policy of Entity A is not acceptable.

### **Review of Residual Value and Useful Life of an Asset**

Residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

### **Illustration 12 (Change in estimate of useful life)**

*Entity A purchased an asset on 1<sup>st</sup> January 20X1 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.*

*On 1<sup>st</sup> January 20X5, 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  $(1,00,000 / 10 \text{ years})$ .

On 1<sup>st</sup> January 20X5, the asset's net book value is  $[1,00,000 - (10,000 \times 4)]$  ₹ 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.

### **Commencement of period for charging Depreciation**

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

#### **Illustration 13**

*Entity B constructs a machine for its own use. Construction is completed on 1<sup>st</sup> November 20X1 but the company does not begin using the machine until 1<sup>st</sup> March 20X2. Comment.*

#### **Solution**

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1<sup>st</sup> November 20X1. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

### **Cessation of Depreciation**

#### **I. Depreciation ceases to be charged when asset's residual value exceeds its carrying amount**

The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

#### **Illustration 14 (Depreciation where residual value is the same as or close to Original cost)**

*A property costing ₹ 10,00,000 is bought in 20X1. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.*

*The estimated residual value in 20 years' time, based on 20X1 prices, is:*

*Case (a) ₹ 10,00,000*

*Case (b) ₹ 9,00,000.*

*Calculate the amount of depreciation.*

### **Solution**

#### **Case (a)**

The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost.

There is, therefore, no depreciable amount and depreciation is correctly zero.

#### **Case (b)**

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.

Annual depreciation (on a straight-line basis) will be ₹ 5,000  $\{[10,00,000 - 9,00,000] \div 20\}$ .

## **II. Depreciation of an asset ceases at the earlier of:**

- The date that the asset is retired from active use and is held for disposal, and
- The date that the asset is derecognised

Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated.

However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

### **Land and Buildings**

Land and buildings are separable assets and are accounted for separately, even when they are acquired together.

#### **A. Land:** Land has an unlimited useful life and therefore is not depreciated.

**Exceptions:** Quarries and sites used for landfill.

Depreciation on Land:

- I. If land itself has a limited useful life:

It is depreciated in a manner that reflects the benefits to be derived from it.

- II. If the cost of land includes the costs of site dismantlement, removal and restoration:

That portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.

**B. Buildings:**

Buildings have a limited useful life and therefore are depreciable assets.

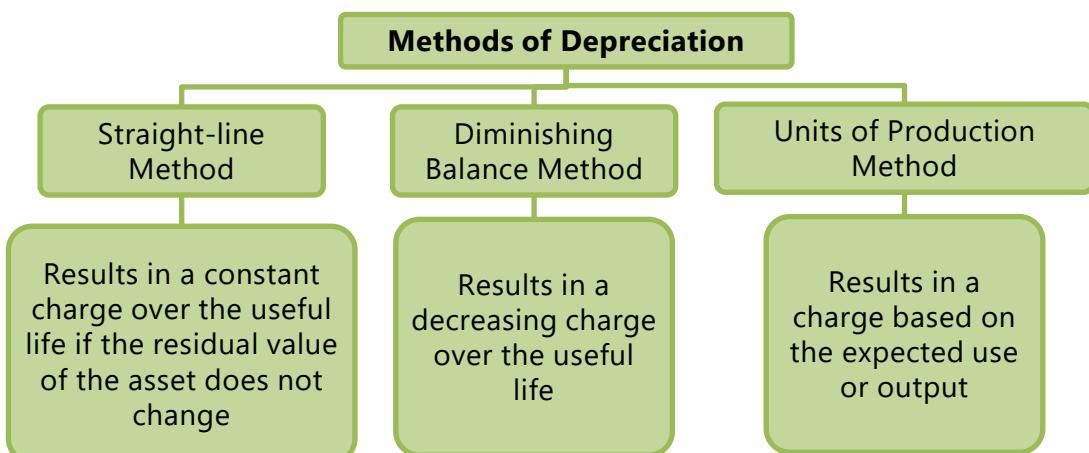
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

**Depreciation Method**

The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

The method selected is applied consistently from period to period unless:

- There is a change in the expected pattern of consumption of those future economic benefits; Or
- That the method is changed in accordance with the statute to best reflect the way the asset is consumed.



**Review of Depreciation Method:**

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected

pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern.

**Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.**

### **Depreciation Method based on Revenue**

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.

### **Illustration 15(Determination of appropriate Depreciation Method)**

*Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products.*

*However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.*

### **Solution**

The straight-line depreciation method should be adopted, because the production output is consistent from year to year.

Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

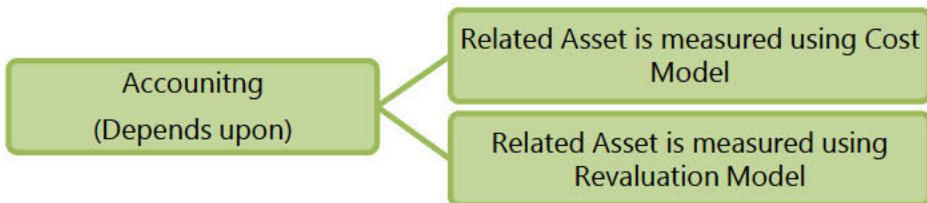
### **Changes in Existing Decommissioning, Restoration and other Liabilities**

The cost of PPE may undergo changes subsequent to its acquisition or construction on account of:

- Changes in Liabilities
- Price Adjustments
- Changes in Duties
- Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and
- Similar factors

The above are included in the cost of the asset.

### **Accounting for the above changes:**



#### **A. If the related asset is measured using the Cost model**

Changes in the Liability should be added to, or deducted from, the cost of the related asset in the current period

**Note:** Amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the Statement of Profit and Loss.

#### **If the adjustment results in an addition to the cost of an asset**

- Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.

**Note:** If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with applicable Accounting standards.

#### **B. If the related asset is measured using the Revaluation model:**

Changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:

- Decrease in the liability credited directly to revaluation surplus in the owners' interest

#### **Exception**

\*It should be recognised in the Statement of Profit and Loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in the Statement of Profit and Loss

**Note:** In the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried

under the cost model, the excess should be recognised immediately in the Statement of Profit and Loss.

