CORPORATE ACCOUNTING

Study Material
CORE COURSE
For
III SEMESTER BBA
BBA3 B04
(2019 Admission)

UNIVERSITY OF CALICUT
SCHOOL OF DISTANCE EDUCATION
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UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

Study Material

CORE COURSE

III SEMESTER BBA

BBA3 B04 – **CORPORATE ACCOUNTING**

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MODULE – I
FINANCIAL REPORTING STANDARDS

Accounting Standards in India

Accounting Standards in India are issued by Accounting Standard Board (ASB) of Institute of Chartered Accountants of India and are largely based on IFRS. With the opening of Indian economy in near past, the convergence to IFRS has become unavoidable. Keeping this in view, ASB decided to form an IFRS task force in August 2006. Based on the recommendation of this task force, the Council of ICAI, in its 269th meeting decided to fully converge with IFRS from the accounting periods commencing on or after 1st April 2011. At initial stage, this convergence will be mandatory for listed and other public interest entities like banks, insurance companies, NBFCs, and large sized organizations with high turnover or annual income.

The Ministry of Corporate Affairs in its Press Release dated 25.2.2011 notified 35 Indian Accounting Standards converged with International Financial Reporting Standards (henceforth called IND AS). The Ministry of Corporate Affairs will implement the IFRS converged Indian Accounting Standards in a phased manner after various issues including tax related issues are resolved with the concerned Departments.

It would be ensured that the implementation of the converged standards in a phased manner is smooth for the stakeholders. The date of implementation of the IND AS will be notified by the Ministry at a later date.

Why this convergence?

Converging with IFRS will have multiple benefits for Indian entities especially those who aspire to go global. Some of the benefits of convergence with IFRS are explained below:

(a) Accessibility to foreign capital markets
(b) Reduced Cost
(c) Enhance Comparability
(d) Boon for multinational group entities
(e) New Opportunities for the professionals

Preface to IFRS

The first preface was published in January 1975, and amended in November 1982. However, it was replaced in April 2002 and further amended twice in January and November 2007. It sets out the objective and due process of the IASB and explains the scope, authority, and timing of application of IFRSs.

IFRS Defined in

Standards and Interpretations adopted by the International Accounting Standards Board (IASB). They comprise

a. International Financial Reporting Standards **[IFRS]**
b. International Accounting Standards **[IAS]**; and
c. Interpretations developed by the IFRS Interpretations Committee **(IFRIC)** and
d. Former Standing Interpretations Committee **(SIC)**

List of IFRS

1. IFRS 1 – First-time Adoption of International Financial Reporting Standards
2. IFRS 2 – Share-based Payment
3. IFRS 3 – Business Combinations
4. IFRS 4 – Insurance Contracts
5. IFRS 5 – Non-current Assets Held for Sale and Discontinued Operations
6. IFRS 6 – Exploration for and evaluation of Mineral Resources
7. IFRS 7 – Financial Instruments: Disclosures
8. IFRS 8 – Operating Segments
9. IFRS 9 – Financial Instruments (This standard will replace IAS 39 Financial Instruments: Recognition and Measurement on being updated completely)
10. IFRS 10 – Consolidated Financial Statements
11. IFRS 11 – Joint Arrangements
12. IFRS 12 – Disclosure of Interests in Other Entities
13. IFRS 13 – Fair Value Measurement

Including IFRSs that are applicable w.e.f. 1st January 2013 IFRS – 13

List of IAS

1. IAS 1 – Presentation of Financial Statements
2. IAS 2 – Inventories
3. IAS 7 – Statement of Cash Flows
4. IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors
5. IAS 10 – Events After the Reporting Period
6. IAS 11 – Construction Contracts
7. IAS 12 – Income Taxes
8. IAS 16 – Property, Plant and Equipment
9. IAS 17 – Leases
10. IAS 18 – Revenue
11. IAS 19 – Employee Benefits
12. IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance
13. IAS 21 – The Effects of Changes in Foreign Exchange Rates
14. IAS 23 – Borrowing Costs
15. IAS 24 – Related Party Disclosures
16. IAS 26 – Accounting and Reporting by Retirement Benefit Plans
17. IAS 27 – Consolidated and Separate Financial Statements (w.e.f 1st January 2013)
18. IAS 28 – Investments in Associates and Joint Ventures (w.e f. 1st January 2013)
19. IAS 29 – Financial Reporting in Hyperinflationary Economies
20. IAS 31 – Interest in Joint Ventures (w.e.f 1st January 2013)
21. IAS 32 – Financial Instruments: Presentation
22. IAS 33 – Earnings Per Share
23. IAS 34 – Interim Financial Reporting
24. IAS 36 – Impairment of Assets
25. IAS 37 – Provisions, Contingent Liabilities and Contingent Assets
26. IAS 38 – Intangible Assets
27. IAS 39 – Financial Instruments: Recognition and Measurement
28. IAS 40 – Investment Property

29. IAS 41 – Agriculture

Including IAS applicable w.e.f. 1st Jan 2013 – 28

List of IFRIC Interpretations

1. IFRIC 1 – Changes in Existing Decommissioning, Restoration and Similar Liabilities
2. IFRIC 2 – Members‘ Share in Co-operative Entities and Similar Instruments
3. IFRIC 4 – Determining whether an Arrangement contains Lease
4. IFRIC 5 – Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
5. IFRIC 6 – Liabilities arising from Participation in a Specific Market- Waste Electrical and Electronic Equipment
6. IFRIC 7 – Applying restatement approach under IAS 29
7. IFRIC 10 – Interim Financial Reporting and Impairment
8. IFRIC 12 – Service Concession Arrangements
9. IFRIC 13 – Customer Loyalty Programmes
10. IFRIC 14 – IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirement and their Interaction
11. IFRIC 15 – Agreements for the Construction of Real Estate
12. IFRIC 16 – Hedges of a Net Investment in a Foreign Operation
13. IFRIC 17 – Distribution of Non – Cash assets to owners
14. IFRIC 18 – Transfer of assets from customers
15. IFRIC 19 – Extinguishing Financial Liabilities with Equity Instruments
16. IFRIC 20 – Stripping Costs in the Production Phase

Including IFRIC Interpretations applicable w.e.f. 1st January 2013 – 16. Before 1st January 2013 - 16

List of SIC Interpretations

1. SIC 7 – Introduction of the EURO
2. SIC 10 – Government Assistance- No Specific Relation to Operating Activities
3. SIC 12 – Consolidation- Special Purpose Entities (w.e.f 1st January 2013
4. SIC 13 – Jointly Controlled Entities- Non Monetary Contribution by Venturers (w.e.f 1st January 2013)
5. SIC 15 – Operating Lease- Incentives
6. SIC 21 – Income Taxes- Recovery of Revalued Non Depreciable Assets
7. SIC 25 – Income Taxes- Change in Tax Status of an Entity or its Shareholders
8. SIC 27 – Evaluating the Substance of Transaction Involving the Legal Form of a Lease
9. SIC 29 – Service Concession Arrangements: Disclosures
10. SIC 31 – Revenue: Barter Transaction Involving Advertising Services
11. SIC 32 – Intangible Assets- Web Site Costs

Including SIC Interpretations applicable w.e.f. 1st January 2013 = 9

Before 1st January 2013 = 11

Total number of IFRS (w.e.f. 1st January 2013) = 13+28+16+9 = 66

Scope of IFRS

(i) All International Accounting Standards (IASs) and Interpretations issued by the former IASC (International Accounting Standard Committee) and SIC (Standard Interpretation Committee) continue to be applicable unless and until they are amended or withdrawn.

(ii) IFRS set out recognition, measurement, presentation and disclosure requirements of transaction and events in general purpose financial statements.

(iii) IFRSs apply to the general purpose financial statements and other financial reporting by profit-oriented entities – those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form.

(iv) Entities other than profit-oriented business entities may also find IFRSs appropriate.

(v) General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows.

(vi) Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.

(vii) IFRS apply to individual company and consolidated financial statements.

(viii) A complete set of financial statements includes a statement of financial position, a statement of comprehensive income, a statement of cash flows, a statement showing either all changes in equity or changes in equity other than those arising from investments by and distributions to owners, a summary of accounting policies, and explanatory notes.

(ix) If an IFRS allows both a 'benchmark' and an 'allowed alternative' treatment, financial statements may be described as conforming to IFRS whichever treatment is followed.

(x) In developing Standards, IASB intends not to permit choices in accounting treatment. Further, IASB intends to reconsider the choices in existing IASs with a view to reducing the number of those choices.

(xi) IFRS will present fundamental principles in bold face type and other guidance in nonbold type (the 'black-letter'/'grey-letter' distinction). Paragraphs of both types have equal authority.

(xii) IAS 1 provides that, the conformity with IAS requires compliance with every applicable IAS and Interpretation requires compliance with all IFRSs as well.

The Conceptual Framework for Financial Reporting

The IASB Framework was approved by the IASC Board in April 1989 for publication in July 1989, and adopted by the IASB in April 2001. The Conceptual Framework was issued by the IASB in September 2010. It superseded the Framework for the Preparation and Presentation of Financial Statements.

This Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Conceptual Framework is:

(a) To assist the Board in the development of future IFRSs and in its review of existing IFRSs;

(b) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;

(c) To assist national standard-setting bodies in developing national standards;

(d) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;

(e) To assist auditors in forming an opinion on whether financial statements comply with IFRSs;

(f) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and

(g) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

Scope of Framework

The Conceptual Framework deals with:

(a) The objective of financial reporting:

The objective of general purpose financial reporting is

i) To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

ii) To assess an entity‘s prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity‘s management and governing board have discharged their responsibilities to use the entities resources.

iii) To provide information regarding the liquidity of the entity

However, the financial statements need not provide all information that an user may require to arrive at decision as they contain only financial information and not the non-financial information.

(b) The qualitative characteristics of useful financial information:

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The fundamental qualitative characteristics are Relevance and Faithful Representation. Comparability, Verifiability, Timeliness and Understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

(c) The definition, recognition and measurement of the elements from which financial statements are constructed:

Elements of Financial Statements include Assets, Liabilities, Equity, Income and Expenses

Recognition of the Elements of Financial Statements

The recognition is based on the probability of the future economic benefits and reliability of measurement. It involves the recognition of assets, liabilities, income and expense.

Measurement of the Elements of Financial Statements

Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognised and reported. The Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including: Historical cost; Current cost; Net realisable (settlement) value and Present value (discounted).

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases. The Framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance, however.

(d) Concepts of capital and capital maintenance.

