

APPLICATION OF ACCOUNTING STANDARDS



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ❑ Understand the provisions of the Accounting Standards specified in the syllabus;
- ❑ Solve the practical problems based on application of Accounting Standards.

CHAPTER OVERVIEW



Practical Application of

AS 4	:	Contingencies and Events occurring after the Balance Sheet Date
AS 5	:	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	:	Construction Contracts
AS 9	:	Revenue Recognition
AS 14	:	Accounting for Amalgamations
AS 17	:	Segment Reporting
AS 18	:	Related Party Disclosures
AS 19	:	Leases
AS 20	:	Earnings Per Share
AS 22	:	Accounting for Taxes on Income
AS 24	:	Discontinuing Operations
AS 26	:	Intangible Assets
AS 29	:	Provisions, Contingent Liabilities and Contingent Assets.

Note: *The Students are advised to refer the bare Text of the Accounting Standards given in the book of Accounting Pronouncements while studying this Chapter.*



1. INTRODUCTION

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The Accounting Standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good

financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks. You must have already studied the concept, objectives, benefits and limitations, applicability and compliance of Accounting Standards, in detail, in Chapter 3 of "Accounting" Intermediate Course Study Material – Group I. We will discuss the Accounting Standards (specified in the syllabus) in this chapter taking individual standard in detail.



2. OVERVIEW OF THE ACCOUNTING STANDARDS

2.1 AS 4 (revised): Contingencies and Events Occurring After the Balance Sheet Date

Introduction

All paragraphs of AS 4 (Revised) that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard. Thus, the present standard (AS 4 (Revised)) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet.

Contingencies

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Accounting Treatment of Contingent Losses

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

Example: ABC has filed case against a debtor for a recovery of ₹ 25 Lakhs. According to the legal team, the chances of recovery is nil. Therefore, ABC should make provision for doubtful debt.

The estimation of the amount of a contingent loss to be provided for in the financial statements, may be based on judgement made, by management. If there is

conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved.

Events Occurring after the Balance Sheet Date

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

For example, for the year ending on 31st March 20X1, financial statement is finalized and approved by the Board of the directors of the company in its meeting held on 04th September 20X1. In this case the events taking place between 01st April 20X1 to 04th September 20X1 are termed as events occurring after the balance sheet date.

Two types of events can be identified:

- a. Adjusting events-** those which provide further evidence of conditions that existed at the balance sheet date. For example, a trade receivable declared insolvent after reporting date and unable to pay full amount against whom provision for doubtful debt was created.
- b. Non-adjusting events-** those which are indicative of conditions that arose subsequent to the balance sheet date. For example, plant got damaged due to occurrence of fire.

Adjusting Events

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

Non-Adjusting Events

Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date but reflect circumstances which have occurred in the following period.

Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

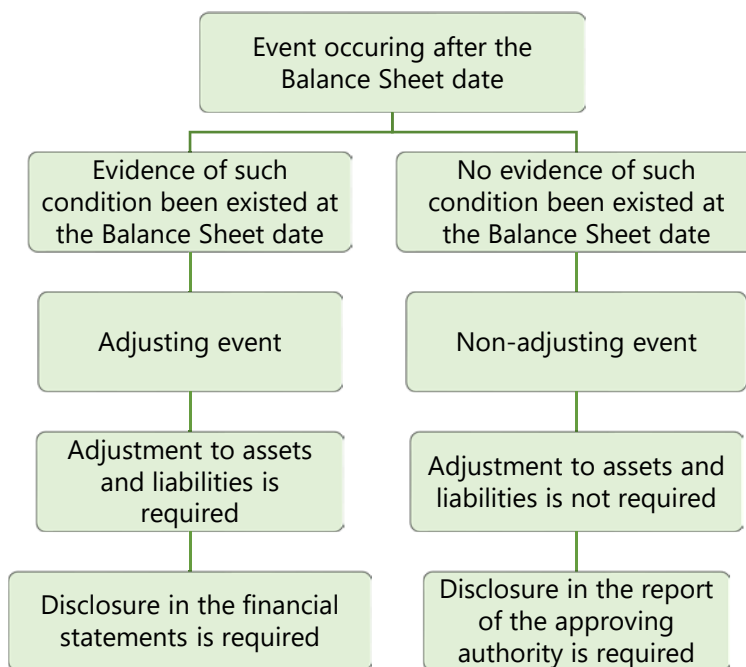
Dividend declared after balance sheet date

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. Thus, no liability for proposed dividends needs to be recognised in financial statements for financial year ended 31st March, 2017 and subsequent years. Such proposed dividends are to be disclosed in the notes as per Companies (Accounting Standards) Amendment Rules, 2016 issued on 30 March 2016.

Events indicating going concern assumption inappropriate

Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise

after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements. In case the going concern assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a liquidation basis.



Disclosure

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

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

Example

A company follows April-March as its financial year. The company recognises cheques dated 31st March or before, received from customers after balance sheet date but before approval of financial statement by debiting Cheques in hand A/c and crediting the Debtors A/c. The Cheques in hand is shown in balance sheet as an item of cash and cash equivalents. All Cheques in hand are presented to bank in the month of April and are

also realised in the same month in normal course after deposit in the bank.

Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on 31st March. Thus the collection of cheques after balance sheet date is not an adjusting event. Recognition of cheques in hand is therefore not consistent with requirements of AS 4 (Revised). Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise, and so no disclosure of such collections in the Directors' Report is necessary.

It should also be noted that, the Framework for Preparation and Presentation of Financial Statement defines assets as resources controlled by an enterprise as a result of past events from which economic benefits are expected to flow to the enterprise. Since the company acquires custody of the cheques after 31st March, it does not have any control over the cheques on 31st March and hence cheques in hand do not qualify to be recognised as asset on 31st March.

Illustration 1

In X Co. Ltd., theft of cash of ₹ 5 lakhs by the cashier in January, 20X1 was detected only in May, 20X1. The accounts of the company were not yet approved by the Board of Directors of the company.

Decide whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.20X1.

Solution

As per AS 4 (Revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognise the loss amounting ₹ 5,00,000 and adjust the accounts of the company for the year ended 31st March, 20X1.

Illustration 2

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.20X2. The accounting year of the company ended on 31.3.20X2. The accounts were approved on 30.6.20X2. The loss from earthquake is estimated at ₹30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

AS 4 (Revised) "Contingencies and Events Occurring after the Balance Sheet Date", states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.20X2. Therefore, loss occurred due to earthquake is not to be recognised in the financial year 20X1-20X2.

However, according to the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore, fundamental accounting assumption of going concern would have to be evaluated. Considering that the going concern assumption is still valid, the fact of earthquake together with an estimated loss of ₹ 30 lakhs should be disclosed in the report of the approving authority for financial year 20X1-X2 to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A company has filed a legal suit against the debtor from whom ₹ 15 lakh is recoverable as on 31.3.20X1. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 20X1. Can the company provide for full amount of ₹ 15 lakhs as provision for doubtful debts? Discuss.

Solution

As per AS 4 (Revised) "Contingencies and Events Occurring After the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date. In the given case, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 20X1 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 20X1.

Illustration 4

In preparing the financial statements of R Ltd. for the year ended 31st March, 20X1, you come across the following information. State with reasons, how you would deal

with this in the financial statements:

The company invested 100 lakhs in April, 20X1 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

AS 4 (Revised) defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 20X1. The disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 20X1 for the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Illustration 5

A Limited Company closed its accounting year on 30.6.20X1 and the accounts for that period were considered and approved by the board of directors on 20th August, 20X1. The company was engaged in laying pipeline for an oil company deep beneath the earth. While doing the boring work on 1.9.20X1 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20X1.

Solution

AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above-mentioned definition and requirements given in AS 4 (Revised). In this case the incidence, which was expected to push up cost, became evident after the date of approval of the accounts. So it is not an 'event occurring after the balance sheet date'.

Illustration 6

While preparing its final accounts for the year ended 31st March, 20X1 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 20X1 a trade receivable for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 20X1 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 20X1?

Solution

As per Accounting Standard 4, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 20X1. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 20X1, then this would have been treated as non-adjusting event and only disclosure required as per AS 4 (Revised), would have been sufficient.

Illustration 7

During the year 20X1-20X2, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ₹ 10 lakhs in its financial statements for the year ended 31st March, 20X2. On 18th May, 20X2, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 20X2, and approved by the board on 30th May, 20X2.

Solution

As per AS 4 (Revised), adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 20X1-X2 for which the provision was also made by it, the decision of the Court on 18th May, 20X2, for payment of the penalty will constitute as

an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 20X2, it would be considered as an event occurring after the approval of the financial statements which is not covered by AS 4 (Revised). In that case, no adjustment in the financial statements of 20X1-X2 would have been required.

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

2.2 AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Introduction

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

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

* Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 (Revised) dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other AS. However, as per the Companies (Accounting Standards) Amendment Rules, 2016–30 March 2016, all paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard.

Net Profit or Loss for the Period

All items of income and expense which are recognized in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

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

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

(b) Extraordinary items: Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period.

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

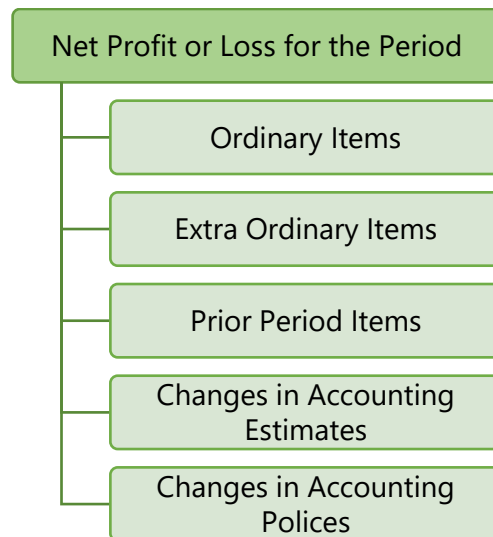
Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

- attachment of property of the enterprise
- an earthquake

(c) Exceptional items¹: When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

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

- (a) The write-down of inventories to net realisable value as well as the reversal of such write-downs
- (b) A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
- (c) Disposals of items of fixed assets
- (d) Disposals of long-term investments
- (e) Legislative changes having retrospective application
- (f) Litigation settlements
- (g) Other reversals of provisions



¹ There is no such term as 'exceptional item' under AS 5 and Schedule III to the Companies Act, 2013, however, the same has been used for better understanding of the requirement. Students may provide a suitable note in this regard in the examination.

PRIOR PERIOD ITEMS

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, mis-interpretation of facts, or oversight.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

CHANGES IN ACCOUNTING ESTIMATES

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

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

For example, Sachin purchased a new machine costing ₹ 10 lacs. Useful life was taken to be for 10 years, therefore, depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was ₹ 5 lacs for the machine, management realises that machine can work for another 2 years only. In this case machine will be depreciated by ₹ 2.5 lacs each year for next 2 years. This is not an example of prior period item but change in accounting estimate.

In the same example, let us suppose there is no change in useful life of the machine after 5 years. The management by mistake calculated the depreciation in the fifth year as 10% of ₹ 6,00,000 i.e. ₹ 60,000 instead of ₹ 1,00,000 and in the next year i.e. sixth year decides to charge depreciation of ₹ 1,40,000. In such a case, ₹ 1,00,000

would be the depreciation of sixth year and ₹ 40,000 depreciation charged by the management in the sixth year will be considered as a prior period item.

As per AS 10 (Revised), Property, Plant and Equipment, 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 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'.