- (ii) Increase in the liability should be recognised in the Statement of Profit and Loss

### **Exception**

\*It should be debited directly to Revaluation surplus in the owners' interest to the extent of any credit balance existing in the Revaluation surplus in respect of that asset

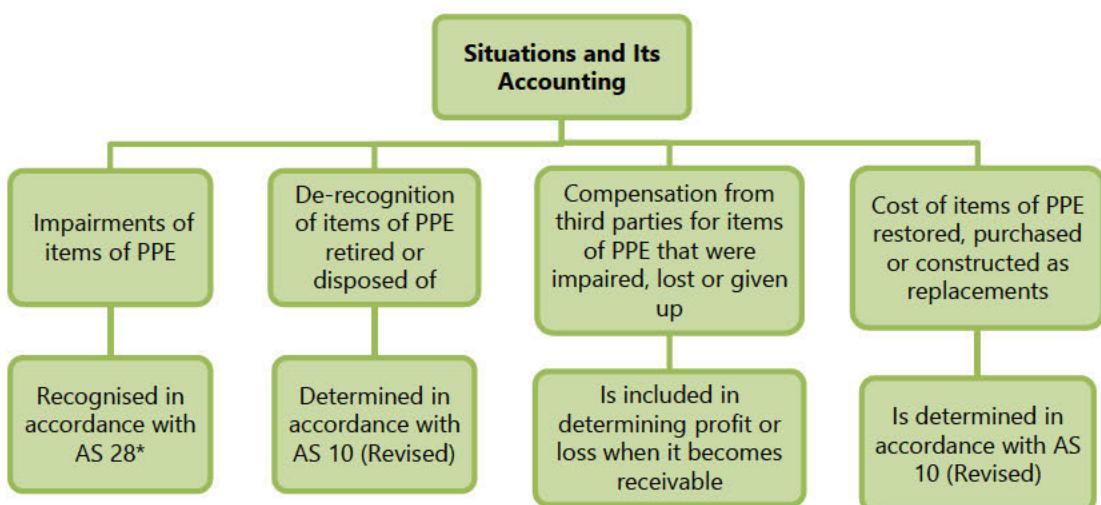
### **Caution**

A change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

What happens if the related asset has reached the end of its useful life?

All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

**Note:** This applies under both the cost model and the revaluation model.



### **Illustration 16 (Gain on replacement of Insured Assets)**

*Entity A carried plant and machinery in its books at ₹2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost ₹20,00,000. The machines were acquired by the insurance company and the company did not receive ₹ 20,00,000 as cash compensation. State, how Entity A should account for the same?*

### **Solution**

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised).

Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised)\* once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

### **Retirements**

Items of PPE retired from active use and held for disposal should be stated at the lower of:

- Carrying Amount, and
- Net Realisable Value

**Note:** Any write-down in this regard should be recognised immediately in the Statement of Profit and Loss.

*\*Students may note that AS 5, AS19, AS 26, AS 28 and AS 29 are not covered in syllabus of Intermediate paper 1 Accounting.*

### **De-recognition**

The carrying amount of an item of PPE should be derecognised:

- On disposal
  - By sale
  - By entering into a finance lease, or
  - By donation, Or
- When no future economic benefits are expected from its use or disposal

## Accounting Treatment

Gain or loss arising from de-recognition of an item of PPE should be included in the Statement of Profit and Loss when the item is derecognised unless AS 19 on Leases, requires otherwise on a sale and leaseback (AS 19 on Leases, applies to disposal by a sale and leaseback.)

Where,

Gain or loss arising from de-recognition of an item of PPE

$$= \text{Net disposal proceeds (if any)} - \text{Carrying Amount of the item}$$

Note: Gains should not be classified as revenue, as defined in AS 9 'Revenue Recognition'.

## Exception

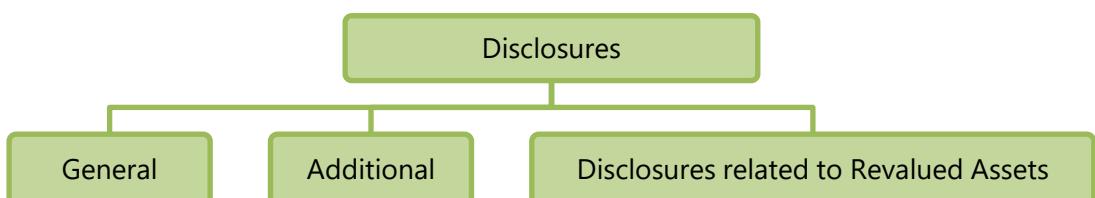
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

## Determining the date of disposal of an item:

An enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods.

## Disclosure



## General Disclosures

The financial statements should disclose, for each class of PPE:

- (a) The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;
- (b) The depreciation methods used;

- (c) The useful lives or the depreciation rates used.  
In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;
- (d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- (e) A reconciliation of the carrying amount at the beginning and end of the period showing:
  - (i) additions
  - (ii) assets retired from active use and held for disposal
  - (iii) acquisitions through business combinations
  - (iv) increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28
  - (v) impairment losses recognised in the statement of profit and loss in accordance with AS 28
  - (vi) impairment losses reversed in the statement of profit and loss in accordance with AS 28
  - (vii) depreciation
  - (viii) net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11
  - (ix) other changes

### **Additional Disclosures**

The financial statements should also disclose:

- (a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- (b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;
- (c) The amount of contractual commitments for the acquisition of property, plant and equipment;

- (d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and
- (e) The amount of assets retired from active use and held for disposal.

### **Disclosures related to Revalued Assets**

If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

- (a) The effective date of the revaluation;
- (b) Whether an independent valuer was involved;
- (c) The methods and significant assumptions applied in estimating fair values of the items;
- (d) The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and
- (e) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

### **Transitional Provisions**

#### Previously Recognised Revenue Expenditure

Where an entity has in past recognised an expenditure in the Statement of Profit and Loss which is eligible to be included as a part of the cost of a project for construction of PPE in accordance with the requirements of this standard

It may do so retrospectively for such a project.