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity‘s return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

(e) Users of financial statement and their information needs

The Framework notes that financial statements cannot provide all the information that users may need to make economic decisions. For one thing, financial statements show the financial effects of past events and transactions, whereas the decisions that most users of financial statements have to make relate to the future. Further, financial statements provide only a limited amount of the non-financial information needed by users of financial statements. While all of the information needs of these user groups cannot be met by financial statements, there are information needs that are common to all users, and general purpose financial statements focus on meeting these needs.

(f) Responsibility for Financial Statements

The management of an enterprise has the primary responsibility for preparing and presenting the enterprise's financial statements.

(g) The Cost Constraint on useful Financial Reporting

Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes cost, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

The IND AS (Indian Accounting Standards) Literature

Preface to the Statements of Accounting Standards sets out ASB's mission and objectives, the scope of Indian Accounting Standards, due process for developing IND AS and interpretations, and policies on effective dates, format, and language for IND AS.

Framework for the Preparation and Presentation of Financial Statements which serves as a guide to resolving accounting issues that are not addressed directly in a standard. It is always advisable for a beginner in IND AS to first properly understand the framework as it sets out basic principles of recognition and measurement of all elements adopted for all the IND AS and Interpretations from ASB.

Purpose of Framework

This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;
(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;
(c) assist the Accounting Standards Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;
(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;
(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and
(f) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

Nothing in this framework overrides any specific Accounting Standard

How to study IND AS?

Ind ASs are the near final Indian Accounting Standards issued by Institute of Chartered Accountants of India and notified by the Government of India. All the 35 standards issued are converged with IFRS. The date of implementation of the IND AS will be notified by the Ministry of Corporate Affairs at a later date.

These standards do not resemble IFRS. Both by presentation and measurement principles they are new set of accounting standards developed in the line of IFRS.

IFRS Adoption Procedure in India

To rationalize accounting practices in the country, the Indian government in 1949, established Institute of Chartered Accountants of India by passing ICAI Act, 1949. Accounting Standard Board was constituted by ICAI in 1977 in order to create harmony among the diversified accounting policies and practices in India. Three steps process was laid down by the accounting professionals in India which are summarized as follows:

Step 1 – IFRS Impact assessment this is the first step. In this step the firm will assess the impact of IFRS adoption on Accounting and Reporting issues, on procedures and systems, and on core business of the entities. Then the firm will find the key conversion dates according to IFRS training plan has laid down. As and when the training plan is in place, the firm will have to identify the important Financial Reporting Standards which will apply to the firm and also the variations among the present financial reporting standards being followed by the firm and IFRS both.

Step 2 – Preparations for IFRS implementation this is the second step of the process, which will carry out such activities required for IFRS implementation process. Then the firm will reform the internal reporting systems and processes. IFRS first deals with the adoption and implementation of first time adoption process.

Step 3 – Implementation this is the final step of the process which deals with the actual implementation of IFRS. The initial phase of this step is to prepare an opening Balance Sheet at the date of transition to IFRS. To understand the actual impact of the transition from the Indian Accounting Standards to IFRS is to be developed. This will follow the full application of IFRS as and when it is required. At the initial stage of implementation of IFRS requires lot of training and various technical difficulties may be experienced. The smooth implementation of the transition from Indian Accounting Standards to IFRS, regular training to personals and identify the problems while carrying out the implementation.

Terminologies used in Ind AS

- The term "Statement of Financial Position" has been replaced by "Balance Sheet"
- The term "Statement of Comprehensive Income" by "Statement of Profit and Loss"
- The words "authorization of the financial statements for issue" have been replaced by "approval of the financial statements for issue"

Principle Assumptions in Preparation of Financial Statements

- Going Concern
- Consistency
- Accruals
- Materiality
- Aggregation
- Offsetting

List of Indian Accounting Standards

These are the near final Indian Accounting Standards (Ind ASs) finalised by the Council of the ICAI and sent to the National Advisory Committee on Accounting Standards (NACAS). These are subject to any changes, which may be made by the Government before their notification. Any changes in the Ind AS vis. a vis. corresponding IAS/IFRS are given in Appendix 1 appearing at the end of each Ind AS.

1. Ind AS 101 – First-time Adoption of Indian Accounting Standards
2. Ind AS 102 – Share based Payment
3. Ind AS 103 – Business Combinations
4. Ind AS 104 – Insurance Contracts
5. Ind AS 105 – Non current Assets Held for Sale and Discontinued Operations
6. Ind AS 106 – Exploration for and Evaluation of Mineral Resources
7. Ind AS 107 – Financial Instruments: Disclosures
8. Ind AS 108 – Operating Segments
9. Ind AS 1 – Presentation of Financial Statements
10. Ind AS 2 – Inventories
11. Ind AS 7 – Statement of Cash Flows
12. Ind AS 8 – Accounting Policies, Changes in Accounting Estimates and Errors
13. Ind AS 10 – Events after the Reporting Period
14. Ind AS 11 – Construction Contracts
15. Ind AS 12 – Income Taxes
16. Ind AS 16 – Property, Plant and Equipment
17. Ind AS 17 – Leases
18. Ind AS 18 – Revenue

19. Ind AS 19 – Employee Benefits
20. Ind AS 20 – Accounting for Government Grants and Disclosure of Government Assistance
21. Ind AS 21 – The Effects of Changes in Foreign Exchange Rates
22. Ind AS 23 – Borrowing Costs
23. Ind AS 24 – Related Party Disclosures
24. Ind AS 27 – Consolidated and Separate Financial Statements
25. Ind AS 28 – Investments in Associates
26. Ind AS 29 – Financial Reporting in Hyperinflationary Economies
27. Ind AS 31 – Interests in Joint Ventures
28. Ind AS 32 – Financial Instruments: Presentation
29. Ind AS 33 – Earnings per Share
30. Ind AS 34 – Interim Financial Reporting
31. Ind AS 36 – Impairment of Assets
32. Ind AS 37 – Provisions, Contingent Liabilities and Contingent Assets
33. Ind AS 38 – Intangible Assets
34. Ind AS 39 – Financial Instruments: Recognition and Measurement
35. Ind AS 40 – Investment Property

IFRICs and SICs not notified

The following IFRICs and SICs are not notified

- IFRIC 4 – Determining whether an Arrangment Contains a Lease
- IFRIC 12 – Service Concession Arrangements
- IFRIC 20 – Stripping Costs of the Production Phase
- SIC 29 Disclosures – Service Concession Arrangements

Eliminated IFRIC Interpretations

- IFRIC 15 - Agreements for the Construction of Real Estate. The standard is excluded because unlike IFRS, IND AS proposes to apply principles of construction contract
- IFRIC 2 – Member‘s Shares in Cooperative Entities and Similar Instruments does not form part of IND AS

Irrelevant SIC Interpretation

- SIC 7 – Introduction of the EURO

The Elements of Financial Statements

1. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

2. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

1. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:
   (a) An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
   (b) A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
   (c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

2. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition.

   In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion before an asset or liability is recognised.

3. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

1. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

2. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

3. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:
   (a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;
   (b) exchanged for other assets;
   (c) used to settle a liability; or
   (d) distributed to the owners of the enterprise.
4. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

5. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

6. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

7. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

1. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these

become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

2. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

3. The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:
   (a) payment of cash;
   (b) transfer of other assets;
   (c) provision of services;
   (d) replacement of that obligation with another obligation; or
   (e) conversion of the obligation to equity. An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

4. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

5. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

1. Equity is the residual interest in the assets of the enterprise after deducting all its liabilities, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

2. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if

transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

3. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

4. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

1. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements.

2. Income and expenses are defined as follows:
   (a) Income is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
   (b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

3. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of profit and loss.

4. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

5. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness. For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

1. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

2. Gains represent other items that meet the definition of income and may or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

3. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

4. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

1. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

2. Losses represent other items that meet the definition of expenses and may or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

3. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions

Capital Maintenance Adjustments

The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves.

Recognition of the Elements of Financial Statements

- Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

- An item that meets the definition of an element should be recognised if:
  (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
  (b) the item has a cost or value that can be measured with reliability.

- In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

a. The Probability of Future Economic Benefits

The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

b. Reliability of Measurement

- The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

- An item that, at a particular point in time, fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.

- An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. The existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

c. Recognition of Assets

- An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

- An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

d. Recognition of Liability

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

e. Recognition of Income

- Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

- The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

f. Recognition of Expenses

- Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

- Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

- When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

- An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

- An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

Measurement of the Elements of Financial Statements

- Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

- A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:
    - **(a) Historical cost:** Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
    - **(b) Current cost:** Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
    - **(c) Realisable (settlement) value:** Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.
    - **(d) Present value:** Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

- The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concept of Capital and Capital Maintenance

Concepts of Capital

- Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

- The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concept of Capital Maintenance and the Determination of Profit

- The concepts of capital give rise to the following concepts of capital maintenance:

(a) Financial capital maintenance: Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) Physical capital maintenance: Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

- The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

- The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

- The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

- Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

- Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period.

All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

- The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

Revised Schedule VI [Presentation of Financial Statements]

The Ministry of Corporate Affairs has recently issued a Revised Schedule VI to the Companies Act, 1956, to lay down a new format for preparation and presentation of financial statements by Indian companies. The revised Schedule VI has been framed as per the Existing Indian Accounting Standards notified under the Companies (Accounting Standards), Rules, 2006. The notification shall come into force for the Balance Sheet and Statement of Profit and Loss Account to be prepared for the financial year commencing on or after 1.4.2011.

Brief Insight to Revised Schedule VI

- The revised schedule VI prescribes the minimum requirements for disclosure on the face of financial statements or in the notes. Line items, sub-line items and subtotals can be presented as an addition or substitution on the face of financial statements when such presentation is relevant for understanding of the company‘s financial position or performance. It should also be noted that the disclosures required under accounting standards and in the Act are in addition to the disclosures set-out in the revised Schedule VI. A company should make such additional disclosures in the notes to accounts or by way of an additional statement unless these are required to be disclosed on the face of the financial statements.

- In case the requirements of the Act and/ or accounting standards requires a change in the treatment or disclosure in the financial statements, the requirements of the Act and/ or accounting standards will prevail over the Schedule VI

- In the existing Schedule VI, break-up of amounts disclosed in main balance sheet and profit and loss (P&L) account was given in the schedules. Additional information was furnished in the notes to account. The revised Schedule VI has eliminated the concept of schedule and such information will now be provided in the notes to accounts. This is in line with the practice under IFRS. Further, all information relating to a particular item of balance sheet and The Statement of Profit and Loss account disclosed in the notes is required to be cross referred to that item on the face of balance sheet/ Statement of Profit and Loss account.

- Except in the case of the first financial statements laid before the company (after its incorporation), the corresponding amounts for the immediately preceding reporting period for all items shown in the financial statements including notes will also be given.