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

- (a) The period of the change, if the change affects the period only; or
- (b) The period of the change and future periods, if the change affects both.

For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset.

The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

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

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

CHANGES IN ACCOUNTING POLICIES

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Accounting Policies can be changed only:

- when the adoption of a different accounting policy is required by statute; or

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

The following are not changes in accounting policies:

- (a) The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;
- (b) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

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

ILLUSTRATIONS

Illustration 1

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 20X1 to September, 20X7 has been received and paid in February, 20X8. However, the same was accounted in the year 20X8-X9. Comment on the accounting treatment done in the said case.

Solution

The final bill having been paid in February, 20X8 should have been accounted for in the annual accounts of the company for the year ended 31st March, 20X8. However, it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 20X8, this material charge has arisen in the current period i.e., year ended 31st March, 20X9. Therefore it should be treated as 'Prior period item' as per AS 5. As per AS 5, prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of

profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

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

Illustration 2

- (i) *During the year 20X1-20X2, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?*
- (ii) *A company signed an agreement with the Employees Union on 1.9.20X2 for revision of wages with retrospective effect from 30.9.20X1. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 20X2-X3?*

Solution

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

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

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

- (ii) It is given that revision of wages took place on 1st September, 20X2 with retrospective effect from 30.9.20X1. Therefore wages payable for the half year from 1.10.20X1 to 31.3.20X2 cannot be taken as an error or omission in the

preparation of financial statements and hence this expenditure cannot be taken as a prior period item. Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages.

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

Illustration 3

The company finds that the inventory sheets of 31.3.20X1 did not include two pages containing details of inventory worth ₹ 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 20X2.

Solution

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

Rectification of error in inventory valuation is a prior period item vide AS 5. Separate disclosure of this item as a prior period item is required as per AS 5.

Illustration 4

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

- (i) *Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.*
- (ii) *Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organisation.*

Solution

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

- (i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.
- (ii) Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

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

2.3 Construction Contracts (AS 7)

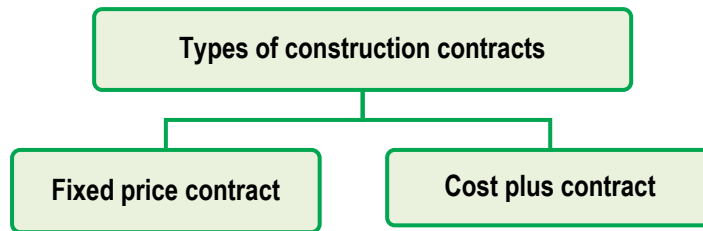
Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors.

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

A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

For the purposes of this Standard, construction contracts also include:

- (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
- (b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets



In a **fixed price contract**, the price is agreed as fixed sum or a fixed rate per unit of output. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

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

Percentage Completion Method

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the stage of completion method (percentage completion method), provides useful information on the extent of contract activity and performance during an accounting period.

AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, AS 7 provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per AS 7, the outcome of fixed price contracts can be estimated reliably **when all the following conditions are satisfied:**

- (i) total contract revenue can be measured reliably;
- (ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
- (iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

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

The outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

- (i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and
- (ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/X1. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 20X1-X2 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 20X2-X3 was ₹ 89,000 to complete the rest of work.

Solution

Profit & Loss Account

Year		₹ 000	Year		₹ 000
20X1-X2	To Construction Costs (for 45% work)	81	20X1-X2	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
20X2-X3	To Construction costs (for 55% work)	89	20X2-X3	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110

Customer Account

Year		₹ 000	Year		₹ 000
20X1-X2	To Contract Price	90	20X1-X2	By Bank	79
				By Balance c/d	11
		90			90
20X2-X3	To Balance b/d	11	20X2-X3	By Bank	
	To Contract Price	110			121
		121			121

AS 7 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

- (a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- (b) contract costs should be recognised as an expense in the period in which they are incurred.

When it is probable that total contract costs will exceed total contract revenue, the expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

Example 2

X Ltd. commenced a construction contract on 01/04/X1. The contract price agreed was reimbursable cost plus 10%. The company incurred ₹ 1,00,000 in 20X1-X2, of which cost of ₹ 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 20X1-X2 is shown below:

Profit & Loss Account

	₹ 000		₹ 000
To Construction Costs	100	By Contract Price (90+9)	99
To Provision for loss	5	Net loss	6
	105		105

Treatment of Costs Relating to Future Activity

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

Uncollectable Contract Revenue

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Stage of Completion

The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

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

Example 3

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

	₹ 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Solution

	₹ 000
A. Cost incurred to date	390
B. Estimate of cost to completion	<u>260</u>
C. Estimated total cost	<u>650</u>
D. Degree of completion (A/C)	60%
E. Revenue Recognised (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	<u>(30)</u>
Expected loss to be recognised immediately	<u>20</u>

Profit & Loss A/c

	₹		₹
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts.

The standard identifies certain cases where for the purposes of accounting, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

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

- (i) separate proposals have been submitted for each asset;
 - (ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
 - (iii) the costs and revenues of each asset can be identified.
- (b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
- (i) the group of contracts is negotiated as a single package;
 - (ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (iii) the contracts are performed concurrently or in a continuous sequence.
- (c) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:
- (i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
 - (ii) the price of the asset is negotiated without regard to the original contract price.

Example 4

XYZ construction Ltd, a construction company undertakes the construction of an industrial complex. It has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should XYZ Ltd, treat construction of each unit as a separate construction contract according to AS 7?

Solution

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

- (a) separate proposals have been submitted for each asset;

- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified.

Therefore, XYZ Ltd. is required to treat construction of each unit as a separate construction contract.

Contract Revenue and Costs

- (a) Contract revenue should comprise:
 - (i) the initial amount of revenue agreed in the contract; and
 - (ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.
- (b) Contract costs should comprise:
 - (i) costs that relate directly to the specific contract;
 - (ii) costs that are attributable to contract activity in general and can be allocated to the contract; and
 - (iii) such other costs as are specifically chargeable to the customer under the terms of the contract.

NOTE:

1. Examples of costs that relate directly to a specific contract include:
 - (a) site labour costs, including site supervision
 - (b) costs of materials used in construction
 - (c) depreciation of plant and equipment used on the contract
 - (d) costs of moving plant, equipment and materials to and from the contract site
 - (e) costs of hiring plant and equipment
 - (f) costs of design and technical assistance that is directly related to the contract
 - (g) the estimated costs of rectification and guarantee work, including expected warranty costs

(h) claims from third parties

Direct costs can be reduced by incidental income that is not included in contract revenue, e.g. sale of surplus material and disposal of plant and equipment.

2. Example of costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance

(b) costs of design and technical assistance that is not directly related to a specific contract

(c) construction overheads

The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16.

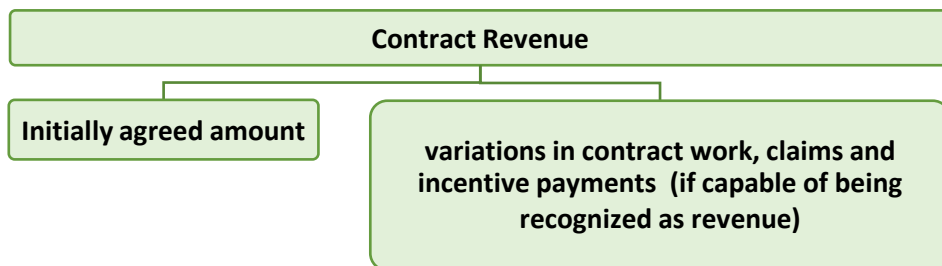
3. Examples of costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

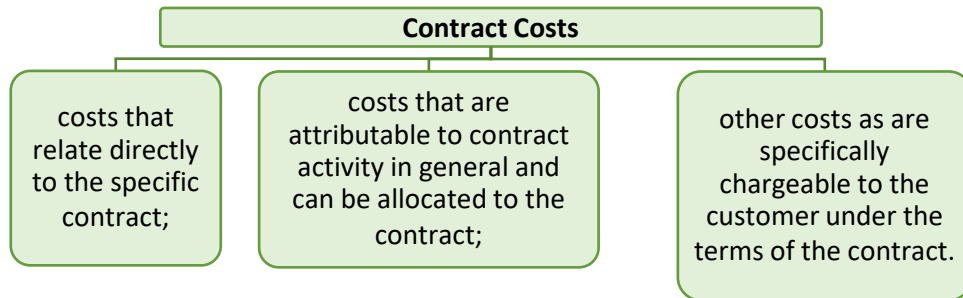
(a) general administration costs for which reimbursement is not specified in the contract

(b) selling costs

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

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





Changes in Estimates

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

- (a) An enterprise should disclose:
 - (i) the amount of contract revenue recognised as revenue in the period;
 - (ii) the methods used to determine the contract revenue recognised in the period; and
 - (iii) the methods used to determine the stage of completion of contracts in progress.
- (b) An enterprise should disclose following in respect of contracts in progress at the reporting date:
 - (i) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
 - (ii) the amount of advances received; and
 - (iii) the amount of retentions.
 - **Retentions** are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

- **Progress billings** are amounts billed for work performed on a contract whether or not they have been paid by the customer.
- **Advances** are amounts received by the contractor before the related work is performed.

(c) An enterprise should present:

- the gross amount due from customers for contract work as an asset; and
- the gross amount due to customers for contract work as a liability.

Particulars	₹
Costs incurred	xxx
Plus: Recognised profits	xxx
Less: Recognised losses	xxx
Less: Progress billings	xxx
Amount	xxx
If above amount is positive - Gross amount due from customers	
If above amount is negative - Gross amount due to customers	

Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 20X1.

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

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

Solution

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

According AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

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

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

(c) Proportion of total contract value recognised as revenue:

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

(d) Amount due from/to customers = (Contract costs + Recognised profits – Recognised

Losses) – (Progress payments received + Progress payments to be received)

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

= [505 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

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

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

	₹ in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognised losses	(100)

Progress billings ₹ (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 2

On 1st December, 20X1, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 20X2, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be recognized in the statement of profit and loss for the year ended 31st March, 20X2 as per provisions of Accounting Standard 7 (Revised)?

Solution

	₹
Cost incurred till 31 st March, 20X2	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>(85,00,000)</u>
Total foreseeable loss	<u>12,00,000</u>

According to AS 7, the amount of ₹ 12,00,000 is required to be recognised as an expense.

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

Proportion of total contract value recognised as turnover:

$$= 67\% \text{ of ₹ } 85,00,000 = \text{₹ } 56,95,000.$$

2.4 Revenue Recognition (AS 9)

AS 9 is mandatory for all enterprises. AS 9 deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- the sale of goods
- the rendering of services

- the use by others of enterprise resources yielding interest, royalties and dividends

AS 9 does not deal with the following aspects of revenue recognition to which special considerations apply:

- Revenue arising from construction contracts;
- Revenue arising from hire-purchase, lease agreements;
- Revenue arising from government grants and other similar subsidies;
- Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of AS 9 are:

- Realized gains resulting from the disposal of, and unrealized gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- Unrealized holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- Realized or unrealized gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- Realized gains resulting from the discharge of an obligation at less than its carrying amount;
- Unrealized gains resulting from the restatement of the carrying amount of an obligation.