**Note:** The effect of such retrospective application, should be recognised net-of-tax in Revenue reserves.

### **PPE acquired in Exchange of Assets**

The requirements of AS 10 (Revised) regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.

## **Spare parts**

On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2 (Revised), and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts.

**Note:** The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

## **Revaluations**

The requirements of AS 10 (Revised) regarding the revaluation model should be applied prospectively.

In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of items of PPE reflects any previous revaluation it should adjust the amount outstanding in the Revaluation reserve against the carrying amount of that item.

**Note:** The carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as Revaluation reserve over the carrying amount of that item should be adjusted in Revenue reserves.

**Reference:** The students are advised to refer the full text of AS 10 (Revised) "Property, Plant and Equipment" (2016).



## **2.5 AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES**

### **Introduction**

The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognise the financial effects of changes in exchange rates in the financial statements.

### **Scope**

This Standard should be applied:

- (a) In accounting for transactions in foreign currencies.
- (b) In translating the financial statements of foreign operations.

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

This Standard does not:

- (a) Specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, the Standard requires disclosure of the reasons for using that currency. The Standard also requires disclosure of the reason for any change in the reporting currency.
- (b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation, which are addressed in AS 3 'Cash flow statement'.
- (c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.
- (d) Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

### **Definitions of the terms used in the Standard**

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

- (a) Buys or sells goods or services whose price is denominated in a foreign currency.
- (b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.
- (c) Becomes a party to an unperformed forward exchange contract or
- (d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

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

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

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

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

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

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

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

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

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

### **Initial Recognition**

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

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

## **Reporting at each balance sheet date**

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

- monetary or non-monetary; and
  - carried at historical cost or fair value (for non-monetary items).
- (a) Foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to disburse, such item at the balance sheet date.
- (b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.
- (c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.
- (d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

## **Recognition of Exchange Differences**

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

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

intervening period up to the period of settlement is determined by the change in exchange rates during that period.

**Note:** Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

According to the Notification, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31<sup>st</sup> March, 2020.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option should be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure should be made of the fact of such exercise of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

For the purposes of exercise of this option, an asset or liability should be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Further in December, 2011, the Ministry of Corporate Affairs inserted paragraph 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006. According to it, in respect of accounting periods commencing on or after the 1<sup>st</sup> April, 2011, an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise, the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which

they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital assets, can be added to or deducted from the cost of the assets and should be depreciated **over the balance life of the assets**, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and **amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods.**

Such option is irrevocable and should be applied to all such foreign currency monetary items. The enterprise exercising such option should disclose the fact of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

### **Classification of Foreign Operations as Integral or Non-integral**

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

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

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

items held by the non-integral foreign operation.

### **Translation of Foreign Integral Operations**

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

### **Translation of Non-Integral Foreign Operations**

The translation of the financial statements of a non-integral foreign operation is done using the following procedures:

- (a) The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;
- (b) Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and
- (c) All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.
- (d) For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period is often used to translate income and expense items of a foreign operation.
- (e) Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.
- (f) A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.
- (g) The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation

procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

- (h) When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise (AS 21 (Revised)\*).
- (i) The exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.
- (j) An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. Remittance from a non-integral foreign operation by way of repatriation of accumulated profits does not form part of a disposal unless it constitutes return of the investment<sup>€</sup>. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognized at the time of a write-down".

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\* AS 21 is not covered in syllabus of Intermediate Paper 1 Accounting.

€ MCA amended this paragraph, by notification dated 18<sup>th</sup> June, 2018, which is relevant for companies.

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

- (a) While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.
- (b) Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.
- (c) The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.
- (d) Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.
- (e) The foreign operation's sales are mainly in currencies other than the reporting currency.
- (f) Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.
- (g) Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.
- (h) There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

### **Illustration 1**

*Classify the following items as monetary or non-monetary item:*

*Inventories*

*Trade Receivables*

*Investment in Equity shares*

*Property, Plant and Equipment.*

### Solution

Inventories	Non-monetary
Trade receivables	Monetary
Investment in equity shares	Non-monetary
Property, Plant and Equipment	Non-monetary

### Illustration 2

	Exchange Rate per \$
Goods purchased on 1.1.20X1 for US \$ 15,000	₹ 75
Exchange rate on 31.3.20X1	₹ 74
Date of actual payment 7.7.20X1	₹ 73

You are required to ascertain the loss/gain to be recognized for financial years ended 31<sup>st</sup> March, 20X1 and 31<sup>st</sup> March, 20X2 as per AS 11.

### Solution

As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.20X1 and corresponding creditors would be recorded at ₹ 11,25,000 (i.e. \$15,000 × ₹ 75)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditors of US \$15,000 on 31.3.20X1 will be reported at ₹ 11,10,000 (i.e. \$15,000 × ₹ 74) and exchange profit of ₹ 15,000 (i.e. 11,25,000 – 11,10,000) should be credited to Profit and Loss account in the year ended 31<sup>st</sup> March, 20X1.

On 7.7.20X1, creditors of \$15,000 is paid at the rate of ₹ 73. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, ₹ 15,000 (i.e. 11,10,000 – 10,95,000) will be credited to Profit and Loss account in the year ended 31<sup>st</sup> March, 20X2.