- For the purposes of revised Schedule VI, the terms used therein will carry the meaning as defined by the applicable accounting standards. Therefore, the terms like related parties, holding and subsidiary company will have the same meaning as defined under the Companies Accounting Standards Rules, 2006.

- The revised Schedule VI requires that in preparing the financial statements including the notes to accounts, a balance should be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

- There is an explicit requirement to use the same unit of measurement uniformly throughout the financial statements. Rounding off rules have been changed and now the option of presenting figures in terms of hundreds and thousands is eliminated for companies whose turnover exceeds Rs. 100 crores. Moreover, the companies with turnover of less than 100 crores can now round it off even to the nearest lakhs or millions or decimal therefore which was not permitted earlier.

Simplification of Disclosures

The revised Schedule VI has removed a number of disclosure requirements that were not considered relevant in the present day context. Examples include:

a. Disclosures relating to managerial remuneration and computation of net profits for calculation of commission
b. Information relating to licensed capacity, installed capacity and actual production
c. Information on investments purchased and sold during the year
d. Investments, sundry debtors and loans & advances pertaining to companies under the same management
e. Commission, brokerage and non-trade discounts

The format of Balance Sheet and Statement of Profit and Loss Account as contained in the Part I and II of the revised Schedule VI are reproduced below.

Unlike Ind-AS 101 which provides an option to provide comparative figures upon first-time adoption of converged Indian accounting standards, the revised Schedule VI aptly does not contain such an option. The corresponding amounts i.e comparatives for the immediately preceding reporting period for all items shown in the Financial Statements including notes is required to be provided.

Understanding Statement of Profit & Loss Account and Balance Sheet under Ind AS

Balance Sheet under Ind AS

Information to be presented in the balance sheet will be as follows. As a minimum, the balance sheet shall include line items that present the following amounts:

(a) property, plant and equipment;
(b) investment property;
(c) intangible assets;
(d) financial assets (excluding amounts shown under (e), (h) and (i));
(e) investments accounted for using the equity method;

(f) biological assets;
(g) inventories;
(h) trade and other receivables;
(i) cash and cash equivalents;
(j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with Ind AS 105 Non-current Assets Held for Sale and Discontinued Operations;
(k) trade and other payables;
(l) provisions;
(m) financial liabilities (excluding amounts shown under (k) and (l));
(n) liabilities and assets for current tax, as defined in Ind AS 12 Income Taxes;
(o) deferred tax liabilities and deferred tax assets, as defined in Ind AS 12;
(p) liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105;
(q) non-controlling interests, presented within equity; and
(r) issued capital and reserves attributable to owners of the parent.

Current and Non Current Distinction

An entity shall present current and non -current assets, and current and non-current liabilities, as separate classifications in its balance sheet.

Current Assets

An entity shall classify an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
(b) it holds the asset primarily for the purpose of trading;
(c) it expects to realise the asset within twelve months after the reporting period; or
(d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as NON –CURRENT ASSETS.

Non Current Assets

The term “non-current” includes tangible, intangible and financial assets of a long-term nature.

Current Liabilities

An entity shall classify a liability as current when:

(a) it expects to settle the liability in its normal operating cycle;
(b) it holds the liability primarily for the purpose of trading;
(c) the liability is due to be settled within twelve months after the reporting period; or
(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

An entity shall classify all other liabilities as NON-CURRENT LIABILITIES.

Information to be presented either in the balance sheet or in the Notes

1. An entity shall disclose, either in the balance sheet or in the notes, further sub classifications of the line items presented, classified in a manner appropriate to the entity's operations.
2. The following shall be disclosed either in the balance sheet or in the statement of changes in equity which is part of the balance sheet, or in the notes:
   - (a) for each class of share capital:
     - i) the number of shares authorised;
     - ii) the number of shares issued and fully paid, and issued but not fully paid;
     - iii) par value per share, or that the shares have no par value;
     - iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
     - v) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
     - vi) shares in the entity held by the entity or by its subsidiaries or associates; and
     - vii) shares reserved for issue under options and contracts for the sale of shares, including terms and amounts; and
   - (b) a description of the nature and purpose of each reserve

MODULE II
IFRS CONVERGED INDIAN ACCOUNTING STANDARDS

Indian Accounting Standards – Ind AS (IFRS Converged Indian Gaap)

Applicability and accounting principles of Indian Accounting Standards (Ind AS)

Presently, the Institute of Chartered Accountants of India (ICAI) has issued 39 Indian Accounting Standards (Ind AS) which have been notified under the Companies (Indian Accounting Standards) Rules, 2015 ("Ind AS Rules"), of the Companies Act, 2013.

Applicability of Ind AS

As per the notification released by the Ministry of Corporate Affairs (MCA) on 16 February 2015, the roadmap for Ind AS implementation is as follows:

Roadmap of IND AS Applicability

Financial Year	Mandatorily Applicable To
2016-17	Companies (listed and unlisted) whose net worth is equal to or greater than 500 crore INR
2017-18	Unlisted companies whose net worth is equal to or greater than 250 crore INR and all listed companies
2018-19 Onwards	When a company's net worth becomes greater than 250 crore INR
2015-16 or later	Entities, not under the mandatory roadmap, may later voluntarily adopt Ind AS

Whenever a company gets covered under the roadmap, Ind AS becomes mandatory, its holding, subsidiary, associate and joint venture companies will also have to adopt Ind AS (irrespective of their net worth).

For the purpose of computing the net worth, reference should be made to the definition under the Companies Act, 2013. In accordance with section 2 (57) of the Companies Act, 2013, net worth is computed as follows:

Net worth means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

Ind AS will apply to both consolidated as well as standalone financial statements of a company.

While overseas subsidiary, associate or joint venture companies are not required to prepare standalone financial statements under Ind AS, they will need to prepare Ind AS adjusted financial information to enable consolidation by the Indian parent.

Presently, insurance companies, banking companies and nonbanking finance companies (NBFCs) are not required to apply Ind AS. The Ind AS rules are silent when these companies are subsidiaries, associates or joint ventures of a parent covered under the roadmap. It appears that these companies will need to report Ind AS adjusted financial information to enable consolidation by the parent.

In case of conflict between Ind AS and the law, the provisions of law will prevail and financial statements are to be prepared in compliance with the law.

Scope of IND AS

India has chosen a path of International Financial Reporting Standards (IFRS) convergence rather than adoption. Hence, Ind AS are primarily based on the IFRS issued by the International Accounting Standards Board (IASB). However, there are certain carve-outs from the IFRS. There are also certain general differences between Ind AS and IFRS:

- The transitional provisions given in each of the standards under IFRS have not been given in Ind AS, since all transitional provisions related to Ind AS, wherever considered appropriate, have been included in Ind AS 101, First-Time Adoption of Indian Accounting Standards, corresponding to IFRS 1, First-Time Adoption of International Financial Reporting Standards.
- Different terminology is used in Ind AS when compared to IFRS, e.g. the term ‘balance sheet’ is used instead of ‘statement of financial position’ and ‘statement of profit and losses is used instead of ‘statement of comprehensive income’.

IND AS

Sl. No.	Name	IND AS
1	First-time Adoption of International Financial Reporting Standards	IND AS 101
2	Share-based Payment	IND AS 102
3	Business Combinations	IND AS 103
4	Insurance Contracts	IND AS 104
5	Non-current Assets Held for Sale and Discontinued Operations	IND AS 105
6	Exploration for and Evaluation of Mineral Assets	IND AS 106
7	Financial Instruments: Disclosures	IND AS 107
8	Operating Segments	IND AS 108
9	Financial Instruments	IND AS 109
10	Consolidated Financial Statements	IND AS 110

11	Joint Arrangements	IND AS 111
12	Disclosure of Interests in Other Entities	IND AS 112
13	Fair Value Measurement	IND AS 113
14	Regulatory Deferral Accounts	IND AS 114
15	Revenue from Contracts with Customers	IND AS 115
16	Presentation of Financial Statements	IND AS 1
17	Inventories	IND AS 2
18	Statement of Cash Flows	IND AS 7
19	Accounting Policies, Changes in Accounting Estimates and Errors	IND AS 8
20	Events After the Reporting Period	IND AS 10
21	Income Taxes	IND AS 12
22	Property, Plant and Equipment	IND AS 16
23	Leases	IND AS 17
24	Employee Benefits (2011)	IND AS 19
25	Accounting for Government Grants and Disclosure of Government Assistance	IND AS 20
26	The Effects of Changes in Foreign Exchange Rates	IND AS 21
27	Borrowing Costs	IND AS 23
28	Related Party Disclosures	IND AS 24
29	Accounting and Reporting by Retirement Benefit Plans	-
30	Separate Financial Statements (2011)	IND AS 27
31	Investments in Associates and Joint Ventures (2011)	IND AS 28
32	Financial Reporting in Hyperinflationary Economies	IND AS 29
33	Financial Instruments: Presentation	IND AS 32
34	Earnings Per Share	IND AS 33
35	Interim Financial Reporting	IND AS 34
36	Impairment of Assets	IND AS 36
37	Provisions, Contingent Liabilities and Contingent Assets	IND AS 37
38	Intangible Assets	IND AS 38
39	Investment Property	IND AS 40
40	Agriculture	IND AS 41

41	Changes in Existing Decommissioning, Restoration and Similar Liabilities	Appendix A to IND AS 16
42	Members' Shares in Co-operative Entities	-
43	Determining Whether an Arrangement Contains a Lease	Appendix C to IND AS 17
44	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabiliation Funds	Appendix A to IND AS 37
45	Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electrical Equipment	Appendix B to IND AS 37
46	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies	Appendix A to IND AS 29
47	Interim Financial Reporting and Impairment	Appendix A to IND AS 34
48	Service Concession Arrangements	Appendix C to IND AS 115
49	IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	Appendix B to IND AS 19
50	Hedges of a Net Investment in a Foreign Operation	Appendix C to IND AS 109
51	Distributions of Non-cash Assets to Owners	Appendix A to IND AS 10
52	Extinguishing Financial Liabilities with Equity Instruments	Appendix D to IND AS 109
53	Stripping Costs in the Production Phase of a Surface Mine	Appendix B to IND AS 16
54	Levies	Appendix C to IND AS 37
55	Introduction of Euro	-
56	Government Assistance – No Specific Relation to Operating Activities	Appendix A to IND AS 20
57	Operating Leases – Incentives	Appendix A to IND AS 17
58	Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders	Appendix A to IND AS 12
59	Evaluating the Substance of Transactions in the Legal Form of a Lease	Appendix B to IND AS 17
60	Disclosure - Service Concession Arrangements	Appendix D to IND AS 115
61	Intangible Assets - Web Site Costs	Appendix A to IND AS 38

Recognition and Measurement of Ind AS 2, Ind AS 12, Ind AS 16, Ind AS 23, Ind AS 37 & Ind AS 38

INVENTORIES – Ind AS 2

Accounting for Inventories

Accounting for inventories is based on the matching concept. As per this concept, inventories should be accounted for an expense in the year in which it is sold. Till that time, it is accounted for as an asset, ie, closing stock. It is also credited in the statement of profit and loss. Ind AS 2 & IAS 2 prescribe accounting treatment for inventories.