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Sale of Goods

Revenue from sales transactions should be recognised when the requirements as to performance set out in below paragraph are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time

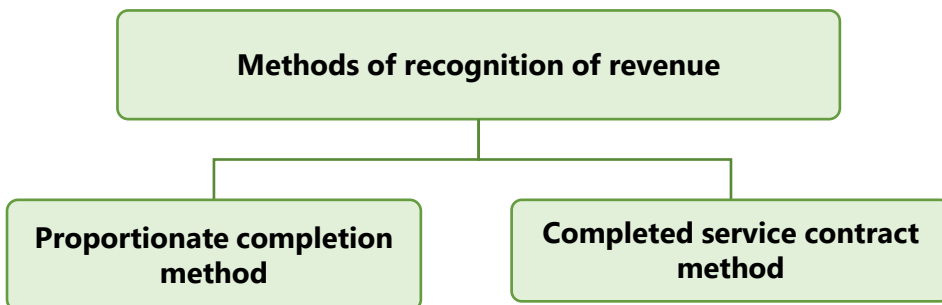
of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) the seller of goods has transferred to the buyer the property in the goods for a price
- (ii) all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- (iii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,



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

Completed Service Contract Method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act e.g. installation of a machine, or repair service.

The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

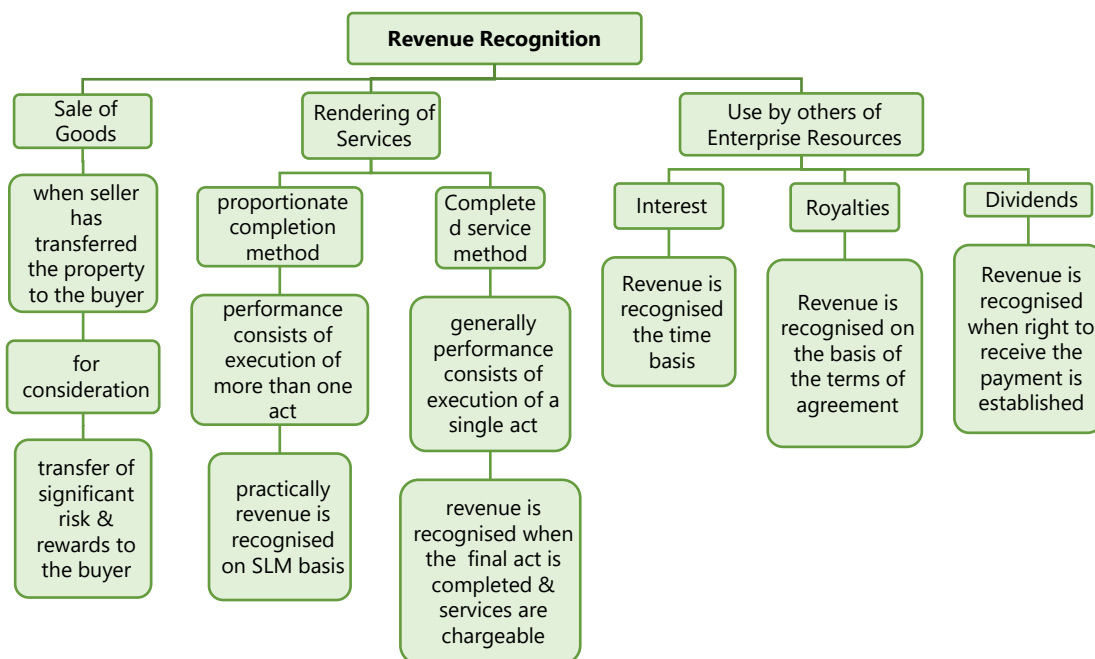
Revenue from sales or service transactions should be recognised when the service is performed provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

Income from other sources - Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

- i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognised on a time proportion basis taking into account the amount outstanding and the rate applicable.
- ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
- iii. Dividends: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to measurability or collectability exists.



*** Sale of goods “for consideration” should be considered as situation when no significant uncertainty exists regarding amount of consideration.**

Effect of Uncertainties on Revenue Recognition

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

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

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

Disclosure

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

Illustration1

The Board of Directors decided on 31.3.20X2 to increase the sale price of certain items retrospectively from 1st January, 20X2. In view of this price revision with effect from 1st January 20X2, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 20X1-20X2. Advise.

Solution

Price revision was effected during the current accounting period 20X1-20X2. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognized in 20X1-20X2.

Illustration2

Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Ltd. during the year 20X1-X2. You are required to state whether and on what basis these revenues can be recognized by X Ltd.

Solution

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

- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable. Therefore X Ltd. should recognize interest revenue of ₹10 Lakhs
- (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement. X Ltd. therefore should recognize royalty revenue of ₹15 Lakhs.

Illustration 3

A claim lodged with the Railways in March, 20X1 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 20X3 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the

treatment of the following in the Final Statement of Accounts for the year ended 31st March, 20X3.

Solution

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

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

Illustration 4

In the year 20X1-X2, XYZ supplied goods on Consignment basis to ABC – a retail outlet worth ₹10,00,000. As per the terms, ABC will only pay XYZ for the goods which are sold by them to the third party. Rest of the goods can be returned back to XYZ and ABC will not have any further liability for these goods.

During the year 20X1-X2, ABC has sold goods worth ₹ 5,50,000 only and rest of the goods are still lying in its store which may get sold by next year. Advise XYZ, how much revenue it can recognize in its books for period 20X1-X2.

Solution

As per AS 9, For consignment risk and rewards are not transferred to the customer on just delivery of the goods and no revenue should be recognized until the goods are sold to a third party. Therefore, XYZ can recognize revenue of ₹ 5,50,000 only.

2.5 Accounting for Amalgamations (AS 14 (Revised))

Introduction

AS 14 (Revised) deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger or purchase.

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

The standard describes the disclosure requirements for both types of amalgamations in the first financial statements. We will discuss the other amalgamation aspects in detail in subsequent paragraphs of this unit.

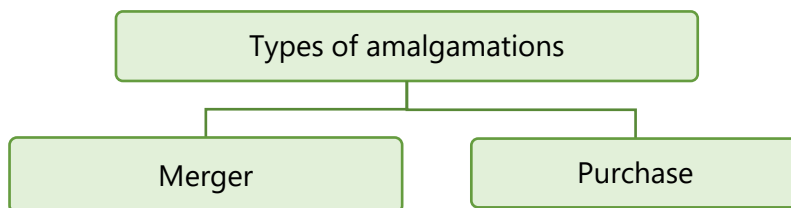
AS 14 (Revised) does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Definition of the Terms used in the Standard

- **Amalgamation** means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies **and includes 'merger'**.
- **Transferor company** means the company which is amalgamated into another company.
- **Transferee company** means the company into which a transferor company is amalgamated.

Types of Amalgamations

Amalgamations fall into two broad categories.



- **Merger** - In amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies.
- **Purchase** - In amalgamations which are in effect a mode by which one company acquires another company and as a consequence:

- ♦ the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or
- ♦ the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

Amalgamation in the Nature of Merger

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Example: X Ltd and Y Ltd, are both in telecom business. As per the arrangement X Ltd will get merged with Y Ltd and their shareholders will get shares in Y Ltd. X Ltd operations will going to be continued under Y Ltd.

Amalgamation in the Nature of Purchase

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above for "Amalgamation in the nature of merger".

Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations.

- For an amalgamation in the nature of merger - pooling of interests method and
- For an amalgamation in the nature of purchase - purchase method.

POOLING OF INTERESTS METHOD

Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

PURCHASE METHOD

Under the purchase method, the transferee company accounts for the amalgamation either

- By incorporating the assets and liabilities at their existing carrying amounts or
- By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

CONSIDERATION

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. In determining the value of the consideration, an assessment is made of the fair value of its elements.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional

payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable

Treatment of Reserves of the Transferor Company on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.

Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.

Adjustments to reserves - Amalgamation in the Nature of Merger

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned.
- Difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company.

Adjustments to reserves - Amalgamation in the Nature of Purchase

If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve or any

other statutory reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with.

In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements.

1. The corresponding debit is "also" to a Reserve Account
2. That Reserve account will show a negative balance
3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".

So the presentation will be as follows:

Notes to Accounts for "Reserves and Surplus"

Description	Amount (Current year)	Amount (Previous Year)
Statutory Reserve (taken over from transferor company)		
General Reserve		
Profit and Loss or Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	(--)	(--)

Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

- (a) the foreseeable life of the business or industry
- (b) the effects of product obsolescence, changes in demand and other economic factors
- (c) the service life expectancies of key individuals or groups of employees
- (d) expected actions by competitors or potential competitors
- (e) legal, regulatory or contractual provisions affecting the useful life

Balance of Profit and Loss Account

In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Disclosures

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Names and general nature of business of the amalgamating companies;
- b. Effective date of amalgamation for accounting purposes;
- c. The method of accounting used to reflect the amalgamation; and
- d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;
- b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
- b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

Illustration 1

A Ltd. take over B Ltd. on April 01, 20X1 and discharges consideration for the business as follows:

- (i) *Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.*
- (ii) *Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.*
- (iii) *It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.*

Determine the amount of purchase consideration as per AS 14.

Solution

Particulars	₹
Equity Shares (42,000 x 10)	4,20,000
15% Preference Share Capital	1,70,000
Add: Premium on Redemption	<u>17,000</u>
Purchase Consideration	<u>6,07,000</u>

Note: As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. Thus, payment to debenture holders are not covered by the term 'consideration'.

Illustration 2

A Ltd. and B Ltd. were amalgamated on and from 1st April, 20X1. A new company C Ltd. was formed to take over the business of the existing companies. A Ltd. and B Ltd. have the following ledger balances as on 31st March, 20X1:

	A Ltd. (₹ in lakhs)	B Ltd. (₹ in lakhs)
Land and Building	550	400
Plant and Machinery	350	250
Investments (Non-current)	150	50
Inventory	350	250
Trade Receivables	300	350
Cash and Bank	300	200
Share Capital:		
Equity Shares of ₹ 100 each	800	750
12% Preference shares of ₹ 100 each	300	200
Reserves and Surplus:		
Revaluation Reserve	150	100
General Reserve	170	150

Investment Allowance Reserve	50	50
Profit and Loss Account	50	30
Secured Loans:		
10% Debentures (₹ 100 each)	60	30
Trade Payables	420	190

Additional Information:

- (1) 10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.
- (2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of ₹ 150 per share (face value of ₹ 100).
- (3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.
- (4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 20X1 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Solution

Balance Sheet of C Ltd. as at 1st April, 20X1

Particulars	Note No.	(₹ in lakhs)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,200
(b) Reserves and Surplus	2	1,650
(2) Non-Current Liabilities		
Long-term borrowings	3	60
(3) Current Liabilities		
Trade payables	8	610
Total		3,520

II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment	4	1,550
(b) Intangible assets	5	20
(c) Non-current investments	6	200
(2) Current assets		
(a) Inventory (350 + 250)		600
(b) Trade receivables	7	650
(c) Cash and bank balances (300 + 200)		500
Total		3,520

Notes to Accounts

		(₹ in lakhs)	(₹ in lakhs)
1.	Share Capital		
	Equity share capital (W.N.1)		
	70,00,000 ² Equity shares of ₹ 10 each	700	
	5,00,000 ³ Preference shares of ₹ 100 each	500	
	(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		1,200
2.	Reserves and surplus		
	Securities Premium Account (W.N.3) (950 + 700)	1,650	
	Investment Allowance Reserve (50 + 50)	100	
	Amalgamation Adjustment Reserve (50 + 50)	(100)	1,650
3.	Long-term borrowings		
	15% Debentures		60

² 40,00,000 + 30,00,000

³ 3,00,000 + 2,00,000

4.	Property, Plant and Equipment		
	Land and Building (550 + 400)	950	
	Plant and Machinery (350 + 250)	600	1,550
5.	Intangible assets		
	Goodwill [W.N. 2] (110 – 90)		20
6.	Non-current Investments		
	Investments (150 + 50)		200
7.	Trade receivables (300 + 350)		650
8.	Trade payables (420 + 190)		610

Working Notes:

		(₹ in lakhs)	
		A Ltd.	B Ltd.
(1)	Computation of Purchase consideration		
	(a) Preference shareholders:		
	$\left(\frac{3,00,00,000}{100} \text{ i.e. } 3,00,000 \text{ shares} \right) \times ₹ 150 \text{ each}$	450	
	$\left(\frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares} \right) \times ₹ 150 \text{ each}$		300
	(b) Equity shareholders:		
	$\left(\frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares} \right) \times ₹ 30 \text{ each}$	1,200	
	$\left(\frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares} \right) \times ₹ 30 \text{ each}$	—	<u>900</u>
	Amount of Purchase Consideration	<u>1,650</u>	<u>1,200</u>
(2)	Net Assets Taken Over		
	Assets taken over:		
	Land and Building	550	400
	Plant and Machinery	350	250
	Investments	150	50
	Inventory	350	250
	Trade receivables	300	350

Objective

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

- (a) Better understand the performance of the enterprise;
- (b) Better assess the risks and returns of the enterprise; and
- (c) Make more informed judgements about the enterprise as a whole.