### Illustration 3

Kalim Ltd. borrowed US\$ 4,50,000 on 01/01/20X1, which will be repaid as on 31/07/20X1. Kalim Ltd. prepares financial statement ending on 31/03/20X1. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different

dates are as under:

01/01/20X1 1 US\$ = ₹ 48.00

31/03/20X1 1 US\$ = ₹ 49.00

31/07/20X1 1 US\$ = ₹ 49.50

### Solution

#### Journal Entries in the Books of Kalim Ltd.

Date	Particulars	₹ (Dr.)	₹ (Cr.)
20X1 Jan. 01	Bank Account (4,50,000 x 48) To Foreign Loan Account Dr.	216,00,000	
March 31	Foreign Exchange Difference Account Dr. To Foreign Loan Account [4,50,000 x (49-48)]	4,50,000	4,50,000
July 01	Foreign Exchange Difference Account Dr. [4,50,000 x (49.5-49)] Foreign Loan Account Dr. To Bank Account	2,25,000 220,50,000	2,22,75,000

### Change in the Classification of a Foreign Operation

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

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

### Tax Effects of Exchange Differences

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

## **Forward Exchange Contract**

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

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

### **Illustration 4**

*Rau Ltd. purchased a plant for US\$ 1,00,000 on 01<sup>st</sup> February 20X1, payable after three months. Company entered into a forward contract for three months @ ₹ 49.15 per dollar. Exchange rate per dollar on 01<sup>st</sup> Feb. was ₹ 48.85. How will you recognise the profit or loss on forward contract in the books of Rau Ltd.?*

### **Solution**

Forward Rate	₹ 49.15
Less: Spot Rate	(₹ 48.85)
Premium on Contract	₹ 0.30
Contract Amount	US\$ 1,00,000
Total Loss (1,00,000 x 0.30)	₹ 30,000

Contract period 3 months (2 months falling in the year ended 31<sup>st</sup> March, 20X1)

Loss to be recognised  $(30,000/3) \times 2 = ₹ 20,000$  in the year ended 31<sup>st</sup> March, 20X1.  
Rest ₹ 10,000 will be recognised in the following year.

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

### **Illustration 5**

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

### **Solution**

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

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

### **Illustration 6**

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

### **Solution**

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

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for

example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange date at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realisable value is translated applying exchange rate when realisable value is determined which is generally closing rate.

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

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

### **Illustration 7**

*A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Branch as at 31.03.20X4:*

<b>Account Name</b>	<b>Amount in £</b>	
	<b>Dr.</b>	<b>Cr.</b>
Machinery (purchased on 01.04.20X1)	5,000	
Debtors	1,600	
Opening Stock	400	
Goods received from Head Office Account (Recorded in HO books as ₹ 4,02,000)	6,100	
Sales		20,000
Purchases	10,000	
Wages	1,000	
Salaries	1,200	

Cash		3,200	
Remittances to Head Office (Recorded in HO books as ₹ 1,91,000)		2,900	
Head Office Account (Recorded in HO books as ₹ 4,90,000)			7,400
Creditors			4,000

- Closing stock at branch is £ 700 on 31.03.20X4.
- Depreciation @ 10% p.a. is to be charged on Machinery.
- Prepare the trial balance after been converted in Indian Rupees.
- Exchange rates of Pounds on different dates are as follow:  
01.04.20X1 – ₹ 61; 01.04.20X3 – ₹ 63 & 31.03.20X4 – ₹ 67

### Solution

#### Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 20X4

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	₹ (Dr.)	₹ (Cr.)
Machinery	5,000		Transaction date rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	31,400		20,58,000	20,58,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

## **Disclosure**

An enterprise should disclose:

- (a) The amount of exchange differences included in the net profit or loss for the period.
- (b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

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

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

- (a) The nature of the change in classification;
- (b) The reason for the change;
- (c) The impact of the change in classification on shareholders' funds; and
- (d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

## **Presentation of Foreign Currency Monetary Item Translation Difference Account (FCMITDA)**

In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset. Therefore, debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

### **Illustration 8**

*A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.20X1 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.20X1 and*

31.12.20X1 respectively. First instalment was paid on 31.12.20X1. The entire difference in foreign exchange has been capitalised.

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

### Solution

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

Calculation of Exchange Difference:

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

Exchange difference = 75 lakhs US Dollars  $\times$  (42.50 – 40.00) = ₹187.50 lakhs (including exchange loss on payment of first instalment)

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

**Note:** The above answer has been given on the basis that the company has not exercised the option of capitalisation available under paragraph 46 of AS 11. However, if the company opts to avail the benefit given in paragraph 46A, then nothing is required to be done since the company has done the correct treatment.

**Reference:** The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates".



## 2.6 AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

### Introduction

AS 12 deals with accounting for government grants such as subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognised until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The

standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets and revenue and those in the nature of promoters' contribution; treatment for refund of government grants etc.

This Standard does not deal with:

- (i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.
- (ii) Government assistance other than in the form of government grants.
- (iii) Government participation in the ownership of the enterprise.

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

### **Government Grants**

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

### **Accounting Treatment of Government Grants**

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

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

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

## **Recognition of Government Grants**

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

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

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

## **Non-monetary Government Grants**

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

## **Presentation of Grants Related to Specific Fixed Assets**

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

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

### **Method I :**

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

### **Illustration 1**

*Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant amount is deducted from the value of fixed asset.*

## Solution

### Journal in the books of Z Ltd.

<b>Year</b>	<b>Particulars</b>	<b>₹ (Dr.)</b>	<b>₹ (Cr.)</b>
1st	Fixed Assets Account Dr. To Bank Account (Being Fixed Assets purchased)	50,00,000	50,00,000
	Bank Account Dr. To Fixed Assets Account (Being grant received from the government)	10,00,000	10,00,000
	Depreciation Account Dr. To Fixed Assets Account (Being Depreciation charged on SLM)	7,00,000	7,00,000
	Profit & Loss Account Dr. To Depreciation Account (Being Depreciation transferred to P/L Account)	7,00,000	7,00,000
2nd	Depreciation Account Dr. To Fixed Assets Account (Being Depreciation charged on SLM)	7,00,000	7,00,000
	Profit & Loss Account Dr. To Depreciation Account (Being Depreciation transferred to P/L Account)	7,00,000	7,00,000

### Method II:

- Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
- Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.
- If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

## Illustration 2

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant is treated as deferred income.