Objectives

The objective of this standard is to prescribe the accounting treatment for inventories. This standard deals with determination of cost and its subsequent recognition as an expense, including any write down to net realizable value.

Scope

This standard applies to all inventories except the following:

(a) Work in progress under a construction contract (dealt by Ind AS 11, Construction Contracts)
(b) Financial instruments, e.g., share, debentures, bonds (governed by Ind AS 32, Financial Instrument)
(c) Biological assets related to agricultural activity and agricultural produce at the point of harvest.

Definition of Inventories

Inventories are assets that are:

1. Held for sale
2. Being prepared for sale
3. Materials to be used in the production process or provision or services.

Inventory includes raw materials, production supplies, work in progress, finished goods and goods in saleable condition (i.e., ready to sell goods that have been purchased for resale.)

Accounting Treatment

Measurement of Inventories

Inventories must be measured at cost or net realizable value, whichever is less. Thus, the two components are cost and net realizable value.

Cost of Inventories

The cost of inventories comprises of

1) Cost of purchase;
2) Cost of conversion;
3) Other costs incurred in bringing the inventories to their present location and condition.

1) Cost of Purchase

(a) Purchase price
(b) Import duties and other taxes
(c) Transport cost
(d) Handling cost
(e) Other cost directly attributable to the acquisition of finished goods, materials and services.

Illustration 1

Malabar Textiles is a trading company dealing in textiles. It incurred the following expenses for the purchase of textiles from New India Textiles:

Amount paid to supplies	2,25,300
Transportation charges	14,500
GST	5%

The purchase bill shows a value of 2,42,000 because New India Textiles allowed a special trade discount of 5% of billed value to Malabar Textiles. New India Textiles also allowed a cash discount of 2% for prompt payment. Calculate the cost of purchase.

Solution

Cost of purchase as per the bill	2,42,000
Less: Trade discount 5%	12,100
	2,29,900
Add: GST (5% of 2,29,900)	11,495
Add: Transportation cost	14,500
Cost of purchase	2,55,895

Note: The amount paid to the supplier * 2,25,300 is after deducting trade discount Rs. 12,100 (5% of 2,42,000) and cash discount 4,600 (2% of net purchase price, i.e., Rs 2,29,900).

To arrive at purchase cost, only trade discount is deductible. Cash discount should not be deducted because it is not allowed on purchase (it is allowed for prompt payment).

2) Cost of Conversion

Costs of conversion of inventories include direct costs such as direct labour, and systematic allocation of production overhead incurred in converting materials into finished goods. Production overhead consists of fixed production overheads and variable production overheads.

a. ***Fixed production overheads:*** Fixed production overheads are those indirect costs of production that remain constant irrespective of the volume of production. Examples are depreciation and maintenance of factory buildings and equipment, cost of factory management and administration etc.

Fixed production overheads should be allocated on the basis of normal capacity. Normal capacity is the production expected to be achieved on average over a number of periods under normal circumstances. The capacity lost due to plant maintenance should be taken into account. When production is abnormally high, the fixed production overheads allocated to each unit will be reduced (to avoid over valuation of inventories).

b. ***Variable production overhead:*** variable production overheads are those indirect cost of production that vary directly with the volume of production. Examples are indirect material and indirect labour.

Illustration 2

Fantacy toys, manufactures toys. It has incurred the following expenses:

Cost of raw materials 600000	Depreciation of machinery 20000
Rebate on purchase 30000	Wages 110000
Electricity charges (factory) 16500	Factory supervision charges 10500

Calculate cost of purchase and cost of conversion

Solution

Cost of raw material	600000
Less: Rebate	30000
Cost of purchase	570000

Wages	110000
Depreciation on machinery	20000
Factory electricity charges	16500
Factory supervision charges	10500
Cost of conversion	157000

3) Other Cost

Other cost to be included in the cost of inventory are those which are incurred in bringing the inventories to their present location and condition. These costs include inward transport and storage prior to completion of production and specific design work required for a special client.

Illustration 3

How will you value the inventory per kg. of finished goods which consisted of:

Material cost:	100 per kg
Direct labour cost:	20 per kg
Direct variable production OH:	10 per kg

Fixed production charges for the year on normal capacity of 10000 kgs. Rs. 100000. At the year end, 2000 kg. of finished goods are in stock.

Solution

The allocation of fixed production overheads is based on the normal capacity of the production facilities, thus cost per kg. of finished goods may be calculated as follows:

Material cost		100
Direct labour cost	20	
Direct variable production overhead	10	
Fixed production overhead	10	40
		140

Thus, the value of 2000 kgs. of finished goods stock at the year end will be Rs. 280000 (2000x140).

Cost which are excluded

(a) Abnormal wastage of material, labour and overhead.
(b) Storage cost, if they are not necessary prior to a further production process.
(c) Administrative overhead
(d) Selling cost
(e) Interest cost when inventories are purchased on deferred payment basis.

Cost of Inventories of a Service Provider

To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and 5 general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

Illustration 4

A management consultancy company is engaged by a client to analyse its internal control systems and provide a report on the same for a fee of Rs. 20,00,000. As at the end of the reporting period, i.e., on 31st March, 2012, the report is not ready. The costs incurred during the financial year for the project are follows: Direct expenses: Salary expenses of staff engaged on the project: Rs. 7,50,000 Overheads: Rs. 5,00,000 (1/5 directly attributable to the project) General administration expenses: Rs. 2,00,000 Assuming that at the end of the reporting period, in accordance with Ind AS 18, revenue has not been recognised, what will be the cost of inventory with regard to this project?

Solution

Management Consultancy Company is a service provider and as per Ind AS 2, in case of a service provider, inventories include the costs of service, for which the entity has not yet recognised related revenue.

Since in the present case revenue has not been recognised, expenses incurred on the project will be treated as cost of inventory.

In accordance with the above, cost of inventories will include:

Cost of personnel directly engaged in providing the services, i.e., salary expenses of staff engaged on the project	Rs. 7,50,000
Directly attributable overheads (Rs. 5,00,000/5)	Rs. 1,00,000
Cost of inventories	Rs. 8,50,000

Expenses incurred on general overheads and any profit margin will not be included in the cost of inventories.

Illustration 5

Venus Trading Company purchases cars from several countries and sells them to Asian countries. During the current year, this company has incurred following expenses:

1. Trade discounts on purchase
2. Handling costs relating to imports
3. Salaries of accounting department
4. Sales commission paid to sales agents
5. After sales warranty costs
6. Import duties
7. Costs of purchases (based on supplier's invoices)
8. Freight expense
9. Insurance of purchases
10. Brokerage commission paid to indenting agents

Evaluate which costs are allowed by Ind AS 2 for inclusion in the cost of inventory in the books of Venus.

Solution

Items number 1, 2, 6, 7, 8, 9, 10 are allowed by Ind AS 2 for the calculation of cost of inventories. Salaries of accounts department, sales commission, and after sale warranty costs are not considered to be the cost of inventory therefore they are not allowed by Ind AS 2 for inclusion in cost of inventory and are expensed off in the profit and loss account.

Techniques for measurement of cost

1. Standard costing method
2. Retail costing method

Standard Costing Method

Standard costing involves setting costs in advance considering the normal production output. Management usually derive standards on the basis of past experience and use this method if cost remains fairly consistent and update the standards if situation changes. Usually such method is used for such material or labour which is hard to trace or measure its consumption or the benefits of such measurement are not much as compared to cost of conducting such measurement. For example cost of glue or nails consumed in production and entity still hold at the end of the period can be done standard costing basis.

Retail Costing Method

Retail method is an easy approach to determine cost by deducting profit from the sales price. This method is employed in situations where inventory has a fairly fast turnover rate. In such situations managing the records of costs incurred is not easy. So this retrograde approach help ease the pressure.

Illustration 6

Mars Fashions is a new luxury retail company located in Lajpat Nagar, New Delhi. Kindly advise the accountant of the company on the necessary accounting treatment for the following items:

(a) One of Company's product lines is beauty products, particularly cosmetics such as lipsticks, moisturizers and compact make-up kits. The company sells hundreds of different brands of these products. Each product is quite similar, is purchased at similar prices and has a short lifecycle before a new similar product is introduced. The point of sale and inventory system is not yet fully functioning in this department. The sales manager of the cosmetic department is unsure of the cost of each product but is confident of the selling price and has reliably informed you that the Company, on average, make a gross margin of 65% on each line.

(b) Mars Fashions also sells handbags. The Company manufactures their own handbags as they wish to be assured of the quality and craftsmanship which goes into each handbag. The handbags are manufactured in India in the head office factory which has made handbags for the last fifty years. Normally, Mars manufactures 100,000 handbags a year in their handbag division which uses 15% of the space and overheads of the head office factory. The division employs ten people and is seen as being an efficient division within the overall company.

In accordance with Ind AS 2, explain how the items referred to in (a) and (b) should be measured.

Solution

(a) The retail method can be used for measuring inventories of the beauty products. The cost of the inventory is determined by taking the selling price of the cosmetics and reducing it by the gross margin of 65% to arrive at the cost.

(b) The handbags can be measured using standard cost especially if the results approximate cost. Given that the company has the information reliably on hand in relation to direct materials, direct labour, direct expenses and overheads, it would be the best method to use to arrive at the cost of inventories.

Cost Formulas

An entity shall use the same cost formula for all inventories having similar nature and use. For inventories with a different nature or use, different cost formulas may be justified. Following are the important cost formulas for the valuation of inventories:

1. **Specific identification method**

   Specific identification is a method of finding out ending inventory cost. It requires a detailed physical count, so that the company knows exactly how many of each goods brought on specific dates remained at year end inventory. When this information is found, the amount of goods are multiplied by their purchase cost at their purchase date, to get a number for the ending inventory cost.

2. **FIFO method**
   This method assumes that the first items bought are the first items sold. Therefore, at the end of the period, any items in inventory are the items purchased most recently.

3. **Weighted average method**
   The weighted average method is an inventory costing method that assigns average costs to each piece of inventory when it is sold during the year.

Illustration 7

Mercury Ltd. uses a periodic inventory system. The following information relates to 2018-2019.