Scope

AS 17 should be applied in presenting general purpose financial statements.

An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements.

Definition of the terms used in the Accounting Standard

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

- a. The nature of the products or services
- b. The nature of the production processes
- c. The type or class of customers for the products or services
- d. The methods used to distribute the products or provide the services
- e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities

A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or

several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

A **geographical segment** is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

- a. Similarity of economic and political conditions.
- b. Relationships between operations in different geographical areas.
- c. Proximity of operations.
- d. Special risks associated with operations in a particular area.
- e. Exchange control regulations and
- f. The underlying currency risks.

A single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:

- a. The location of production or service facilities and other assets of an enterprise; or
- b. The location of its customers.

The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

A **reportable segment** is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by AS 17.

Segment revenue is the aggregate of

- (i) The portion of enterprise revenue that is directly attributable to a segment,
- (ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and
- (iii) Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and
- c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

- (i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and
- (ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,
- (iii) Including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature.
- c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- d. Income tax expense; and
- e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include:

- income tax assets;
- assets used for general enterprise or head-office purposes.

Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services.

Segment liabilities do not include:

- income tax liabilities;
- borrowings and other liabilities that are incurred for financing rather than operating purposes.

Assets and liabilities that relate jointly to two or more segment should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

Treatment of Interest for determining Segment Expense

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories.

In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2 (Revised), and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

Allocation

An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in AS 17.

Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment.

While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

Primary and Secondary Segment Reporting Formats

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments.

If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

Business and Geographical Segments

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered for:

- a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions (that is, an internally reported segment that meets the definition should not be further segmented).
- b. For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and
- c. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

Identifying Reportable Segments (Quantitative Thresholds)

A business segment or geographical segment should be identified as a reportable segment if:

- a. Its revenue from sales to external customers and from transactions with other segments is 10% or more of the total revenue, external and internal, of all segments; or
- b. Its segment result, whether profit or loss, is 10% or more of –
 - (i) The combined result of all segments in profit, or

(ii) The combined result of all segments in loss,

Whichever is greater in absolute amount; or

c. Its segment assets are 10% or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments constitutes less than 75% of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10% thresholds, until at least 75% of total enterprise revenue is included in reportable segments.

A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10% thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10% thresholds.

If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10% thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10% thresholds in the preceding period.

Segment Accounting Policies

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. AS 17 does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that

- (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and
- (b) the basis of measurement for this additional information is clearly described.

Primary Reporting Format

An enterprise should disclose the following for each reportable segment:

- a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
- b. Segment result;
- c. Total carrying amount of segment assets;
- d. Total amount of segment liabilities;
- e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
- f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
- g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements.

In presenting the reconciliation;

- segment revenue should be reconciled to enterprise revenue;
- segment result should be reconciled to enterprise net profit or loss;
- segment assets should be reconciled to enterprise assets; and
- segment liabilities should be reconciled to enterprise liabilities.

Secondary Segment Information

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

- a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose

revenue from sales to external customers is 10% or more of enterprise revenue;

- b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments.

If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10% or more of enterprise revenue or whose segment assets are 10% or more of the total assets of all business segments:

- a. Segment revenue from external customers;
- b. The total carrying amount of segment assets; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

Other Disclosures

In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

Some changes in accounting policies may relate specifically to segment reporting.

Example could be:

- changes in identification of segments; and
- changes in the basis for allocating revenues and expenses to segments.

Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effects of the change, if reasonably determinable.

An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

Illustration1

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments: **₹ in lakhs**

Particulars	M	N	O	P	Q	R	Total
Segment Assets	40	80	30	20	20	10	200
Segment Results	50	(190)	10	10	(10)	30	(100)
Segment Revenue	300	620	80	60	80	60	1,200

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

Its segment result whether profit or loss is 10% or more of:

- ♦ The combined result of all segments in profit; or
- ♦ The combined result of all segments in loss,

whichever is greater in absolute amount; or

Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as

reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

On the basis of turnover criteria segments M and N are reportable segments.

On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of ₹ 200 lakhs).

On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in at least one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

Illustration 2

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Solution

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Illustration 3

M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are ₹ 10.00 crores. Segment X has ₹ 2.00 crores, segment Y has ₹ 3.00 crores and segment Z has ₹ 5.00 crores. Deferred tax assets included in the assets of each segments are X- ₹ 0.50 crores, Y— ₹ 0.40 crores and Z— ₹ 0.30 crores. The accountant contends that all the three segments are reportable segments. Comment.

Solution

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are ₹ 8.8 crores [₹ 10 crores – (₹ 0.5 + ₹ 0.4 + ₹ 0.3)]. Segment X holds total assets of ₹ 1.5 crores (₹ 2 crores – ₹ 0.5 crores);

Segment Y holds ₹ 2.6 crores (₹ 3 crores – ₹ 0.4 crores); and Segment Z holds ₹ 4.7 crores (₹ 5 crores – ₹ 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Illustration 4

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

	₹ ('000)
<i>Forging Shop Division</i>	
Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	<u>6,135</u>
	<u>10,800</u>
<i>Bright Bar Division</i>	
Sales to Fitting Division	45
Export Sales to Rwanda	<u>300</u>
	<u>345</u>
<i>Fitting Division</i>	
Export Sales to Maldives	<u>270</u>

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

Solution

Diversifiers Ltd. Segmental Report

(₹ '000)

Particulars	Divisions			Inter Segment Eliminations	Consolidated Total
	Forging shop	Bright Bar	Fitting		
Segment Revenue					
Sales:					
Domestic	90	—	—	—	90
Export	<u>6,135</u>	<u>300</u>	<u>270</u>	—	<u>6,705</u>
External Sales	6,225	300	270	—	6,795
Inter-Segment Sales	<u>4,575</u>	<u>45</u>	—	<u>4,620</u>	—
Total Revenue	<u>10,800</u>	<u>345</u>	<u>270</u>	<u>4,620</u>	<u>6,795</u>
Segment Result (Given)	240	30	(12)		258
Head Office Expenses					<u>(144)</u>
Operating Profit					114
Interest Expense					<u>(16)</u>
Profit Before Tax					<u>98</u>
Information in Relation to Assets and Liabilities:					
Fixed Assets	300	60	180	—	540
Net Current Assets	<u>180</u>	<u>60</u>	<u>135</u>	—	<u>375</u>
Segment assets	<u>480</u>	<u>120</u>	<u>315</u>	—	915
Unallocated Corporate Assets (75 + 72)	—	—	—	—	<u>147</u>
Total assets					<u>1,062</u>
Segment liabilities	30	15	180	—	225
Unallocated corporate liabilities					<u>57</u>
Total liabilities					<u>282</u>

Sales Revenue by Geographical Market

	Home Sales	Export Sales (by forging shop division)	Export to Rwanda	Export to Maldives	(₹ '000) Consolidated Total
External sales	90	6,135	300	270	6,795

Illustration 5

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Solution

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz- 'Automobile batteries' and 'batteries for Invertors and UPS'.

Reference: The students are advised to refer the full text of AS 17 "Segment Reporting".

2.7 AS 18: Related Party Disclosures

Introduction

AS 18 prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

Related Party Relationships

Related party - parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

AS 18 deals only with related party relationships described in (a) to (e) below:

- a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).
- b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.
- c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.
- d. Key management personnel and relatives of such personnel and
- e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

In the context of AS 18, the following are deemed not to be related parties:

- a. Two companies simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings).
- b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and
- c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):
 - (i) Providers of finance
 - (ii) Trade unions
 - (iii) Public utilities
 - (iv) Government departments and government agencies including government sponsored bodies

Related party disclosure requirements as laid down in AS 18 do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

No disclosure is required in consolidated financial statements in respect of intra-group transactions.

No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Related Party Issue

Related party relationships are a normal feature of commerce and business.

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into.

Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. Sometimes, no price is charged in related party transactions, for example, free provision of management services and the extension of free credit on a debt.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

Definitions of other Terms used in AS 18

Related party transaction: A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Control:

- (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

- (b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or
- (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of AS 18, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of the governing body of that company/enterprise. An enterprise is deemed to have the power to appoint a director/member of the governing body, if any of the following conditions is satisfied:

- (a) A person cannot be appointed as director/member of the governing body without the exercise in his favour by that enterprise of such a power as aforesaid or
- (b) A person's appointment as director/member of the governing body follows necessarily from his appointment to a position held by him in that enterprise or
- (c) The director/member of the governing body is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise is considered to have a **substantial interest** in another enterprise if that enterprise owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.

An Associate: An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

Significant influence: Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. It may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant

influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investing party holds, directly or indirectly through intermediaries, less than 20% of the voting power of the enterprise, it is presumed that the investing party does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

Illustration 1

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

Solution

Reporting entity- A Ltd.

- B Ltd. (subsidiary) is a related party
- O Ltd.(subsidiary) is a related party

Reporting entity- B Ltd.

- A Ltd. (holding company) is a related party
- O Ltd. (subsidiary) is a related party

Reporting entity- O Ltd.

- A Ltd. (holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party

Reporting entity- Z Ltd.

- O Ltd. (associate) is a related party

Key Management Personnel: Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

For example, in the case of a company, the managing directors, whole time directors, manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the categories of 'related party relationships' discussed above.

Relative: In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Joint Venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

Joint Control– the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

Holding Company– a company having one or more subsidiaries.

Subsidiary - a company:

- (a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or
- (b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

Fellow subsidiary– a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

Disclosure

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

This is to enable users of financial statements to form a view about the effects of related party relationships on the enterprise.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

- (i) The name of the transacting related party;
- (ii) A description of the relationship between the parties;
- (iii) A description of the nature of transactions;
- (iv) Volume of the transactions either as an amount or as an appropriate proportion;
- (v) Any other elements of the related party transactions necessary for an understanding of the financial statements;
- (vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;
- (vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

Illustration

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-20X1. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

Solution

As per AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

2.8 AS 19: Leases

Introduction

The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

A Lease is an agreement whereby the Lessor (*legal owner of an asset*) conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time.