### Solution

#### Journal in the books of Z Ltd.

<b>Year</b>	<b>Particulars</b>	<b>₹ (Dr.)</b>	<b>₹ (Cr.)</b>
1st	Fixed Assets Account To Bank Account (Being fixed assets purchased)	Dr. 50,00,000	50,00,000
	Bank Account To Deferred Government Grant Account (Being grant received from the government)	Dr. 10,00,000	10,00,000
	Depreciation Account To Fixed Assets Account (Being depreciation charged on SLM)	Dr. 9,00,000	9,00,000
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to P/L Account)	Dr. 9,00,000	9,00,000
	Deferred Government Grants Account To Profit & Loss Account (Being proportionate government grant taken to P/L Account)	Dr. 2,00,000	2,00,000
2nd	Depreciation Account To Fixed Assets Account (Being depreciation charged on SLM)	Dr. 9,00,000	9,00,000
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to P/L Account)	Dr. 9,00,000	9,00,000

Deferred Government Grant Account To Profit & Loss Account (Being proportionate government grant taken to P/L Account)	Dr.	2,00,000	2,00,000
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### Illustration 3

*Santosh Ltd. has received a grant of ₹8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed ₹2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.*

### Solution

As per AS 12 'Accounting for Government Grants', when government grant is received for a specific purpose, it should be utilised for the same. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the elements of the grant is incorrect as per AS 12.

### Presentation of Grants Related to Revenue

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

### Presentation of Grants of the Nature of Promoters' Contribution

Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

### Illustration 4

*Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment, for which no repayment was ordinarily expected. Moreover,*

*there was no condition that the company should purchase any specified assets for this subsidy. Having fulfilled all the conditions under the scheme, the company on its investment of ₹50 crore in capital assets received ₹10 crore from the Government in January, 20X2 (accounting period being 20X1-20X2). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 20X2.*

*Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.*

### **Solution**

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus, it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment desired by the company is not proper.

### **Illustration 5**

*How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?*

- (i) ₹35 Lakhs received from the Local Authority for providing Medical facilities to the employees.
- (ii) ₹100 Lakhs received as Subsidy from the Central Government for setting up a unit in notified backward area. This subsidy is in nature of promoters' contribution.

### **Solution**

- (i) ₹ 35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either

separately or under a general heading such as 'Other Income'. Alternatively, ₹ 35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

- (ii) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of ₹ 100 lakhs should be credited to capital reserve.

### **Refund of Government Grants**

- Government grants sometimes become refundable because certain conditions are not fulfilled and are treated as an extraordinary item (AS 5).
- The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.
- The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.
- Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

### **Disclosure**

- i. The accounting policy adopted for government grants, including the methods of presentation in the financial statements;
- ii. The nature and extent of government grants recognised in the financial

statements, including grants of non-monetary assets given at a concessional rate or free of cost.

### **Illustration 6**

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs (This amount was reduced from the cost of fixed asset). Grant was considered as refundable in the end of 2<sup>nd</sup> year to the extent of ₹ 7,00,000. Pass the journal entry for refund of the grant as per the first method.

### **Solution**

Fixed Assets Account	Dr.	₹ 7,00,000
To Bank Account		₹ 7,00,000

(Being government grant on asset refunded)

### **Illustration 7**

A fixed asset is purchased for ₹ 20 lakhs. Government grant received towards it is ₹ 8 lakhs. Residual Value is ₹ 4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 5 lakhs due to non-compliance with certain conditions. Pass journal entries for first two years.

### **Solution**

#### **Journal Entries**

<b>Year</b>	<b>Particulars</b>		<b>₹ in lakhs (Dr.)</b>	<b>₹ in lakhs (Cr.)</b>
1	Fixed Asset Account To Bank Account (Being fixed asset purchased)	Dr.	20	20
	Bank Account To Fixed Asset Account (Being grant received from the government reduced the cost of fixed asset)	Dr.	8	8
	Depreciation Account (W.N.1) To Fixed Asset Account (Being depreciation charged on Straight Line method (SLM))	Dr.	2	2

	Profit & Loss Account To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 1)	Dr.	2	2
2	Fixed Asset Account To Bank Account (Being government grant on asset partly refunded which increased the cost of fixed asset)	Dr.	5	5
	Depreciation Account (W.N.2) To Fixed Asset Account (Being depreciation charged on SLM on revised value of fixed asset prospectively)	Dr.	3.67	3.67
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 2)	Dr.	3.67	3.67

#### Working Notes:

##### 1. Depreciation for Year 1

	₹ in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12
Depreciation $\left[ \frac{12-4}{4} \right]$	2

##### 2. Depreciation for Year 2

	₹ in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12

Less: Depreciation for the first year $\left[ \frac{12-4}{4} \right]$	2
	10
Add: Government grant refundable	<u>5</u>
	<u>15</u>
Depreciation for the second year $\left[ \frac{15-4}{3} \right]$	3.67

### Illustration 8

On 1.4.20X1, ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 20X4 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd. assuming that the company did not charge any depreciation for year 20X4?

### Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing deferred income balance, as appropriate, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(₹ in lakhs)
1st April, 20X1	Acquisition cost of machinery (₹ 1,500 – ₹ 300)	1,200.00
31st March, 20X2	Less: Depreciation @ 20%	(240.00)
	Book value	960.00
31st March, 20X3	Less: Depreciation @ 20%	(192.00)
	Book value	768.00
31st March, 20X4	Less: Depreciation @ 20%	(153.60)

1st April, 20X4	Book value	614.40
May, 20X4	Add: Refund of grant	300.00
	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting ₹ 914.40 lakhs is to be provided prospectively over the residual useful life of the asset.

### Illustration 9

A Ltd. purchased a machinery for ₹40 lakhs. (Useful life 4 years and residual value ₹8 lakhs) Government grant received is ₹16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant in the third year and the value of the fixed assets, if:

- (1) the grant is credited to Fixed Assets A/c.
- (2) the grant is credited to Deferred Grant A/c.

### Solution

**In the books of A Ltd.**  
**Journal Entries (at the time of refund of grant)**

**(1) If the grant is credited to Fixed Assets Account:**

		₹	₹
I	Fixed Assets A/c To Bank A/c (Being grant refunded)	Dr. 16 lakhs	16 lakhs

- II The balance of fixed assets after two years depreciation will be ₹16 lakhs (W.N.1) and after refund of grant it will become (₹16 lakhs + ₹16 lakhs) = ₹32 lakhs on which depreciation will be charged for remaining two years. Depreciation =  $(32-8)/2 = ₹12$  lakhs p.a. will be charged for next two years.

**(2) If the grant is credited to Deferred Grant Account:**

As per para 14 of AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (₹16 lakhs / 4 years) = ₹4 lakhs p.a.