Date	Particular	Unit	Cost p.u.	Total Cost
April	Inventory	200	10	2,000
May	Purchases	50	11	550
September	Purchases	400	12	4,800
February	Purchases	350	14	4,900
	Total	1,000		12,250

Physical inventory at 31.03.2019, 400 units. Calculate ending inventory value and cost of sales using:

(a) FIFO
(b) Weighted Average

Solution

FIFO inventory 31.03.2019	350 @14 =	4,900
	50 @ 12 =	600
		5,500
Cost of Sales	12,250 – 5,500 =	6,750
Weighted average cost per item	12,250/1000 =	12.25
Weighted average inventory at 31.03.2019	400 × 12.25 =	4,900
Cost of sales 2018-2019	12,250-4,900 =	7,350

Net Realizable Value

Estimation of net realizable value is necessary in the valuation of inventories. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale.

Written Down of Inventories

The general rule is that inventories should not be carried in excess of amounts expected to be realized from their sale or use.

In some situations, NRV is likely to be less than cost. Following are the situations

1) An increase in cost
2) Fall in selling price
3) Physical deterioration in the condition of inventory
4) Obsolescence
5) Errors in production or purchasing

Recognition as an Expense

The following treatment is required when inventories are sold:

(a) The carrying amount of the inventory is recognized as an expense in the period in which the related revenue is recognized.
(b) The amount of any write down of inventories to its net realizable value and all losses of inventories are recognized as an expense in the period the write down or loss occurs
(c) If an inventory item which was written down previously, remains unsold and its NRV has subsequently increased, then in such a case, the previous write down should reversed and the inventory should be carried at cost.
(d) Some inventories may be allocated or transferred to other assets account.

Presentation and Disclosure

The financial statements should disclose the following in respect of inventories

(a) Accounting policies adopted for measuring inventories and cost formula used.
(b) Total carrying amount of inventories and amount per category.
(c) Amount of inventory recognized as an expense during the period
(d) Amount of inventory carried at fair value less costs to sell.
(e) Circumstances led to the reversal of a written down.
(f) Inventory pledged as security for liabilities.
(g) The amount of any written down of inventories recognized as an expense in the period.
(h) The amount of any reversal of any written down that is recognized in the period.

Illustration 8

Sun Pharma Limited, a renowned company in the field of pharmaceuticals has the following four items in inventory: The Cost and Net realizable value is given as follows:

Item	Cost	Net Realisable Value
A	2,000	1,900
B	5,000	5,100
C	4,400	4,550
D	3,200	2,990
Total	14,600	14,540

Determine the value of Inventories:

(a) On an item by item basis
(b) On a group basis

Solution

Inventories shall be measured at the lower of cost and net realisable value.

Item by item basis:	
A	1,900
B	5,000
C	4,400
D	2,990
	14,290
Group basis	14,540

Illustration 9

The following information of Zenith Ltd. is given below: **You are required to:**

(1) Calculate the value of raw materials and finished goods at cost.

(2) Calculate the value of closing stock when

(a) Net realizable value of finished goods B is Rs. 800

(b) Net realizable value of finished goods B is Rs. 600

Raw Material A	
Closing Balance	1000 units
	Rs. per unit
Cost price including excise duty	400
GST (Input credit is available)	20
Freight inward	40
Unloading charges	20
Replacement cost	300
Finished Goods B	
Closing balance	2400 units
Raw materials consumed	440
Direct labour	120
Direct overhead	80

Raw material A is used for production of finished goods B. The total fixed overhead for the year was Rs. 4 lakhs on normal capacity of 20,000 units.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

Raw Material A	**Rs. per unit**
Cost price	400
Less: GST on which Input credit is available	(20)
	380
Add: Freight inward	40
Unloading charges	20

Total cost	440
Finished Goods B	**Rs. per unit**
Raw materials consumed	440
Direct labour	120
Direct overhead	80
Fixed overhead (Rs. 4,00,000/20,000 units)	20
Total cost	660

a) When Net Realisable Value (NRV) of the Finished Goods B is Rs. 800 per unit

NRV is greater than the cost of Finished Goods B i.e. Rs. 660 per unit Hence, Raw Material and Finished Goods will be valued at cost. Accordingly, value of closing stock will be:

	Quantity	**Rate**	**Amount (Rs.)**
Raw Material A	1,000	440	4,40,000
Finished Goods B	2,400	660	15,84,000
Total cost of closing stock			20,24,000

b) When Net Realisable Value of the Finished Goods B is Rs. 600 per unit

NRV is less than the cost of Finished Goods B i.e. Rs. 660 per unit

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

Accordingly, value of closing stock will be:

	Quantity	**Rate**	**Amount (Rs.)**
Raw Material A	1,000	300	3,00,000
Finished Goods B	2,400	600	14,40,000
Total cost of closing stock			17,40,000

Illustration 10

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

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

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

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

Solution

Valuation of Closing Inventory

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

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

Illustration 11

On 1.6.2018, X Ltd. Purchases raw material from one of its regular supplier at Rs. 60 lakhs.

As per terms of the contract, the entity would pay the amount after 2 years.

Assume Incremental borrowing rate of X Ltd. is 11%.

1. Find out purchase price applying Ind AS 2?
2. How should the difference be accounted for?

Solution

Purchase price = Present value of Rs. 60 lakhs discounted at the purchaser's incremental borrowing rate.

$$\text{Purchase Price} = \frac{\text{Rs. 60 lakhs}}{(1+11\%)^2} = \text{Rs. 48.70 lakhs}$$

Accounting entries:

(Amount in Rs. Lakhs)

Date	**Particulars**	**Dr.**	**Cr.**
1.6.2015	Purchase A/c Dr. To Trade Payables A/c	48.70	 48.70
31.3.2016	Unwinding of Discount A/c Dr. To Trade Payables A/c	4.46	 4.46
31.3.2017	Unwinding of Discount A/c Dr. To Trade Payables A/c	5.85	 5.85
Date	**Particulars**	**Dr.**	**Cr.**
31.5.2017	Unwinding of Discount A/c Dr. To Trade Payables A/c	0.99	 0.99
31.3.2017	Trade Payables A/c Dr. To Bank A/c	60.00	 60.00

Illustration 12

A dealer of sanitary fittings hold 1000 pcs of wash basins for delivering a constructor under firm contract. The contract quantity is 900 pcs @ Rs. 3,400 whereas retail price of the same is Rs. 4,200.

What should be the net realisable value of the inventories?

Solution

As per Paragraph 31, Ind AS 2, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices.

Accordingly, net realisable value of 1000 pcs of wash basin should be -

900 x 3,400	=	Rs. 30,60,000
100 x 4,200	=	Rs. 4,20,000
		Rs. 34,80,000

INCOME TAX – (IAS 12 and Ind AS 12)

IAS 12 Income Taxes implements a so-called 'comprehensive balance sheet method' of accounting for income taxes which recognises both the current tax consequences of transactions and events and the future tax consequences of the future recovery or settlement of the carrying amount of an entity's assets and liabilities. Differences between the carrying amount and tax base of assets and liabilities, and carried forward tax losses and credits, are recognised, with limited exceptions, as deferred tax liabilities or deferred tax assets, with the latter also being subject to a 'probable profits' test.

Objectives

- Calculate taxes under Ind AS 12
- Describe the recognition criteria for deferred tax liabilities and assets
- Explain the deferred tax effects on business combinations.
- Detail the recognition of deferred tax assets arising from unused tax
- Detail the recognition of deferred tax assets arising from unused tax losses or credits.
- Detail presentation and disclosure requirements of income taxes

Some Definitions

1. **Accounting Profit** – Profit or loss for a period per the books of account.
2. **Taxable Profit** – The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable)
3. **Tax expense** – The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax
4. **Current tax** – The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. If the income is positive we have to pay taxes. But if the entity incurs a loss then taxes are c/f in India. But in some

countries government pays refunds for tax loss. Hence the act has used the term taxes payable and recoverable both.

5. **Tax base of asset / liability:** It is the amount attributable to that asset or liability for tax purposes.
6. **Carrying amount of asset / liability:** It is the amount attributable to that asset or liability for accounting purposes.
7. **Deductible temporary differences:** Carry forward of unused tax losses and credits. IT gives rise to the recovery of tax if the asset / liability is settled. à it gives rise to DTA
8. **Taxable temporary differences:** It results in the payment of tax when the carrying amount of the asset or liability is settled à it gives rise to DTL
9. **Deferred Tax Assets (DTA):** The amounts of income taxes recoverable in future periods. It is the tax effect on Deductible temporary difference.
10. **Deferred Tax Liabilities (DTL):** The amounts of income taxes payable in future periods. It is the tax effect on Taxable temporary difference.

Important Terms Used

Tax base = Carrying Amount → No DTA / DTL

For an Asset: Tax base > Carrying Amount → DTA

For an Asset: Tax base < Carrying Amount → DTL

For a liability: Tax base > Carrying Amount → DTL

For a liability: Tax base < Carrying Amount → DTA

Consolidated Financial Statements

(1) Temporary differences can also arise from adjustments on consolidation.

(2) Deferred tax is determined on the basis of the consolidated financial statements and not the individual entity accounts.

(3) Therefore, the carrying value of an item in the consolidated accounts can be different from the carrying value in the individual entity accounts, thus giving rise to a temporary difference.

(4) An example is the consolidation adjustment that is required to eliminate unrealized profits / losses on intergroup transfer of inventory. Such an adjustment will give rise to a temporary difference, which will reverse when the inventory is sold outside the group

Illustration 13

An entity acquired plant and equipment for ₹ 10,00,000 on 1/4/2015. The asset is depreciated at 30% a year on the straight-line basis, and local tax legislation permits the management to depreciate the asset at 25% a year for tax purposes. At the end of March 2017 the asset was tested for impairment and the recoverable amount estimated to be ₹ 3,00,000.

Required: Calculate the following for each of the years: 31/3/2016, 31/3/2017:

1. Carrying amount of the asset
2. Tax base of the asset
3. Taxable temporary difference (TTD)

4. Deductible temporary difference (DTD)
5. DTA / DTL

Assuming tax rate of 30%.

Solution

Year	Carrying Amount	Tax Base	Deductible TD	Taxable TD	DTA #	DTL
31/3/2016	Rs. 7,00,000	7,50,000	50,000	-	15,000	-
31/3/2017	Rs. *3,00,000	5,00,000	2,00,000	-	60,000	-

* 3,00,000 = 7,00,000 – 3,00,000 Depreciation – 1,00,000 Impairment loss = ₹ 3,00,000.