Applicability of AS 19

The standard applies to all leases other than:

- (a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and
- (b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- (c) lease agreements to use lands

Definitions

A **non-cancellable lease** is a lease that is cancellable only:

- (a) upon the occurrence of some remote contingency; or
- (b) with the permission of the lessor; or
- (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

- (d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The **lease term** is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

- (a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or
- (b) in the case of the lessor, any residual value guaranteed to the lessor:
 - (i) by or on behalf of the lessee; or
 - (ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Economic life is either:

- (a) the period over which an asset is expected to be economically usable by one or more users; or
- (b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

- (a) the period over which the leased asset is expected to be used by the lessee; or

- (b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed residual value is:

- (a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and
- (b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:

- (a) the gross investment in the lease; and
- (b) the present value of
 - (i) the minimum lease payments under a finance lease from the standpoint of the lessor; and
 - (ii) any unguaranteed residual value accruing to the lessor,

at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of

- (a) the minimum lease payments under a finance lease from the standpoint of the lessor; and
- (b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

Types of leases

For accounting purposes, leases are classified as:

- (i) Finance leases; and
- (ii) Operating leases.

Finance lease - A lease classified as *Finance Lease* if it transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.

Operating Lease - A lease is classified as an *Operating Lease* if it does not transfer substantially all the risk and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form

Indicators of Finance Lease

Situations, which would normally lead to a lease being classified as a finance lease are:

- (a) The lease transfers ownership of the asset to the lessee by the end of the lease term;
- (b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

Example - Mr. A has taken a car on lease for 5 years from XYZ. After 5 years of lease term Mr. A has the option to purchase this car for ₹ 20,000, whereas it is assumed the car market value at the end of 5th year would be ₹ 2,00,000. Considering the option to buy it at bargain price, it is reasonably certain that Mr. A would exercise that option.

- (c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

Example - XYZ has taken a property on lease for 32 years from ABC, expected economic life of the property is 40 years. Since XYZ is going to use the asset over major part of its economic life (80% in this case), it will meet the condition to be treated as finance lease.

- (d) At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- (e) The leased asset is of a specialized nature such that only the lessee can use it without major modifications being made.

Example – PQR, a hospital ordered 10 ambulances, specially designed as per the requirement of PQR. These ambulances are taken on lease and it cannot be used by anyone else without and major modifications. This would meet the condition of finance lease.

Additional Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- (a) If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee;
- (b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and
- (c) If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term.

Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Accounting for Finance Leases (Books of lessee)

Following is the accounting treatment of Finance Leases in the books of Lessee:

- (i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:
 - Fair value of leased asset at the inception of the lease
 - Present value of minimum lease payments from the standpoint of the lessee (present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used)
- (ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.
- (iii) Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.
- (iv) A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.
- (v) Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Computation of interest rate implicit on lease

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

- (a) the minimum lease payments under a finance lease from the standpoint of the lessor; and
- (b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Discounting rate = R% p.a;

Lease Rents = L_1, L_2, \dots, L_n (Payable annually, at the end of each year)

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

$$\text{PV of MLP} = \frac{L_1}{(1+R)^1} + \frac{L_2}{(1+R)^2} + \frac{L_n}{(1+R)^n} + \frac{GR}{(1+R)^n}$$

$$\text{Present value of unguaranteed residual value} = \frac{UGR}{(1+R)^n}$$

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

Example 1

Annual lease rents = ₹ 50,000 at the end of each year.

Lease period = 5 years;

Guaranteed residual value = ₹ 25,000

Unguaranteed residual value (UGR) = ₹ 15,000

Fair Value at the inception (beginning) of lease = ₹ 2,00,000

Interest rate implicit on lease is computed below:

Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is ₹ 2 lakhs.

PV of minimum lease payments and unguaranteed residual value at guessed rate 10%

Year	MLP + UGR ₹	DF (10%)	PV ₹
1	50,000	0.909	45,450

2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
5	15,000	0.621	9,315
			2,14,340

PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Year	MLP + UGR ₹	DF (14%)	PV ₹
1	50,000	0.877	43,850
2	50,000	0.769	38,450
3	50,000	0.675	33,750
4	50,000	0.592	29,600
5	50,000	0.519	25,950
5	25,000	0.519	12,975
5	15,000	0.519	7,785
			1,92,360

Interest rate implicit on lease is computed below by interpolation:

$$\text{Interest rate implicit on lease} = 10\% + \frac{14\% - 10\%}{2,14,340 - 1,92,360} \times (2,14,340 - 2,00,000) = 12.6\%$$

Example 2

Annual lease rents = ₹ 50,000 at the end of each year.

Lease period = 5 years;

Guaranteed residual value = ₹ 25,000

Unguaranteed residual value (UGR) = ₹ 15,000

Fair Value at the inception (beginning) of lease = ₹ 2,00,000

Interest rate implicit on lease is = 12.6%

Present value of minimum lease payment is computed below:

Year	MLP ₹	DF (12.6%)	PV ₹
1	50,000	0.890	44,500
2	50,000	0.790	39,500
3	50,000	0.700	35,000
4	50,000	0.622	31,100
5	50,000	0.552	27,600
5	25,000	0.552	13,800
			1,91,500

Present value of minimum lease payment = ₹ 1,91,500

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	₹	₹
Asset A/c Dr. To Lessor (Lease Liability) A/c (Being recognition of finance lease as asset and liability)	1,91,500	1,91,500

Example 3

Using data for example 2 and assuming zero residual value, allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments ₹	Finance Charge (12.6%) ₹	Principal ₹	Principal due ₹
0	--	--	--	1,91,500
1	50,000	24,129	25,871	1,65,629
2	50,000	20,869	29,131	1,36,498
3	50,000	17,199	32,801	1,03,697
4	50,000	13,066	36,934	66,763

5	75,000	8,237*	66,763	
	2,75,000	83,500	1,91,500	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

	₹	₹
Finance Charge A/c <i>Dr.</i> To Lessor (Being finance charge due for the year)	24,129	24,129
Lessor <i>Dr.</i> To Bank A/c (Being payment of lease rent for the year)	50,000	50,000
P & L A/c <i>Dr.</i> To Finance Charge A/c (Being recognition of finance charge as expense for the year)	24,129	24,129

Example 4

In example 2, suppose unguaranteed residual value is not determinable and lessee's incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee's incremental borrowing rate.

Present value of minimum lease payment using lessee's incremental borrowing rate 10% is computed below:

Year	MLP ₹	DF (10%)	PV ₹
1	50,000	0.909	45,450
2	50,000	0.826	41,300

* The difference between this figure and finance charge [$66,763 \times 12.6\% = 8412$] is due to approximation in computation.

3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
			2,05,025

Present value of minimum lease payment = ₹ 2,05,025

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	₹	₹
Asset A/c Dr.	2,00,000	
To Lessor (Lease Liability)		2,00,000
(Being recognition of finance lease as asset and liability)		

Since the liability is recognised at fair value ₹ 2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals ₹ 2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

PV of minimum lease payments at guessed rate 12%

Year	Minimum Lease Payments ₹	DF (12%)	PV ₹
1	50,000	0.893	44,650
2	50,000	0.797	39,850
3	50,000	0.712	35,600
4	50,000	0.636	31,800
5	50,000	0.567	28,350
5	25,000	0.567	14,175
			1,94,425

$$\text{Required discounting rate} = 10\% + \frac{12\% - 10\%}{2,05,025 - 1,94,425} \times (2,05,025 - 2,00,000) = 10.95\%$$

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments ₹	Finance Charge (10.95%) ₹	Principal ₹	Principal due ₹
0	--	--	--	2,00,000
1	50,000	21,900	28,100	1,71,900
2	50,000	18,823	31,177	1,40,723
3	50,000	15,409	34,591	1,06,132
4	50,000	11,621	38,379	67,753
5	75,000	7,247*	67,753	
	2,75,000	75,000	2,00,000	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

	₹	₹
Finance Charge A/c <i>Dr.</i> To Lessor (Being finance charge due for the year)	21,900	21,900
Lessor <i>Dr.</i> To Bank A/c (Being payment of lease rent for the year)	50,000	50,000
P & L A/c <i>Dr.</i> To Finance Charge (Being recognition of finance charge as expense for the year)	21,900	21,900

Illustration 1

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease term = 4 years

* The difference between this figure & finance charge $[67,753 \times 10.95\% = 7418]$ is due to approximation in computation

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Lease Payment ₹	Implicit interest rate (Discount rate @15%)	Present value ₹
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	<u>7,50,000*</u>	0.5718	<u>4,28,850</u>
Total	<u>26,25,000</u>		<u>18,55,850</u>

Present value of minimum lease payments ₹ 18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the asset and corresponding lease liability should be recognised at ₹ 18,55,850 as per AS 19.

* Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹ 1,25,000.

Disclosures made by the Lessee

The lessee should, in addition to the requirements of AS 10 (Revised), Property, Plant and Equipment, and the governing statute, make the following disclosures for finance leases:

- (a) assets acquired under finance lease as segregated from the assets owned;
- (b) for each class of assets, the net carrying amount at the balance sheet date;
- (c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than five years;
 - (iii) later than five years;
- (d) contingent rents recognised as expense in the statement of profit and loss for the period;
- (e) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date; and
- (f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
 - (i) the basis on which contingent rent payments are determined;
 - (ii) the existence and terms of renewal or purchase options and escalation clauses; and
 - (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III enterprises (and SMCs) need not make disclosures required by (c), (e) and (f) above.

Accounting for finance leases (Books of lessor)

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

Gross investment in Lease (GIL)

$$= \text{Minimum Lease Payments (MLP)} + \text{Unguaranteed Residual value (UGR)}$$

Net investment in Lease (NIL)

$$= \text{Gross investment in Lease (GIL)} - \text{Unearned Finance Income (UFI)}.$$

$$\text{Unearned finance income (UFI)} = \text{GIL} - (\text{PV of MLP} + \text{PV of UGR})$$

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

$$(\text{PV of MLP} + \text{PV of UGR}) = \text{Fair Value}.$$

The above definitions imply that:

$$(a) \quad \text{Unearned Finance Income (UFI)} = \text{GIL} - \text{Fair Value}$$

$$(b) \quad \text{Net Investment in Lease} = \text{GIL} - \text{UFI} = \text{GIL} - (\text{GIL} - \text{Fair Value}) = \text{Fair Value}$$

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value: Profit recognised at the inception of lease = Fair Value – Cost

$$\text{Total earning of lessor} = \text{GIL} - \text{Cost}$$

$$= (\text{GIL} - \text{Fair Value}) + (\text{Fair Value} - \text{Cost})$$

$$= \text{Unearned Finance Income} + (\text{Fair Value} - \text{Cost})$$

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. The discounting rate in such situations should be the commercial rate of interest (refer discussion on 'manufacturer or dealer lessor' below).

Recognition of Finance Income

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

Initial Direct Costs

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

Review of unguaranteed residual value by lessor

AS 19 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly. In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately. An upward adjustment of the estimated residual value is not made.

Illustration 2

Prakash Limited leased a machine to Badal Limited on the following terms:

		(₹ In lakhs)
(i)	Fair value of the machine	48.00
(ii)	Lease term	5 years
(iii)	Lease rental per annum	8.00
(iv)	Guaranteed residual value	1.60
(v)	Expected residual value	3.00
(vi)	Internal rate of return	15%

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively.

Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any

unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

- (a) **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 8,00,000 × 5 years) + ₹ 1,60,000] + ₹ 1,40,000 = ₹ 43,00,000 (a)

- (b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	MLP inclusive of URV ₹	Internal rate of return (Discount factor @ 15%)	Present Value ₹
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440
5	8,00,000	0.4972	3,97,760
	<u>1,60,000 (GRV)</u>	0.4972	<u>79,552</u>
	41,60,000		27,61,312 (i)
	<u>1,40,000 (URV)</u>	0.4972	<u>69,608 (ii)</u>
	<u>43,00,000</u>	(i) + (ii)	<u>28,30,920(b)</u>

Unearned Finance Income (a) - (b) = ₹ 43,00,000 – ₹ 28,30,920 = ₹ 14,69,080.

Manufacturer or dealer lessor

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate

of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Disclosures

The lessor should make the following disclosures for finance leases:

- (a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than five years;
 - (iii) later than five years;
- (b) unearned finance income;
- (c) the unguaranteed residual values accruing to the benefit of the lessor;
- (d) the accumulated provision for uncollectible minimum lease payments receivable;
- (e) contingent rents recognised in the statement of profit and loss for the period;
- (f) a general description of the significant leasing arrangements of the lessor; and
- (g) accounting policy adopted in respect of initial direct costs.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a) and (f) above.

Accounting for Operating Leases

Accounting treatment in the Books of lessee

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Lease payments may be tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such

payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, AS 19 requires lessees to recognise operating lease payments as expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Example - Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively. The total lease payment ₹ 1,20,000 in this example should be recognised in proportion of output as ₹ 15,000 in year 1, ₹ 30,000 in year 2 and ₹ 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalisation A/c.

The accounting entries for year 1 in books of lessee are suggested below:

		₹	₹
Lease Rent A/c	Dr.	15,000	
Lease Equalization A/c	Dr.	10,000	
To Lessor			25,000
(Being lease rent for the year due)			
Lessor	Dr.	25,000	
To Bank A/c			25,000
(Being payment of lease rent for the year)			
P & L A/c	Dr.	15,000	
To Lease Rent A/c			15,000
(Being recognition of lease rent as expense for the year)			

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Disclosures by lessees

The paragraph 25 requires lessees to make following disclosures for operating leases:

- the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:

- (i) not later than one year;
- (ii) later than one year and not later than five years;
- (iii) later than five years;
- (b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;
- (c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;
- (d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;
- (e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
 - (i) the basis on which contingent rent payments are determined;
 - (ii) the existence and terms of renewal or purchase options and escalation clauses; and
 - (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a), (b) and (e) above.

Accounting treatment in the books of lessor

- (i) The lessor should present an asset given under operating lease as fixed assets in its balance sheets.
- (ii) Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.
- (iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.

- (iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28⁴.

A manufacturer or dealer lessor should recognise the asset given on operating lease as fixed asset in their books by debiting concerned Fixed Asset A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales.

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

$$\text{Total lease rent} = 120\% \text{ of ₹ 5 lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}$$

$$= ₹ 6 \text{ lakhs} \times \frac{60,000 \text{ units}}{1,25,000 \text{ units}} = ₹ 2.88 \text{ lakhs}$$

$$\text{Annual lease rent} = ₹ 2,88,000 / 3 = ₹ 96,000$$

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are ₹ 48,000, ₹ 96,000 and ₹ 1,44,000 respectively.

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is ₹ 40,000.

The accounting entries for year 1 in books of lessor are suggested below:

		₹	₹
Machine given on Operating Lease	Dr.	5,00,000	
To Purchase			5,00,000
(Being machine given on operating lease brought into books)			
Lessee	Dr.	96,000	

⁴ Students may note that AS 28 is not covered in syllabus of Intermediate paper 5 Advanced Accounting.

To Lease Equalization A/c		48,000
To Lease Rent		48,000
(Being lease rent for the year due)		
Bank Dr.	96,000	
To Lessee		96,000
(Being receipt of lease rent for the year)		
Lease Rent Dr.	48,000	
To P & L A/c		48,000
(Being recognition of lease rent as income for the year)		
Depreciation Dr.	40,000	
To Machine given on Operating Lease		40,000
(Being depreciation for the year)		
P & L A/c Dr.	40,000	
To Depreciation		40,000
(Being depreciation for the year transferred to P & L A/c)		

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Disclosures by lessors

As per AS 19, the lessor should, in addition to the requirements of AS 10 (Revised) and the governing statute, make the following disclosures for operating leases:

- (a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
 - (i) the depreciation recognised in the statement of profit and loss for the period;
 - (ii) impairment losses recognised in the statement of profit and loss for the period;
 - (iii) impairment losses reversed in the statement of profit and loss for the period;

- (b) the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:
 - (i) not later than one year;
 - (ii) later than one year and not later than five years;
 - (iii) later than five years;
- (c) total contingent rents recognised as income in the statement of profit and loss for the period;
- (d) a general description of the lessor 's significant leasing arrangements; and
- (e) accounting policy adopted in respect of initial direct costs.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (b) and (d) above.

Sale and Leaseback

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

- ***Where sale and leaseback results in finance lease***

The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

- ***Where sale and leaseback results in operating lease***

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

Profit and loss should be recognised immediately. However if the loss is compensated by future lease payments at below market price, it should be deferred

and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

Case 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Illustration 3

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

- (a) *Sale price of ₹ 50 lakhs is equal to fair value.*
- (b) *Fair value is ₹ 60 lakhs.*
- (c) *Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.*
- (d) *Fair value is ₹ 40 lakhs and sale price is ₹ 50 lakhs.*
- (e) *Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs*
- (f) *Fair value is ₹ 35 lakhs and sale price is ₹ 39 lakhs.*

Solution

Following will be the treatment in the given cases:

- (a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹ 10 lakhs (i.e. 50 – 40) in its books.
- (b) When fair value is ₹ 60 lakhs then also profit of ₹ 10 lakhs should be immediately recognised by A Ltd.
- (c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment.
- (d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortised over the lease period.
- (e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 – 40) to be immediately recognised in its books and balance profit of ₹ 4 lakhs (50-46) is to be amortised/deferred over lease period.

- (f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

2.9 AS 20: Earnings per Share

Introduction

The objective of AS 20 is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.

This Accounting Standard is mandatory for all companies. However, disclosure of diluted earnings per share (both including and excluding extraordinary items) is not mandatory for SMCs. Such companies are however encouraged to make these disclosures.

In consolidated financial statements, the information required by AS 20 should be presented on the basis of consolidated information.

Definition of the terms used in AS 20

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

A financial asset is any asset that is

- a. Cash;
- b. A contractual right to receive cash or another financial asset from another enterprise;
- c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

- d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

- a. Debt instruments or preference shares, that are convertible into equity shares;
- b. Share warrants;
- c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and
- d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Basic Earnings Per Share

Basic earnings per share is calculated as

$$\frac{\text{Net profit (loss) attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

Earnings- Basic

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the

period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

- a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and
- b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per share- Basic

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

The time-weighting factor is:

$$\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}$$

Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration 1

Date	Particulars			Balance
1st January	Balance at beginning of year	1,800	-	1,800

31st May	Issue of shares for cash	600	-	2,400
1st November	Buy Back of shares	-	300	2,100

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

$$(1,800 \times 5/12) + (2,400 \times 5/12) + (2,100 \times 2/12) = 2,100 \text{ shares.}$$

The weighted average number of shares can alternatively be computed as follows:

$$(1,800 \times 12/12) + (600 \times 7/12) - (300 \times 2/12) = 2,100 \text{ shares}$$

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

- Equity shares issued in exchange for cash are included when cash is receivable;
- Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;
- Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;
- Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;
- Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and
- Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an **amalgamation in the nature of purchase** are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued as part of the consideration in an **amalgamation in the nature**

of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Illustration 2

<i>Date</i>	<i>Particulars</i>	<i>No. of Shares</i>	<i>Face Value</i>	<i>Paid up Value</i>
1 st January	Balance at beginning of year	1,800	₹ 10	₹ 10
31 st October	Issue of Shares	600	₹ 10	₹ 5

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

$$(1,800 \times 12/12) + (300 \times 2/12) = 1,850 \text{ shares.}$$

Where an enterprise has equity shares of **different nominal values** but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Contingently Issuable Shares

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Bonus Issue, Share split and Right issue

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

- a. A bonus issue;
- b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;
- c. A share split; and
- d. A reverse share split (consolidation of shares).

In case of a **bonus issue or a share split**, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported means along with the impact to current year adjustment, it will also impact the calculation of EPS of last year retrospectively.

For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Illustration 3

Net profit for the year 20X1 ₹ 18,00,000

Net profit for the year 20X2 ₹ 60,00,000

No. of equity shares outstanding until 30th September 20X2 20,00,000

Bonus issue 1st October 20X2 was 2 equity shares for each equity share outstanding at 30th September, 20X2

Calculate Basic Earnings Per Share.

Solution

No. of Bonus Issue $20,00,000 \times 2 = 40,00,000$ shares

Earnings per share for the year 20X2 $\frac{\text{₹ } 60,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 1.00$

$$\text{Adjusted earnings per share for the year 20X1} = \frac{\text{₹ } 18,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 0.30$$

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X1, the earliest period reported.

The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a **rights issue**, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

Illustration 4

Net profit for the year 20X1 ₹ 11,00,000

Net profit for the year 20X2 ₹ 15,00,000

No. of shares outstanding prior to rights issue 5,00,000 shares

Rights issue price ₹ 15.00

Last date to exercise rights 1st March 20X2

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 20X2 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

$$\frac{\text{Fair value of shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}} \\ \frac{(\text{₹ } 21.00 \times 5,00,000 \text{ shares}) + (\text{₹ } 15.00 \times 1,00,000 \text{ Shares})}{5,00,000 \text{ Shares} + 1,00,000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{₹ (21.00)}}{\text{₹ (20.00)}} = 1.05$$

Computation of earnings per share:

EPS for the year 20X1 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 20X1 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05)
= ₹ 2.10

EPS for the year 20X2 including effects of rights issue:

$$(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12) = 5,87,500 \text{ shares}$$

$$\text{EPS} = 15,00,000/5,87,500 = ₹ 2.55$$

Diluted Earnings Per Share

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period., that is:

- a. The net profit for the period attributable to equity shares is:
 - i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
 - ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
 - iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

- b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of AS 20, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Earnings- Diluted

For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

- (a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;
- (b) interest recognised in the period for the dilutive potential equity shares; and
- (c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Illustration 5

<i>Net profit for the current year</i>	<i>₹ 1,00,00,000</i>
<i>No. of equity shares outstanding</i>	<i>50,00,000</i>
<i>Basic earnings per share</i>	<i>₹ 2.00</i>

No. of 12% convertible debentures of ₹ 100 each	1,00,000
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	₹ 12,00,000
Tax relating to interest expense (30%)	₹ 3,60,000

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year $(1,00,00,000 + 12,00,000 - 3,60,000) = ₹ 1,08,40,000$

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: $(50,00,000 + 10,00,000) = 60,00,000$ Shares

Diluted earnings per share: $(1,08,40,000/60,00,000) = ₹ 1.81$

Per share- Diluted

For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable

if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Diluted EPS in case of share options

For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

- a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and
- b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Illustration 6

<i>Net profit for the year 20X1</i>	<i>₹ 12,00,000</i>
<i>Weighted average number of equity shares outstanding during the year 20X1</i>	<i>5,00,000 shares</i>
<i>Average fair value of one equity share during the year 20X1</i>	<i>₹ 20.00</i>
<i>Weighted average number of shares under option during the year 20X1</i>	<i>1,00,000 shares</i>
<i>Exercise price for shares under option during the year 20X1</i>	<i>₹ 15.00</i>

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	<i>Earnings</i> ₹	<i>Shares</i>	<i>Earnings/Share</i> ₹
Net profit for the year 20X1	12,00,000		
Weighted average no. of shares during year 20X1		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value $(100,000 \times 15.00)/20.00$		<u>(75,000)</u>	
Diluted earnings per share	<u>12,00,000</u>	<u>5,25,000</u>	<u>2.29</u>

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

Dilutive Potential Equity Shares

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In considering whether potential equity shares are dilutive or antidilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the

earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

Presentation

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Disclosure

An enterprise should disclose the following:

- a. Where the statement of profit and loss includes extraordinary items (as defined in AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

- b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;
- c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and
- d. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with AS 20. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

2.10 AS 22: Accounting for Taxes on Income

Introduction

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

Objective

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons.

Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes.

Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income.

Definitions

Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.

Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

Current Tax + Deferred Tax = Tax expense (Tax saving)

Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing differences.

The differences between taxable income and accounting income can be classified into permanent differences and timing differences.

Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. This may lead to recognition of deferred tax in the books.

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

For Example, XYZ has been charged with the fine on the late payment of the tax amount due to authorities. This would be considered as an expense in the profit

and loss account, however this is specifically a disallowed expense for computation of taxable income. This will be treated as permanent difference as this difference will never reverse.

Recognition

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation.

This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Permanent differences do not result in deferred tax assets or deferred tax liabilities.

Measurement

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted by the balance sheet date.

However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

Deferred tax assets and liabilities should not be discounted to their present value.

Re-assessment of Unrecognised Deferred Tax Assets

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Review of previously recognised Deferred Tax Assets

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

Disclosure

Statement of profit and loss

Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, considering the requirements under the Companies Act, 2013, the amount of income tax and other taxes on profits should be disclosed.

AS 22 does not require any reconciliation between accounting profit and the tax expense.

Balance sheet

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

An enterprise should offset assets and liabilities representing current tax if the enterprise:

- a. Has a legally enforceable right to set off the recognised amounts and
- b. Intends to settle the asset and the liability on a net basis.

An enterprise should offset deferred tax assets and deferred tax liabilities if:

- a. The enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and
- b. The deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

Relevant Explanations to AS 22

Accounting for Taxes on Income in the situations of Tax Holiday under sections 80-IA and 80-IB of the Income Tax Act, 1961

The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income Tax Act, 1961

The deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the context of section 115JB of the Income Tax Act, 1961

The payment of tax under section 115JB of the Act is a current tax for the period. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

Virtual certainty supported by convincing evidence

Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

Illustration 1

Rama Ltd., has provided the following information:

	₹
<i>Depreciation as per accounting records</i>	<i>= 2,00,000</i>
<i>Depreciation as per income tax records</i>	<i>= 5,00,000</i>
<i>Unamortised preliminary expenses as per tax record</i>	<i>= 30,000</i>

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognised as transition adjustment? Tax rate 50%.

Solution

Table showing calculation of deferred tax asset / liability

<i>Particulars</i>	<i>Amount</i>	<i>Timing differences</i>	<i>Deferred tax</i>	<i>Amount @ 50%</i>
	₹			₹
Excess depreciation as per tax records (₹ 5,00,000 – ₹ 2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				<u>1,35,000</u>

Illustration 2

From the following details of A Ltd. for the year ended 31-03-20X1, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

<i>Particulars</i>	₹
Accounting Profit	6,00,000
Book Profit as per MAT	3,50,000
Profit as per Income Tax Act	60,000
Tax rate	20%
MAT rate	7.50%

Solution

Tax as per accounting profit $6,00,000 \times 20\% = ₹ 1,20,000$

Tax as per Income-tax Profit $60,000 \times 20\% = ₹ 12,000$

Tax as per MAT $3,50,000 \times 7.50\% = ₹ 26,250$

Tax expense = Current Tax + Deferred Tax

₹ 1,20,000 = ₹ 12,000 + Deferred tax

Therefore, Deferred Tax liability as on 31-03-20X1

= ₹ 1,20,000 – ₹ 12,000 = ₹ 1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-20X1

Current Tax + Deferred Tax liability + Excess of MAT over current tax

$$= ₹ 12,000 + ₹ 1,08,000 + ₹ 14,250 (26,250 - 12,000)$$

$$= ₹ 1,34,250$$

Illustration 3

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.20X1. For the years ending 31.3.20X2 and 31.3.20X3, it made profits of ₹ 1,00,000 and ₹ 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.20X1, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 20X2 and 20X3 for tax purposes. Prepare a statement of Profit and Loss for the years ending 20X1, 20X2 and 20X3.

Solution

Statement of Profit and Loss

	31.3.20X1	31.3.20X2	31.3.20X3
	₹	₹	₹
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax (20,000 x 40%)			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year (2,00,000 x 40%)	80,000		
Tax effect of timing differences reversed/adjusted during the year (1,00,000 x 40%)		(40,000)	(40,000)
Profit (Loss) After Tax Effect	(1,20,000)	60,000	72,000

Illustration 4

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statements during 20X0-20X1, 20X1-20X2 and 20X2-20X3 for ₹ 11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognised revenue of ₹ 7,00,000, ₹ 18,00,000 and ₹ 23,00,000 for the years 20X0-20X1, 20X1-20X2 and 20X2-20X3 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 20X0-20X1, 20X1-20X2 and 20X2-20X3.

Solution

Calculation of Deferred Tax Asset/Liability in Omega Limited

Year	Accounting Income	Taxable Income	Timing Difference	Timing Difference (balance)	Deferred Tax	Deferred Tax Liability (balance)
20X0-20X1	11,00,000	7,00,000	4,00,000	4,00,000	1,40,000	1,40,000
20X1-20X2	16,00,000	18,00,000	(2,00,000)	2,00,000	(70,000)	70,000
20X2-20X3	<u>21,00,000</u>	<u>23,00,000</u>	(2,00,000)	NIL	(70,000)	NIL
	48,00,000	48,00,000				

Reference: The students are advised to refer the full text of AS 22 "Accounting for Taxes on Income"

2.11 AS 24: Discontinuing Operations

Introduction

AS 24 is applicable to all discontinuing operations. The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position

by segregating information about discontinuing operations from information about continuing operations.

Discontinuing Operation

A discontinuing operation is a component of an enterprise:

- a. That the enterprise, pursuant to a single plan, is:
 - (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
 - (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
 - (iii) Terminating through abandonment and
- b. That represents a separate major line of business or geographical area of operations.
- c. That can be distinguished operationally and for financial reporting purposes.

Separate major line of business or geographical area of operations

- A reportable business segment or geographical segment as defined in AS 17 'Segment Reporting', would normally satisfy criteria and it would represent a separate major line of business or geographical area of operations.
- A part of such a segment may also satisfy criteria and it would represent a separate major line of business or geographical area of operations
- For an enterprise that operates in a single business or geographical segment which does not report segment information, a major product or service line may also satisfy the criteria.

Instead of disposing of a component substantially in its entirety, an enterprise may discontinue and dispose of the component by selling its assets and settling its liabilities piecemeal (individually or in small groups). For piecemeal disposals, while the overall result may be a net gain or a net loss, the sale of an individual asset or settlement of an individual liability may have the opposite effect. Moreover, there is no specific date at which an overall binding sale agreement is entered into. Rather, the sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress

at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

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

- a. Gradual or evolutionary phasing out of a product line or class of service.
- b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.
- c. Shifting of some production or marketing activities for a particular line of business from one location to another and
- d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

- a. The operating assets and liabilities of the component can be directly attributed to it.
- b. Its revenue can be directly attributed to it.
- c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 does not, in itself, bring into question the enterprise's ability to continue as a going concern.

Initial Disclosure event

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

- a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or
- b. The enterprise's board of directors or similar governing body has both
 - (i) approved a detailed, formal plan for the discontinuance and
 - (ii) made an announcement of the plan.

A detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number of employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

Recognition and Measurement

For recognising and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

Presentation and Disclosure

INITIAL DISCLOSURE

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- a. A description of the discontinuing operation(s)
- b. The business or geographical segment(s) in which it is reported as per AS 17
- c. The date and nature of the initial disclosure event.
- d. The date or period in which the discontinuance is expected to be completed if known or determinable
- e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled
- f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period
- g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto
- h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period

DISCLOSURES OTHER THAN INITIAL DISCLOSURES NOTE

All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

Other disclosures

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

- a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and
- b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

Updating the disclosures

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed.

Separate disclosure for each discontinuing operation

Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

Presentation of the required disclosures

The above disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

- a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

- b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

Restatement of prior periods

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

Disclosure in interim financial reports

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, 'Interim Financial Reporting', including:

- a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and
- b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

2.12 AS 26 : Intangible Assets

Introduction

The objective of AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. AS 26 also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

Scope

AS 26 should be applied by all enterprises in accounting for intangible assets, except:

- a. Intangible assets that are covered by another Accounting Standard
For example, AS 26 does not apply to:
 - (a) intangible assets held by an enterprise for sale in the ordinary course of business (AS 2 and AS 7)
 - (b) deferred tax assets (AS 22)
 - (c) leases that fall within the scope of AS 19

- (d) goodwill arising on an amalgamation (AS 14 (Revised)) and goodwill arising on consolidation (AS 21 (Revised))
- b. Financial assets.
- c. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and
- d. Intangible assets arising in insurance enterprises from contracts with policyholders.

However, AS 26 applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.

AS 26 also applies to:

- (i) expenditure on advertising, training, start - up cost
- (ii) Research and development activities
- (iii) Right under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts
- (iv) Patents, copyrights and trademarks

Definitions

An asset is a resource:

- a. Controlled by an enterprise as a result of past events and
- b. From which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary assets are assets other than monetary assets.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable amount is the cost of an asset less its residual value.

Useful life is either:

- (a) the period of time over which an asset is expected to be used by the enterprise; or

- (b) the number of production or similar units expected to be obtained from the asset by the enterprise.

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An active market is a market where all the following conditions exist:

- a. The items traded within the market are homogeneous.
- b. Willing buyers and sellers can normally be found at any time and
- c. Prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

A financial asset is any asset that is:

- a. Cash,
- b. A contractual right to receive cash or another financial asset from another enterprise,
- c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or
- d. An ownership interest in another enterprise.

Intangible Assets

An intangible asset is

- an identifiable
- non-monetary asset
- without physical substance
- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or

systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by AS 26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

- The definition of an intangible asset requires that an intangible asset be *identifiable*. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.
- An intangible asset can be clearly distinguished from goodwill if the asset is *separable which means* that enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

- Separability is not a necessary condition for identifiability. If an asset generates *future economic benefits* only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.

Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise as employees may leave the enterprise anytime or even loyal customers may decide to purchase goods and services from other suppliers. Hence, these items don't even qualify as intangible asset as per the definition given in AS 26.

Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

- a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
- b. The cost of the asset can be measured reliably.

An intangible asset should be measured initially at cost.

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

An intangible asset should be measured initially at cost.