$\times 2$  years = ₹8 lakhs were credited to Profit and Loss Account and ₹8 lakhs was the balance of Deferred Grant Account after two years.

Therefore, on refund in the 3<sup>rd</sup> year, following entry will be passed:

		₹	₹
I	Deferred Grant A/c	Dr.	8 lakhs
	Profit & Loss A/c	Dr.	8 lakhs
	To Bank A/c		16 lakhs
	(Being Government grant refunded)		

- II Deferred grant account will become Nil. The fixed assets will continue to be shown in the books at ₹24 lakhs (W.N.2) and depreciation will continue to be charged at ₹8 lakhs per annum for the remaining two years.

#### Working Notes:

**1. Balance of Fixed Assets after two years but before refund (under first alternative)**

Fixed assets initially recorded in the books = ₹40 lakhs – ₹16 lakhs = ₹24 lakhs

Depreciation p.a. = (₹24 lakhs – ₹8 lakhs)/4 years = ₹4 lakhs per year

Value of fixed assets after two years but before refund of grant  
= ₹24 lakhs – (₹4 lakhs x 2 years) = ₹16 lakhs

**2. Balance of Fixed Assets after two years but before refund (under second alternative)**

Fixed assets initially recorded in the books = ₹40 lakhs

Depreciation p.a. = (₹40 lakhs – ₹8 lakhs)/4 years = ₹8 lakhs per year

Book value of fixed assets after two years = ₹40 lakhs – (₹8 lakhs x 2 years)  
= ₹24 lakhs

**Note:** Value of fixed assets given above is after refund of government grant.

**Reference:** The students are advised to refer the full text of AS 12 "Accounting for Government Grants".



## 2.7 ACCOUNTING FOR INVESTMENTS [AS 13 (REVISED)]

### Introduction

The standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realisable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Standard does not deal with:

- a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9
- b. Operating or finance leases
- c. Investments on retirement benefit plans and life insurance enterprises
- d. Mutual funds, venture capital funds and/ or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

### Definition of the terms used in the Standard

**Investments** are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade (inventory) are not 'investments'

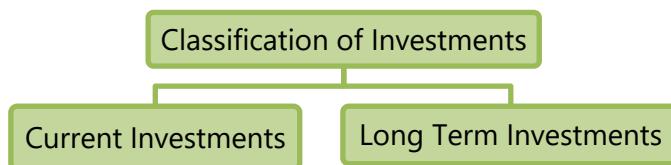
**Fair value** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

**Market value** is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

## Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). For some investments, an active market exists from which a market value (fair value) can be established. For other investments, an active market does not exist and other means are used to determine fair value.

## Classification of Investments



**A current investment** is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

**A long term investment** is an investment other than a current investment.

## Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties etc.

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued or asset given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued.

If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up or the fair value of the investment acquired, whichever is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part

of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

### **Carrying Amount of Investments**

The carrying amount for current investments is the lower of cost and fair value.

Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed category-wise (i.e. equity shares, preference shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

Any reduction to fair value is debited to profit and loss account, however, if fair value of investment is increased subsequently, the increase in value of current investment up to the cost of investment is credited to the profit and loss account (and excess portion, if any, is ignored).

Long term investments are usually carried at cost. The carrying amount of long-term investments is therefore determined on an individual investment basis.

Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

## **Investment Properties**

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

An investment property is accounted for in accordance with cost model as prescribed in AS 10 (Revised), 'Property, Plant and Equipment'. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

## **Disposal of Investments**

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment<sup>3</sup>.

## **Reclassification of Investments**

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

## **Disclosure**

The following disclosures in financial statements in relation to investments are appropriate: -

- a. The accounting policies followed for valuation of investments.
- b. The amounts included in profit and loss statement for:
  - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should

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<sup>3</sup> In respect of shares, debentures and other securities held as stock-in-trade, the cost of stocks disposed of is determined by applying an appropriate cost formula (e.g. first-in, first-out, average cost, etc.). These cost formulae are the same as those specified in AS 2 (Revised), in respect of Valuation of Inventories.

- be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
- ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
  - iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
  - d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.
  - e. Other disclosures as specifically required by the relevant statute governing the enterprise.

### **Illustration 1**

*An unquoted long term investment is carried in the books at a cost of ₹2 lakhs. The published accounts of the unlisted company received in May, 20X1 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31<sup>st</sup> March, 20X1?*

### **Solution**

As it is stated in the question that financial statements for the year ended 31<sup>st</sup> March, 20X1 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors. Also, the fall in value of investments has been considered on account of conditions existing on the balance sheet date.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. AS 13 (Revised) 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31<sup>st</sup> March, 20X1.

## **Illustration 2**

*X Ltd. on 1-1-20X1 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realisable value of all such investment on 31-3-20X1 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is not temporary in nature. How will you recognise the reduction in financial statements for the year ended on 31-3-20X1?*

### **Solution**

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.20X1 to 31.3.20X1), AS 13 (Revised) lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realisable value of all such investments on 31.3.20X1 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13 (Revised), 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realisable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its shares to one third which is quite a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will also be charged to the Statement of profit and loss.

### **Illustration 3**

*M/s Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 20X3 at a cost of ₹ 2,50,000. It also earlier purchased Gold of ₹ 4,00,000 and Silver of ₹ 2,00,000 on 1<sup>st</sup> March, 20X1. Market value as on 31<sup>st</sup> March, 20X4 of above investments are as follows:*

	₹
Shares	2,25,000
Gold	6,00,000
Silver	3,50,000

*How above investments will be shown in the books of accounts of M/s Innovative Garments Manufacturing Company Limited for the year ending 31st March, 20X4 as per the provisions of Accounting Standard 13 "Accounting for Investments"?*

### **Solution**

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares - if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (₹ 2,50,000) and market value (₹ 2,25,000) as on 31 March 20X4, i.e., ₹ 2,25,000.

If equity shares are acquired with an intention to hold for long term period (more than one year), then should be considered as long-term investment to be shown at cost in the Balance Sheet of the company. However, provision for diminution should be made to recognise a decline, if other than temporary, in the value of the investments.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1<sup>st</sup> March, 20X1) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31<sup>st</sup> March, 20X4, i.e., ₹ 4,00,000 and ₹ 2,00,000 respectively, though their market values have been increased.