DTA in the first year is ₹ 15000 [50000×30%] and in the second year it increased to ₹ 60,000 [200000×30%] which means DTA further arises ₹ 45,000 during 31/3/2017.

Illustration 14

Land carried in the balance sheet ₹ 45,00,000 as on 31/3/2016. It was revalued @ 40% upwards. Tax rate 30%. Calculate the following: Carrying Amount, Tax base (TB), Deductible Timing Difference (DTD), Deferred Tax Asset (DTA), Taxable Timing Difference (TTD), Deferred Tax Liabilities (DTL).

Solution

CA = Rs. 63,00,000, TB = Rs. 45,00,000, TTD = Rs. 18,00,000, DTL = ₹ 5,40,000 (the company will sell the asset and then it has to pay tax on revaluation).

Land	Dr.	₹ 18,00,000	
To Revaluation Reserves			₹18,00,000
Revaluation Reserves	Dr.	₹ 5,40,000	
To DTL			₹ 5,40,000

Illustration 15

From the following calculate Carrying Amount, Tax base (TB), Deductible Timing Difference (DTD), Deferred Tax Asset (DTA), Taxable Timing Difference (TTD), Deferred Tax Liabilities (DTL).

The following are some of the transactions related to Systis Co.

The following details for the year ended 31.03.2016, being the end of the reporting period, are given:

1. Interest receivable is ₹ 100,000 is included in the SOFP (balance sheet). This will be included in the taxable profit when cash is collected.
2. Development costs of ₹200,000 were incurred. They are capitalised and are to be amortised over future periods when determining the accounting profit. However, the amount is deducted when determining the taxable profit for the year 31.3.2016.
3. The cost of retirement benefits provided for (unpaid on end of the reporting period) of ₹50,000 while determining accounting profits. However, the amount is deductible for tax purposes only when contributions are paid into a fund.
4. Research costs worth ₹30,000 are recognised as an expense while determining the accounting profits. According to local tax laws, the amount is permitted as a deduction in the future on the fulfilment of certain conditions.

Show the effect of these transactions on the financial statements of Systis Co. Tax 30%.

Solution

Carrying Amount	Tax Base	Deductible TD	Taxable TD	DTA	DTL
₹ 1,00,000 (A)	Nil	-	₹ 1,00,000	-	₹ 30,000
₹ 2,00,000 (A)	Nil	-	₹ 2,00,000	-	₹ 60,000
₹ 50,000 (L)	Nil	₹ 50,000	-	₹ 15000	-
	₹ 30,000*	₹ 9000	-	₹ 9000	

30,000* it is the tax base which indicate the amount of deduction to be received in future. In Accounting Income it is already expensed.

Net Summarised Entry:

DTA	Dr	₹ 24,000	
To P/L			₹ 24,000
P/L	Dr	₹ 90,000	
To DTL			₹ 90,000

Illustration 16

An entity purchases plant and equipment for $2 million. In the tax jurisdiction, there are no tax allowances available for the depreciation of this asset; neither are any profits or losses on disposal taken into account for taxation purposes. The entity depreciates the asset at 25% per annum. Taxation is 40%.

Required: Explain the deferred tax position of the plant and equipment on initial recognition and at the first yearend after initial recognition. Also calculate DTL / DTA.

Solution:

Tax base = Nil, DTA/ DTL = Nil. The entity will not receive any tax benefit in any way from the asset. It is a permanent difference.

Illustration 17

Menulist Limited a subsidiary of Catalogue Limited sold goods costing ₹ 10,00,000 to its parent for ₹ 11,00,000 and all of these goods are still held in inventory at the year-end. Assume a tax rate of 40%.

Required: Explain the deferred tax implications.

Solution:

The unrealized profit of ₹ 1,00,000 will have to be eliminated from the consolidated income statement and from the consolidated balance sheet in group inventory. The sale of the inventory is a taxable event, and it causes a change in the tax base of the inventory. The carrying amount in the consolidated financial statements of the inventory will be ₹10,00,000, but the tax base is ₹11,00,000. This gives rise to a deferred tax asset of ₹1,00,000 at the tax rate of 40%, which is 40,000.

ACCOUNTING FOR TANGIBLE NON-CURRENT ASSETS – (Ind AS 16)

Scope of Ind AS- 16

The requirements of Ind AS 16 are applied to accounting for all property, plant, and equipment unless another Standard permits otherwise, except:

- Property, plant, and equipment classified as held for sale in accordance with Ind AS-105

- Biological assets relating to agricultural activity under Ind AS – 41
- Mineral rights, mineral reserves, and similar non-regenerative resources

Criteria for Recognition

An item of property, plant, and equipment should be recognized as an asset if and only if it is probable that future economic benefits associated with the asset will flow to the entity and the cost of the item can be measured reliably. Any expenditure incurred that meets these recognition criteria must be accounted for as an asset.

Measurement for Recognition

Cost in case of purchase in consideration of cash

An item of property, plant, and equipment that satisfies the recognition criteria should be recognized initially at its cost. The Standard specifies that cost comprises:

- Purchase price, including import duties, non-refundable purchase taxes, less trade discounts and rebates.
- Costs directly attributable to bringing the asset to the location and condition necessary for it to be used in a manner intended by the entity
- Initial estimates of dismantling, removing, and site restoration costs.

Examples of directly attributable costs include

- Employee benefits of those involved in the construction or acquisition of an asset
- Cost of site preparation
- Initial delivery and handling costs
- Installation and assembly costs
- Costs of testing, less the net proceeds from the sale of any product arising from test production (Trial run).
- Borrowing costs to the extent permitted by Ind AS 23, Borrowing Costs
- Professional fees

Examples of costs that are not directly attributable costs and therefore must be expensed in the income statement include

- Costs of opening a new facility (inaugural expenses)
- Costs of introducing a new product or service e.g.: advertisement
- Office and administration expenses e.g.: office rent
- Advertising and promotional costs
- Costs of conducting business in a new location or with a new class of customer
- Training costs
- Administration and other general overheads
- Costs of incidental operations, Example: cost of material for sample testing (not intended to be for commercial reason)
- Initial operating losses e.g.: loss of gross profit due to low capacity.
- Costs of relocating or reorganizing part or all of an entity's operations e.g.: costs of shifting business.

Illustration 18

Pollisure Limited is installing a new plant at its production facility. It has incurred these costs:

1) Cost of the plant (cost as per supplier's invoice plus taxes) ₹ 75,00,000, includes refundable taxes ₹ 1,70,000 and non – refundable taxes ₹ 6,45,000
2) Initial delivery and handling costs ₹ 200,000
3) Cost of site preparation 5,00,000
4) Consultants used for advice on the acquisition of the plant ₹700,000
5) Estimated dismantling costs to be incurred after 5 years ₹ 5,20,000
6) Trial run costs: Materials ₹ 2,20,000, Labour ₹ 1,87,000, Overheads ₹ 1,70,000. The entire product was sold at 75% of cost.
7) Inauguration expenses ₹ 25,000
8) Operating losses before commercial production 1,10,000. Discounting rate: 10%.

Required: Please advise Pollisure Limited on the costs that can be capitalized in accordance with Ind AS - 16.

Solution:

According to Ind AS - 16, these costs can be capitalized:

Cost of the plant:		
Purchase price		₹ 75,00,000
Add:		
Refundable taxes	1,70,000	
Initial delivery and handling costs	2,00,000	
Cost of site preparation	5,00,000	
Consultants used for advice on the acquisition of the plant	7,00,000	
PV of Estimated dismantling costs to be incurred after 5 years	**3,22,879***	
Trial run costs (Materials ₹ 2,20,000+Labour ₹ 1,87,000+Overheads ₹ 1,70,000)	5,77,000	₹ 24,69,879
Less:		
Sale proceeds of trail run production (187000+170,000+220,000) × 0.75		₹ 4,32,750
		₹ 95,37,129

Working Note:

Inauguration expenses ₹25,000, Operating losses before commercial production ₹1,10,000 cannot be capitalized. They should be written off to the income statement in the period they are incurred.

*** PV of ₹ 5,20,000 = ₹5,20,000 / (1+0.10)5 = ₹ 3,22,879**

Cost in Case of Exchange of Asset:

If an asset is acquired in exchange for another asset, then the acquired asset is measured at its fair value. In the following cases the deemed cost will not be the Fair Value:

i) if the exchange lacks commercial substance

ii) or the fair value cannot be reliably measured, in which case the acquired asset should be measured at the carrying amount of the asset given up.

Cost of Asset in Case of Share Based Payment:

If the asset is acquired under share based payment transaction, its cost will be determined as per Ind AS – 102.

Cost of Asset in Case of Deferred Credit Basis:

The cost of an asset is measured at the cash price equivalent at the date of acquisition. If payment is "deferred" beyond normal credit terms, then the difference between the cash price and the total price is recognized as a finance cost and treated accordingly. The general practice is not to discount the future cash flows.

Dismantle and Restoration Cost:

Dismantle and site restoration cost is to be capitalized to the cost of an asset. It is incurred while the asset is installed. A provision at present value is required for the site restoration cost on the other hand. In case of a Mine site restoration costs is to be added to the mine. But the further digging and extracting of ore is to be added to the inventory production while the inventory is extracted.

Component Accounting

Recognition: Useful life specified in the Schedule II to the Companies Act is for whole of the asset. Where cost of a part of the asset is significant to the total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part will be determined separately. Ind AS and Schedule II mandates 'component approach', which is in line with international practices. It requires companies to separately depreciate part of an asset that are significant and have a useful life different from the useful life of the asset as a whole. Previously companies use to charge component replacement to profit / loss account. But now it will be separately capitalised.

Deprecation: Depreciation of component is to be independently depreciated separate from the remaining asset.

Example: Building and its Elevator can be treated as a separate component. Also Aircraft body and its engine can be treated as two separate assets.

Derecognition: Old component will be eliminated (derecognized) and new asset will be recognized. Depreciation of such component is independent of other assets.

Stand - By Equipment

Recognition: It is a separate asset and hence qualifies for PPE.

Deprecation: It is depreciated as per normal rates provided in Schedule II.

Derecognition: SBE will be eliminated (derecognized) separately and a new asset will be recognized. Depreciation of such SBE is independent of other assets.

Major Spares

Recognition: Major spare parts also known as capital spare parts. They are used in relation to specific machinery. They are capitalized when consumed.

Deprecation: Such spare parts are depreciated over the useful life of the principal asset.

Derecognition: When machinery spares and component parts are replaced the old part is derecognized and new part is recognized. The depreciation of the replaced parts will be only to the extent of the life of the old asset.

Other Spare Parts like Consumables, Maintenance Supplies

Recognition: They are expensed to P/L on consumption.