Separate Acquisition

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of an intangible asset comprises:

- its purchase price,
- any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and
- any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14 (Revised). In accordance with AS 26:

- a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and
- b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an

active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of assets

An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10. The cost of such an item is measured at fair value unless

- (a) the exchange transaction lacks commercial substance or
- (b) the fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

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

Internally generate goodwill

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase &
- Development Phase

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

- a. Activities aimed at obtaining new knowledge.
- b. The search for, evaluation and final selection of, applications of research findings or other knowledge.
- c. The search for alternatives for materials, devices, products, processes, systems or services;
- d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

- a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b. Its intention to complete the intangible asset and use or sell it.
- c. Its ability to use or sell the intangible asset.
- d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and
- f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

- a. The design, construction and testing of pre-production or pre-use prototypes and models.
- b. The design of tools, jigs, moulds and dies involving new technology.
- c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and
- d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

AS 26 takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

- a Expenditure on materials and services used or consumed in generating the intangible asset.
- b The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.
- c Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licenses that are used to generate the asset and
- d Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset, these should be expensed off in profit and loss account:

- a Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.
- b Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and
- c Expenditure on training the staff to operate the asset.

Example

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was ₹10 lacs, of which ₹9 lacs was incurred before 1 December 20X1 and 1 lac was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹5 lacs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of ₹1 lac (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The ₹9 lacs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until

1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is ₹ 20 lacs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 19 lacs.

At the end of the year 20X2, the cost of the production process is ₹ 21 lacs (₹ 1 lac expenditure recognised at the end of 20X1 plus ₹ 20 lacs expenditure recognised in 20X2). The enterprise recognises an impairment loss of ₹ 2 lacs to adjust the carrying amount of the process before impairment loss (₹ 21 lacs) to its recoverable amount (₹ 19 lacs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in AS 28, are met.

Recognition of an Expense

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

- a. It forms part of the cost of an intangible asset that meets the recognition criteria or
- b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred.

Examples of other expenditure that is recognised as an expense when it is incurred include:

- (a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);
- (b) expenditure on training activities;

- (c) expenditure on advertising and promotional activities; and
- (d) expenditure on relocating or re-organising part or all of an enterprise.

The above guidance does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognised as expenses cannot be reclassified as cost of intangible asset in later years.

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

- a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and
- b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement subsequent to initial recognition

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use.

Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. AS 26 adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption

that the useful life generally does not exceed ten years is rebutted and the enterprise:

- a. Amortises the intangible asset over the best estimate of its useful life.
- b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and
- c. Discloses the reasons why the presumption is rebutted and the factors that played a significant role in determining the useful life of the asset.

Examples

A. An enterprise has purchased an exclusive right to generate hydroelectric power for 60 years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least 60 years.

The enterprise amortises the right to generate power over 60 years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for 30 years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least 30 years.

The enterprise amortises the right to operate the motorway over 30 years, unless there is evidence that its useful life is shorter.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain.

There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include

- the straight-line method,

- the diminishing balance method and
- the unit of production method.

The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset.

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories.

Residual Value

Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The residual value of an intangible asset should be assumed to be zero unless:

- a. There is a commitment by a third party to purchase the asset at the end of its useful life or
- b. There is an active market for the asset and:
 - i. Residual value can be determined by reference to that market and
 - ii. It is probable that such a market will exist at the end of the asset's useful life.

Review of amortisation period and amortisation method

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 "Impairment of Assets" is not covered at Inter level.

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) if

- disposed or
- when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Disclosure

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

1. The useful lives or the amortisation rates used.
2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period showing:
 - I. Additions, indicating separately those from internal development and through amalgamation.
 - II. Retirements and disposals.
 - III. Impairment losses recognised in the statement of profit and loss during the period.
 - IV. Impairment losses reversed in the statement of profit and loss during the period.
 - V. Amortisation recognised during the period and
 - VI. Other changes in the carrying amount during the period.

Other Disclosures

The financial statements should also disclose:

- If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.
- A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.
- The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and
- The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

Illustration 1

ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.20X1. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.20X8. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.20X8.

Solution

Journal Entry

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

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

Illustration 2

The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 20X1-20X2, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 20X2.

Solution

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

Illustration 3

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

Is the procedure adopted by the company correct?

Solution

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

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

In the given case, advertisement expenditure of ₹ 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

2.13 AS 29 (Revised): Provisions, Contingent Liabilities and Contingent Assets

Introduction

AS 29 (Revised) came into effect in respect of accounting periods commenced on or after 1-4-2004. The objective of AS 29 (Revised) is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of AS 29 (Revised) is also to lay down appropriate accounting for contingent assets.

Scope

AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than

- a. Those resulting from financial instruments that are carried at fair value;
- b. Those resulting from executory contracts except where the contract is onerous;
- c. Those arising in insurance enterprises from contracts with policy-holders; and
- d. Those covered by another Accounting Standard.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

Definitions

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

A **Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A Contingent liability is:

- (a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) A present obligation that arises from past events but is not recognised because:
 - (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) A reliable estimate of the amount of the obligation cannot be made.

A **Contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A **Restructuring** is a programme that is planned and controlled by management, and materially changes either:

- (a) The scope of a business undertaken by an enterprise; or
- (b) The manner in which that business is conducted.

Recognition**Provisions****A provision should be recognised when:**

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

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

Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, e.g., the opinion of experts. On the basis of such evidence:

- (a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and
- (b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future.

Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of AS 29, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

The use of estimates is an inherent part of preparing financial statements and does not undermine their reliability. Provisions require a greater degree of estimation than most other items, but AS 29 (Revised) emphasises that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognised. AS 29 (Revised) concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability will, instead, be disclosed as a contingent liability.

For example:

XYZ is in mining business. It is operating in a country where XYZ is legally bound to clean and restore the environment on expiry of license after 10 years. XYZ can reliably estimate the amount required to restore the environment caused by the mining business.

Since it is a present obligation which cannot be avoided resulted from past event, it is probable that resources will flow out of business to settle the same and estimate can be measured reliably. XYZ is required to recognize a provision for the same.

Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

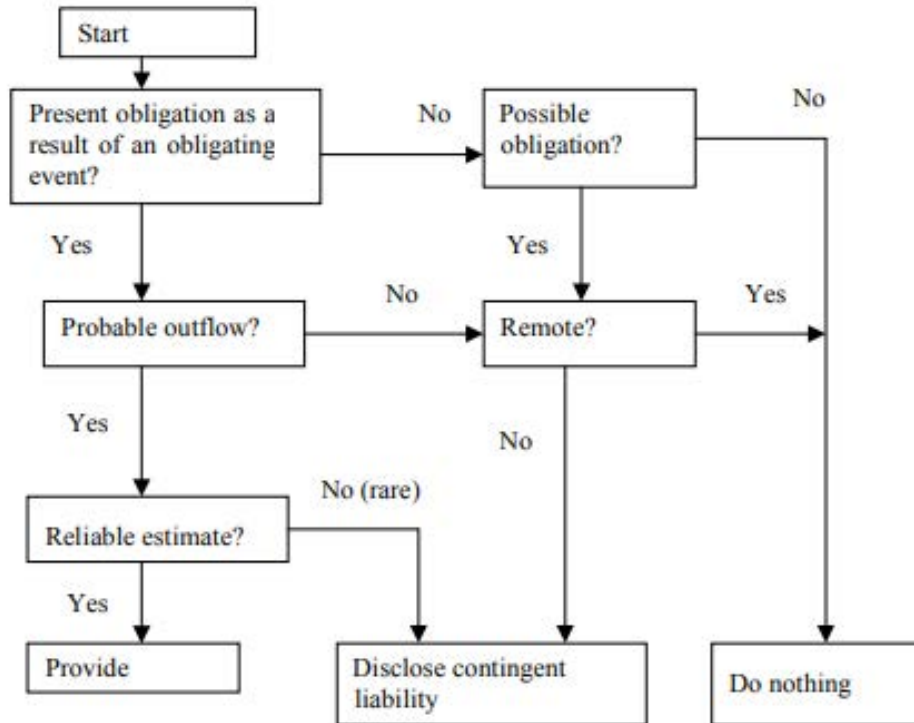
Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

Example:

A customer of XYZ has filed a case against them for providing them wrong product and not returning the same. XYZ has taken legal advice from their lawyer who believes it is not probable yet that resources may be required to settle the same.

Since it is not meeting all the criteria of provision, it will be treated as contingent liability and will just be disclosed in the notes.

Decision tree



Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Table- Provisions and contingent liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
<i>There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.</i>	<i>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</i>	<i>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</i>
Provision is recognised. Disclosures are required for the provision.	No provision is recognised. Disclosures are required for the contingent liability.	No provision is recognised. No disclosure is required.

Measurement

Best Estimate

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The estimates of outcome and financial effect are determined by:

- the judgment of the management of the enterprise,
- supplemented by experience of similar transactions and,
- in some cases, reports from independent experts.

The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment.

The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.

The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

Risks and uncertainties

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events

It is only those obligations arising from past events that exist independently of the enterprise's future actions (ie the future conduct of its business) that are recognised as provisions.

Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

An enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognised only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

Table- Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
<i>The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.</i>	<i>The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.</i>	<i>The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.</i>
The enterprise has no liability for the amount to be	The reimbursement is recognised as a separate asset in the balance sheet	The expected reimbursement is not recognised as an asset.

reimbursed.	and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability.	
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

A provision should be used only for expenditures for which the provision was originally recognised. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

FUTURE OPERATING LOSSES

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

RESTRUCTURING

The following are examples of events that may fall under the definition of restructuring:

- (a) Sale or termination of a line of business
- (b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another

- (c) Changes in management structure, for example, eliminating a layer of management
- (d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations

A provision for restructuring costs is recognised only when the recognition criteria for provisions are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

- (a) Necessarily entailed by the restructuring; and
- (b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

- (a) Retraining or relocating continuing staff;
- (b) Marketing; or
- (c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

For each class of provision, an enterprise should disclose:

- (a) The carrying amount at the beginning and end of the period;
- (b) Additional provisions made in the period, including increases to existing provisions;

- (c) Amounts used (i.e. incurred and charged against the provision) during the period; and
- (d) Unused amounts reversed during the period.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

An enterprise should disclose the following for each class of provision:

- (a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- (b) An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and
- (c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

- (a) An estimate of its financial effect,
- (b) An indication of the uncertainties relating to any outflow; and
- (c) The possibility of any reimbursement.

Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

In extremely rare cases, disclosure of some or all of the information required by AS 29 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration 1

At the end of the financial year ending on 31st December, 20X1, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	Loss (₹)
<i>In respect of five cases (Win)</i>	100%	–
<i>Next ten cases (Win)</i>	50%	–
<i>Lose (Low damages)</i>	40%	1,20,000
<i>Lose (High damages)</i>	10%	2,00,000
<i>Remaining five cases</i>		
<i>Win</i>	50%	–
<i>Lose (Low damages)</i>	30%	1,00,000
<i>Lose (High damages)</i>	20%	2,10,000

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

Solution

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

- (i) There is a present obligation arising out of past events but not recognised as provision.
- (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- (iii) The possibility of an outflow of resources embodying economic benefits is not remote.
- (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognised as provision.

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

Expected loss in next ten cases = 40% of ₹ 1,20,000 + 10% of ₹ 2,00,000
= ₹ 48,000 + ₹ 20,000 = ₹ 68,000

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

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 10,40,000 (₹ 68,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Illustration 2

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 20X2. The company seeks your advice on the following:

- (i) *The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14th February, 20X4 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.*
- (ii) *The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2.*

Solution

- (i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 20X4. The amount paid under protest can be kept under the heading 'Loans & Advances' and also disclosed as a contingent liability of ₹ 2.10 crore.
- (ii) The arrears for the period from June, 20X1 to March, 20X2 are required to be provided for in the accounts of the company for the year ended on 31st March, 20X2.