### **Illustration 4**

*ABC Ltd. wants to re-classify its investments in accordance with AS 13 (Revised). Decide and state on the amount of transfer, based on the following information:*

- (1) *A portion of current investments purchased for ₹20 lakhs, to be reclassified as long term investment, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹25 lakhs.*

- (2) Another portion of current investments purchased for ₹ 15 lakhs, to be reclassified as long term investments. The market value of these investments as on the date of balance sheet was ₹ 6.5 lakhs.
- (3) Certain long term investments no longer considered for holding purposes, to be reclassified as current investments. The original cost of these was ₹ 18 lakhs but had been written down to ₹ 12 lakhs to recognise other than temporary decline as per AS 13 (Revised).

### Solution

As per AS 13 (Revised), where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

- (1) In the first case, the market value of the investment is ₹ 25 lakhs, which is higher than its cost i.e. ₹ 20 lakhs. Therefore, the transfer to long term investments should be carried at cost i.e. ₹ 20 lakhs.
- (2) In the second case, the market value of the investment is ₹ 6.5 lakhs, which is lower than its cost i.e. ₹ 15 lakhs. Therefore, the transfer to long term investments should be carried in the books at the market value i.e. ₹ 6.5 lakhs. The loss of ₹ 8.5 lakhs should be charged to profit and loss account.

As per AS 13 (Revised), where long-term investments are re-classified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

- (3) In the third case, the book value of the investment is ₹ 12 lakhs, which is lower than its cost i.e. ₹ 18 lakhs. Here, the transfer should be at carrying amount and hence this re-classified current investment should be carried at ₹ 12 lakhs.

#### Reference:

1. Students are advised to refer 'chapter 9' for more problems on practical application of AS 13 (Revised).
2. The students are also advised to refer the full bare text of AS 13 (Revised) "Accounting for Investments".



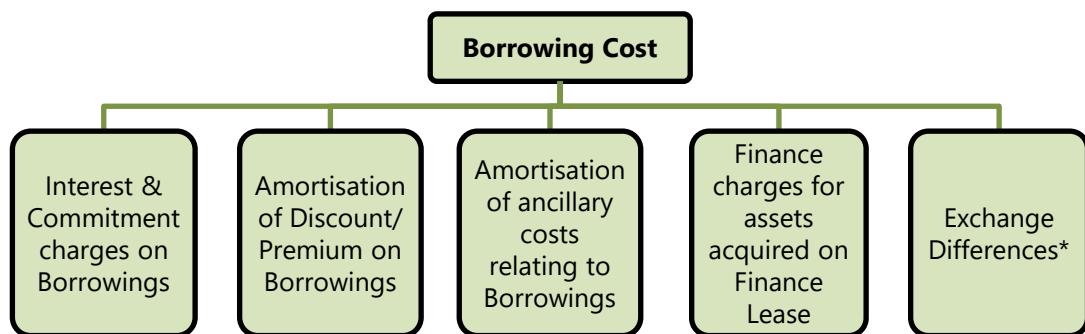
## 2.8 AS 16: BORROWING COSTS

### Introduction

The objective of AS 16 is accounting for borrowing costs. It does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

### Definitions

**Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.**



\*To the extent they are regarded as an adjustment to interest cost

**A qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Accounting standard further clarifies the meaning of the expression 'substantial period of time'. According to it, substantial period of time primarily depends on the facts and circumstances of each case. It further states that, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case. In

estimating the period, time which an asset takes technologically and commercially to get it ready for its intended use or sale should be considered.

### **Exchange Differences on Foreign Currency Borrowings**

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, ‘The Effect of Changes in Foreign Exchange Rates’ . For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

#### **Example**

*XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X1, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X1, the exchange rate between the currencies was ₹45 per USD. The exchange rate, as at March 31, 20X2, is ₹48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X1.*

*The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:*

- (i) *Interest for the period = USD 10,000 x 5% x ₹48/USD = ₹24,000*
- (ii) *Increase in the liability towards the principal amount = USD 10,000 x (48-45)  
= ₹30,000*
- (iii) *Interest that would have resulted if the loan was taken in Indian currency  
= USD 10,000 x 45 x 11% = ₹49,500*
- (iv) *Difference between interest on local currency borrowing and foreign currency borrowing = ₹49,500 – ₹24,000 = ₹25,500*

*Therefore, out of ₹30,000 increase in the liability towards principal amount, only ₹25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹49,500 being the aggregate of interest of ₹24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the*

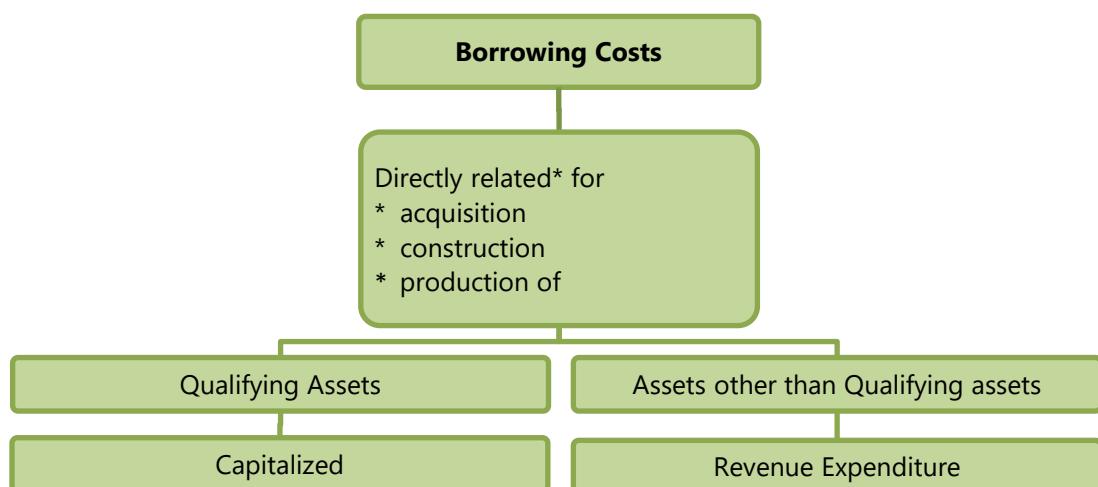
*extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500.*

*Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.*

*In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e., ₹ 34,500 (₹ 58,500 – ₹ 24,000)] is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11 'The Effects of Changes in Foreign Exchange Rates'.*

### **Borrowing Costs Eligible for Capitalisation**

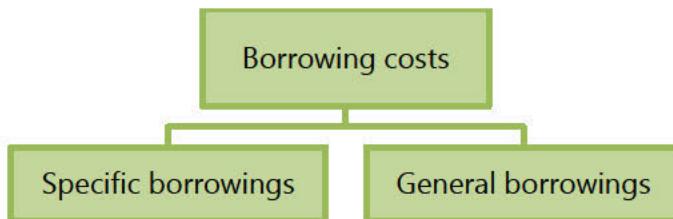
#### **Treatment of Borrowing Costs**



\*or that could have been avoided if the expenditure on qualifying assets had not been made

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable

that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.



### Illustration 1

*PRM Ltd. obtained a loan from a bank for ₹50 lakhs on 30-04-20X1. It was utilised as follows:*

<b>Particulars</b>	<b>Amount (₹ in lakhs)</b>
Construction of a shed	50
Purchase of a machinery	40
Working Capital	20
Advance for purchase of truck	10

*Construction of shed was completed in March 20X2. The machinery was installed on the date of acquisition. Delivery of truck was not received. Total interest charged by the bank for the year ending 31-03-20X2 was ₹ 18 lakhs. Show the treatment of interest.*

### Solution

Qualifying Asset as per AS 16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalised =  $18 \times 50/120 = ₹ 7.5$  lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs = ₹ 10.5 lakhs

### Specific borrowings

When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that

borrowing during the period less any income on the temporary investment of those borrowings.

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

### **General borrowings**

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

### **Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount**

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

### **Illustration 2**

*X Ltd. began construction of a new building on 1<sup>st</sup> January, 20X1. It obtained ₹1 lakh special loan to finance the construction of the building on 1<sup>st</sup> January, 20X1 at an interest rate of 10%. The company's other outstanding two non-specific loans were:*

<b>Amount</b>	<b>Rate of Interest</b>
₹ 5,00,000	11%
₹ 9,00,000	13%

The expenditures that were made on the building project were as follows:

		₹
January	20X1	2,00,000
April	20X1	2,50,000
July	20X1	4,50,000
December	20X1	1,20,000

Building was completed by 31<sup>st</sup> December 20X1. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.

### Solution

#### (i) Computation of weighted average accumulated expenses

	₹
₹ 2,00,000 x 12 / 12	= 2,00,000
₹ 2,50,000 x 9 / 12	= 1,87,500
₹ 4,50,000 x 6 / 12	= 2,25,000
₹ 1,20,000 x 1 / 12	= <u>10,000</u>
	6,22,500

#### (ii) Calculation of weighted average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest	Amount of interest (₹)
5,00,000	11%	= 55,000
<u>9,00,000</u>	13%	= <u>1,17,000</u>
14,00,000		<u>1,72,000</u>
Weighted average rate of interest $\left( \frac{1,72,000}{14,00,000} \times 100 \right)$		= 12.285% (approx)

#### (iii) Interest on weighted average accumulated expenses

₹	
Specific borrowings ( $\text{₹ } 1,00,000 \times 10\%$ )	= 10,000
Non-specific borrowings ( $\text{₹ } 5,22,500^* \times 12.285\%$ )	= 64,189
Amount of interest to be capitalised	= 74,189

**(iv) Total expenses to be capitalised for building**

₹	
Cost of building ₹ ( $2,00,000 + 2,50,000 + 4,50,000 + 1,20,000$ )	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

**(v) Journal Entry**

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12. 20X1	Building account To Bank account (Being amount of cost of building and borrowing cost thereon capitalised)	Dr.	10,94,189	10,94,189

**Commencement of Capitalisation**

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- a. **Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:** Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.
- b. Borrowing costs are being incurred.

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\* ( $\text{₹ } 6,22,500 - \text{₹ } 1,00,000$ )

- c. **Activities that are necessary to prepare the asset for its intended use or sale are in progress:** The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

### **Suspension of Capitalisation**

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example: capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

### **Cessation of Capitalisation**

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed

part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

### **Disclosure**

The financial statements should disclose:

- a. The accounting policy adopted for borrowing costs; and
- b. The amount of borrowing costs capitalised during the period.

### **Illustration 3**

*The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 20X2 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 20X1-20X2 on the entire Institutional Term Loan of ₹ 580 lakhs.*

### **Solution**

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

A qualifying asset is an asset that necessarily takes a substantial period of time\* to get ready for its intended use or sale.

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

<b>Purpose</b>	<b>Nature</b>	<b>Interest to be capitalised</b>	<b>Interest to be charged to profit and loss account</b>
		<b>₹ in lakhs</b>	<b>₹ in lakhs</b>
Modernisation and renovation of plant and machinery	Qualifying asset	$** 52.20 \times \frac{406}{580} = 36.54$ $** 52.20 \times \frac{58}{580} = 5.22$	
Advance to supplies for additional assets	Qualifying asset		$52.20 \times \frac{116}{580} = 10.44$
Working Capital	Not a qualifying asset		
		41.76	10.44

\* A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

\*\* It is assumed in the above solution that the modernisation and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31<sup>st</sup> March, 20X2.

#### Illustration 4

Take Ltd. has borrowed ₹30 lakhs from State Bank of India during the financial year 20X1-20X2. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹50 lakhs. As on 31<sup>st</sup> March, 20X2, since the said project was not complete, the directors

*of Take Ltd. resolved to capitalise the interest accruing on borrowings amounting to ₹4 lakhs and add it to the cost of investments. Comment.*

### **Solution**

As per AS 13 (Revised) "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31<sup>st</sup> March, 20X2.

**Reference:** The students are advised to refer the full text of AS 16 "Borrowing Costs" (issued 2000).