Deprecation: N.A.

Derecognition: When such spares are replaced by new parts, the carrying amount of old part is continued to be depreciated. Cost of new part is written – off.

Presentation in B/S:

Stand by Equipment → Separate fixed asset

Unconsumed component / major spare parts → capital wip (fixed asset)

Unconsumed other spare parts → Inventory (current asset)

Overhauling expenses (subsequently incurred)

Recognition: Regular inspections and overhaul charges is Transferred to P/L. Major inspections and overhaul charges (may be once in 3-4 years) is Separately Capitalised

Deprecation: Such capitalized overhaul is to be depreciated till the next overhaul.

Derecognition: N.A.

Compensation for impairment:

For impairment losses, reference should be made to IAS 36. In this context, any compensation received for impairment or loss of an asset shall be included in the income statement.

Measurement after Recognition:

After initial recognition of an item of property, plant, and equipment, the asset should be measured using either the cost model or the revaluation model. The cost model requires an asset, after initial recognition, to be carried at cost less accumulated depreciation and impairment losses.

The revaluation model requires an asset, after initial recognition, to be measured at a revalued amount, which is its fair value less subsequent depreciation and impairment losses. In this case, fair value must be reliably measurable. Revaluations must be made with sufficient regularity to ensure that the carrying amount is not materially different from fair value. However, if an asset is revalued, then the entire class of asset must be revalued, again to avoid "cherry-picking" and a mixture of valuation bases.

Provisions regarding Revaluation with depreciation is same as AS-10. Upward / downward revaluations, utilising of Revaluation surplus is also similar.

Derecognition: Derecognition is the opposite of recognition. The carrying amount of an item of property, plant, and equipment shall be derecognized:

a. on disposal (disposal can be sale / entering into finance lease / donation),

b. when no future economic benefit is expected from its use or disposal.

Any gain on disposal is the difference between the net disposal proceeds and the carrying amount of the asset. Gains on disposal shall not be classified in the income statement as revenue, it will be shown as Other Income.

Stripping Costs:

In oil and gas exploration, exploration and production costs are accounted for using the successful efforts method. Under this method, costs of successful exploratory drilling and drilling operations are capitalized as property, plant, and equipment.

Successful drillings are depreciated based on the production and the estimated available resources. Geophysical investigations, including unsuccessful exploratory drilling, exploratory and exploratory dry-hole costs are charged against income.

Provision for Depreciation

Remember provisions relating to Depreciation are same in Ind AS-16 and Schedule II. Meaning of Depreciation, Rates (covered by Part 'C' of Schedule II), Method (SLM, WDV and Units of production method) provisions are same.

Derecognition of Depreciation: As per Ind AS-16; Depreciation will be derecognized on Sale, on eliminating an asset which provides no economic benefits, reclassification of asset from fixed asset to NCA – Held for Sale Ind AS – 105.

Illustration 19

Zhanubori (P) Ltd purchases a complex Asset A on 1/4/2015. It consists of the following:

	Cost (Rs.)	Estimated life
Component M	15,00,000	12 years
Major Spare part X	6,00,000	6 years
Remaining asset	17,00,000	16 years

Ignore estimated salvage value for all calculations.

Major part is replaced after 5 years at a cost of ₹ 6,50,000. Sale proceeds of old major part was ₹ 2,50,000. Compute the Deprecation for the year 2019-2020 and the year 2020-2021.

Solution

Date	Particulars	Component (n = 12)	Remaining asset (including spare part) n = 16
1/4/2015	Cost	15,00,000	23,00,000
5 years →	Provision for depreciation	*(6,25,000)	**(7,18,750)
31/3/2020	Carrying amount	8,75,000	15,81,250
	Less: Spare part sold	-	***(4,12,500)
	Add: Addition	-	+ 6,50,000

31/3/2020	Balance	8,75,000	18,18,750
2020-2021	Depreciation	(1,25,000)	(1,65,341)

Depreciation for 2019-2020 = ₹ 1,25,000 + ₹ 1,43,750 = ₹ 2,68,750

Depreciation for 2020-2021 = ₹ 1,25,000 + ₹ 1,65,341 = ₹ 3,90,341.

* ₹ 6,25,000 = ₹ 15,00,000 x 5 / 12;
** ₹ 718750 = ₹ 23,00,000 x 5/ 16;
*** Journal:

Cash A/c	Dr.	250,000	
Loss on sale		162,500	
To Asset (spare)			412500

(₹ 60,0,000 - ₹ 60,0000 × 5/16)

Illustration 20

Birdy Airways, an aviation company, acquired an aircraft for ₹ 21,00,000. The aircraft is expected to have life of 15 years. Birdy Airways is required to have aircraft inspected every three years to ascertain whether they are travel worthy.

Without the inspection, which requires a high degree of expertise, Samson Airways cannot operate the aircraft. The cost attributable to inspection is ₹ 600,000 (cost of inspection is included in the above cost of aircraft). Birdy acquired the aircraft on the previous inspection, which was carried out on 1 April 2017. As at 1 April 2020 Birdy Airways incurred ₹7,50,000 as the cost of the new inspection.

Required:

Compute depreciation as per Ind AS – 16 for 1/4/2017 till 31/3/2020, as well as from 1/4/2020 till 31/3/2020.

Solution:

Birdy Airways will recognize the aircraft at ₹ 15,00,000, depreciate it over 15 years and recognize the inspection cost at ₹ 600,000 deprecating it over 3 years.

April 2017 to April 2020

Depreciation charge	₹
Aircraft to be depreciated over 15 years= 1,500,000/15 years inspection cost to be depreciated	100,000
over 3 years=600,000/3 years	200,000
Total depreciation to be recognized each year	300,000

April 2020 to April 2023

The company should recognize the inspection cost of ₹750,000 and derecognize the earlier cost:

Depreciation charge	₹
Aircraft to be depreciated over 15 years= 1,500,000/15 years	100,000
Inspection cost to be depreciated over 3 years= 750,000/3 years	250,000
Total depreciation to be recognized each year	350,000

BORROWING COST – Ind AS 23

Definition

- Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds
- Borrowing costs may include:-
  - Interest expense calculated using the effective interest method as described in IND AS 109 Financial Instruments
  - Finance charges in respect of finance leases
  - Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

Qualifying Assets

- A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale
- Examples include:-
  - Inventories (that are not produced over a short period of time)
  - Manufacturing plants
  - Power generation facilities
  - Intangible assets
  - Investment properties

Recognition

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are required to be capitalised as part of the cost of that asset
- Other borrowing costs are recognised as an expense when incurred
- If funds are borrowed specifically, the amount of borrowing costs eligible for capitalisation are the actual borrowing costs incurred on that borrowing less any investment income on the temporary investment of any excess borrowings not yet used
- If funds are borrowed generally, the amount of borrowing costs eligible for capitalisation are determined by applying a capitalisation rate (weighted average of borrowing costs applicable to the general borrowings) to the expenditures on that asset
- The amount of the borrowing costs capitalised during the period cannot exceed the amount of borrowing costs incurred during the period

Capitalisation

1. Capitalisation commences when:
   - Expenditures for the asset are being incurred
   - Borrowing costs are being incurred
   - Activities that are necessary to prepare the asset for its intended use or sale are in progress
2. Capitalisation is suspended during extended periods in which active development is interrupted
3. Capitalisation ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

   When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation of borrowing costs ceases when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

Disclosure

- Amount of borrowing cost capitalised during the period
- Capitalisation rate used

Borrowing Cost is the aggregate of:

Sl. No.	Particulars	Amount
1	Interest on Bank OD, Short term and long term borrowings	XXXX
2	Amortisation of premium or discounts on loans	XXXX
3	Amortization of Ancilliary costs in the arrangement of loans	XXXX
4	Finance Charges which are part of financial lease	XXXX
5	Exchange differences reflecting to interest costs	XXXX
		XXXXX

Illustration 21

Calculate the borrowing cost in the case of P Ltd., a distillery unit.

(a) 6 Crores arranged by 10% Debentures repayable after 8 years, 2 crores by 8 years loan from IFCI and 2 crores from O D with Canara Bank. The IFCI interest is 9% p.a. and OD interest is 13% p.a.
(b) The Cost of issue of Debentures is Rs.20 and lakhs.
(c) The Service charges for IFCI loan and consultancy charges together amounted 5% of loan.
(d) Debentures repayable at 5% premium

Solution

Sl.No.	Particulars	Amount
1	Interest on Debentures (6 Cr. X 10%)	60,00,000
2	Interest on IFCI loan 2 Cr. @ of 9%	18,00,000
3	Interest on OD 2 Cr @ of 13%	26,00,000
4	Issue cost of New Debentures (20,00,000/8)	2,50,000
5	Service Charges and consultancy fee for IFCI loan (2 Cr @ 5% = 10,00,000/8)	1,25,000
6	Premium on Debentures 6 Cr @ 5% = 30,00,000 / 8	3,75,000
	Total Annual Borrowing Cost	1,11,50,000

Illustration 22

Dhangar Ltd has a cattle field which serves the company milk, wool etc. The livestock is carried at Fair Value. The opening fair value of livestock is ₹ 54,40,000. The closing fair value ₹ 67,33,000. Out of which ₹ 2,00,000 worth was purchased during the year. Fresh borrowings were taken at the beginning of the year to buy livestock. The total borrowings by the year end was ₹ 22,00,000 @ 12%. Calculate the borrowing cost as per Ind AS – 23 and comment.

Solution:

Ind AS – 23 is not applicable on Assets carried at fair value. It is applicable on those assets which are carried at cost less depreciation. Also further the assets should be qualifying assets. In the present case the entire Borrowing Cost of ₹ 2,64,000 is charged to profit / loss account. BC should not be capitalized on biological assets.

Illustration 23

Hyper Ltd is engaged in development of properties and further sell it in the open market. The development process takes substantial period of time. It has financed its inventories by taking loan from Yekoshore Development Bank € 75 million. The economy is under hyper inflationary situation. The interest rate is 32%. The inflation is 200%. You are required to calculate the borrowing cost attributable towards the capitalization of asset as per IAS – 23.

Solution:

Ind AS – 23: In case of Hyperinflationary situation the borrowing cots relate to the inflationary element is charged to income statement and not to be capitalized.

Accordingly the effective (real element of) interest = 32% / 200% = 16%.

BC requires capitalization = 75 x 16% = € 12 million.

BC charged to P/L = 75 x 32% - 12 = € 12 million.

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS – IND AS 37

Definition

- Provision – a liability of uncertain timing or amount.
- Contingent liability
    - A possible obligation that arises from past events, whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly in the control of the entity; or
    - A present obligation that arises from past events that is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured reliably.
- Contingent asset – possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Scope

Excludes provisions, contingent liabilities and contingent assets arising from:

- Non-onerous executory contracts
- Those covered by other IND ASs:
    - IND AS 12 Income Taxes
    - IND AS 17 Leases
    - IND AS 19 Employee Benefits
    - IND AS 104 Insurance Contracts
    - IND AS 103 Contingent consideration

- IND AS 115 Revenue from contracts with customers

Provisions – Important Points on Ind AS 37

Provisions are recognised when:

(1) Discounting long term provisions: Site restoration costs to be capitalized to the cost of an asset. It is incurred while the asset is installed. A provision at present value is required for the site restoration cost on the other hand. Even other provisions are required to be discounted.

Illustration 24

Workers of a company filed a suit against the accident which recently took place in the premises of the company. One fellow worker lost a hand in the accident. The company accepted the obligation but the workers demanded a huge amount hence the case has been filed in the court. The company is ready to go to the Supreme Court for exact compensation.

The experts regarding the case suggested a compensation of Rs. 10,00,000 to be provided. It is further estimated that SC will dispose off the case over 6 years. Risk free rate is 6%.

Compute the provision for the first year.

Solution:

Year 1:

Profit / loss (10,00,000 / 1.066)	Dr	7,04,960	
To Provision for compensation			7,04,960
(Being provision made for workers compensation at present value)			
Discount (P/L) (704960 x 6%))	Dr	42,298	
To Provision for compensation			42,298
(Being unwinding of discount)			

(2) Constructive obligation: In accordance with Ind AS – 37, a constructive obligation derives from an entity's actions. It includes the valid expectation on the part of other parties, past practice, announcements etc. Ultimately provision is required not only for legal obligation but also for constructive obligation. Where else AS-29 considers legal obligation. Even though it does not specifically excludes constructive obligation.

Example: constructive obligation: Workers of company X Ltd positively expects bonus in the month of November as the company is highly profit making company. The company has to make a provision even if no legal obligation arises. This is constructive obligation.

CSR is not a legal obligation for those companies not falling under the CSR provisions. Whether it is a constructive obligation depends.

(3) Restructuring provision: Restructuring provision is made on constructive obligation. In contrast AS 29 requires restructuring provision to be made based on legal obligation. For ex: A company has made a public announcement to close a business or job curtailment has been announced for a division. Of course discontinuing operations and provisions goes hand in hand.

Measurement

- **Use of provision:** Provisions are measured at the best estimate of the expenditure required to settle the present obligation at reporting date
- **Changes in provision:** In determining the best estimate, the related risks and uncertainties are taken into account
- **Present Value:** Where the effect of the time value of money is material, the amount of the provision is the present value of the expenditures expected to be required to settle the obligation. The discount rate used is a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability
    - The discount rate does not reflect risks for which future cash flow estimates have been adjusted.
- Future events that may affect the amount required to settle the obligation are reflected in the amount of the provision where there is sufficient objective evidence that they will occur
- Gains from the expected disposal of assets are not taken into account in measuring the provision
- **Reimbursement**: Reimbursements from third parties for some or all expenditure required to settle a provision are recognised only when it is virtually certain that the reimbursement will be received. The reimbursement is treated as a separate asset, which cannot exceed the amount of the provision
- Provisions are reviewed at each reporting date and adjusted to reflect the current best estimate
- If it is no longer probable that an outflow of economic benefits will be required to settle the obligation, the provision is released
- Provisions are not recognised for future operating losses

Onerous Contracts

- Onerous contract – one where the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it
- For onerous contract, the provision is recognised and measured at the lower of:
    - The cost of fulfilling the contract
    - The costs / penalties incurred in cancelling the contract.
- Before a separate provision for an onerous contract is recognised, an entity recognises any impairment loss (IND AS 36 Impairment of Assets) that has occurred on assets dedicated to that contract.

Restructuring Provisions should be accrued as follows:

Restructuring provisions are only permitted to be recognised when an entity has:

- A detailed formal plan for the restructuring identifying:
    - The business or part of business concerned; principal locations affected; location, function, approximate number of employees to be compensated for termination of services; expenditures that will be undertaken and when the plan will be implemented.
- Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing (e.g. by a public announcement) its main features to those affected before the end of the reporting period

- Restructuring provisions only include the direct expenditures arising from the restructuring – i.e. those that are both necessarily entailed by the restructuring and not associated with the entity's on-going activities.

Illustration 25

An entity has entered into a contract to purchase specific quantity of coal at the rate of `50 per unit over a period of three years. The contract is not cancellable without payment of compensation. The current market price of coal is `45 per unit. The coal is purchased for consumption during the manufacturing process the output of which is sold in the market at a profit. Is the contract an onerous contract?

Solution

No, the contract is not an onerous contract because the entity will derive economic benefits from the contract including the benefits of using the coal in the manufacturing process and the final product will be sold in the market at a profit.

Following costs should not be included in the restructuring provisions:

(a) Cost of retraining or relocating continuing staff
(b) Cost of marketing
(c) Cost of investment in new systems and distribution network

Examples of possible provisions

(a) Warranties
(b) Major repairs
(c) Environmental contamination

Contingent liabilities

A contingent liability is a possible obligation that arises from past event and the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future event not wholly within the control of the enterprise.

Examples of contingent liabilities

(a) Guarantees on behalf of associates and others
(b) Claims against firm
(c) Liabilities of case pending in the court
(d) Income tax demand under appeal
(e) Uncalled liability on partly paid up shares

Contingent liability:

- a possible obligation depending on whether some uncertain future event occurs, or
- a present obligation but payment is not probable or the amount cannot be measured reliably

Recognition of contingent liability

An entity should not recognize contingent liabilities in the financial statements, instead, an entity should disclose them by way of notes below the balance sheet. If the possibility of an outflow of resources is remote, even the disclosure is not required.

Contingent asset:

- a possible asset that arises from past events, and
- whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Recognition of contingent asset

Contingent assets are not recognized in financial statements because this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is recognized. A contingent asset is disclosed, where an inflow of economic benefits is probable.

Illustration 26

A Indian based shipping company lost an entire shipload of cargo valued at ₹50 lakhs on a voyage to Australia. It is, however, covered by an insurance policy. According to the report of the surveyor the amount is collectible, subject to the deductible clause (i.e., 10% of the claim) in the insurance policy. Before year-end, the shipping company received a letter from the insurance company that a letter was in the mail for 90% of the claim.

The international freight forwarding company that entrusted the shipping company with the delivery of the cargo overseas has filed a lawsuit for ₹50 lakhs, claiming the value of the cargo that was lost on high seas, and also consequential damages of ₹20 lakhs resulting from the delay. According to the legal counsel of the shipping company, it is probable that the shipping company would have to pay the ₹ 50 lakhs, but it is a remote possibility that it would have to pay the additional ₹ 20 lakhs claimed by the international freight forwarding company, since this loss was specifically excluded in the freight forwarding contract.

Required: What provision or disclosure would the shipping company need to make at year-end?

Solution:

The shipping company would need to recognize a contingent asset of ₹ 45 lakhs (the amount that is virtually certain of collection… refer theory of reimbursement). Also it would need to make a provision for ₹ 50 lakhs towards the claim of the international freight forwarding company. Because the probability of the claim of ₹ 20 lakhs is remote, no provision or disclosure would be needed for that.

Illustration 27

Pratapta Zesty operates a fleet of 200 delivery vehicles. On 1 January 2018 legislation was passed requiring all such vehicles to undergo modifications to reduce the amount of harmful emissions they produce or face large ongoing financial penalties. The legislation require that modifications be completed by 31 March 2018.

The approximate cost of such modifications is ₹5,000 per vehicle. Pratapta Zesty has not yet modified any of its vehicles.

The government has not yet imposed any penalties on Pratapta but the legislation indicated that the annual penalty will be ₹4,000 per vehicle. This amount will be payable for every complete year from 1 April 2018 that modifications do not take place and vehicles continue to be operated. The penalty will be levied pro-rata for any part year of non-compliance. Year ending is 30th September.

Solution:

The key issue here is the extent of any provisions that need to be made in respect of the vehicle modifications. This issue is governed by Ind AS 37- Provisions, contingent liabilities and contingent assets. Ind AS 37 states that a provision is required where, at the reporting date:

- The entity has a present obligation arising out of a past event
- There is a probable future outflow of economic benefits
- The outflow can be estimated reliably.

A key factor in the above criteria is that the obligations must be unavoidable. As far as the modifications are concerned although the legislation took effect from 31 March 2018 the vehicle have nevertheless been used for six months in the current financial year so there cannot be any unavoidable obligation to modify them at the reporting date.

One obligation that does appear to be unavoidable is the penalties that will become payable as a result of the illegal use of the vehicles from the effective date of the legislation. Therefore a provision of 4,00,000 (200×4×6/12) would be necessary due to the illegal operation of the vehicles for six months. This provision would be recognized as a liability in the statement of financial position, with a charge of 4,00,000 in the income statement.

Illustration 28

On 31 March 2018 Kallappa was in the process of defending a legal case brought against it for damages caused due to the supply by Kallappa of faulty products. Kallappa's lawyers provided the following estimates of the likely outcome of the case:

A 70% chance of defending the case successfully.

A 20% chance of being required to pay ₹3 million in damages. A 10% chance of being required to pay ₹5 million in damages.

The draft financial statements included a provision for ₹1.1 million (70% x nil + 20% x $3 million + 10% x $5 million). The charge in the statement of comprehensive income was made to administrative expenses.

The directors of Kappa have estimated that the legal costs of defending the case will total ₹4,00,000. ₹ 3,00,000 of this has already been invoiced by the lawyers covering fees up to and including 31 March 2018. Kallappa has included ₹ 3,00,000 in trade payables and charged ₹3,00,000 to administrative expenses, but has not provided for the expected future costs of ₹1,00,000.

In the event of successfully defending the case, the directors of Kallappa believe there is a 'good chance' that they will be able to recover their legal costs, but they have not yet reflected this fact in the draft financial statements.

Solution:

Under the provisions of Ind AS 37- provisions, contingent liabilities and contingent assets- where a single obligation is being measured the provision that is recognized should be for the most likely outcome. In the case the most likely outcome is that the case will be successfully defended so no provision should be made for possible damages, although the range of outcomes should be disclosed. Therefore 1.1 million should be removed from administrative expenses.

As far as the legal costs are concerned these will be payable to the lawyers irrespective of whether or not the case is successfully defended. The event giving rise to the legal claim, has occurred before the year end. Therefore the full amount of the likely costs should be provided for and 1,00,000 added to administrative expenses. The issue of a potential reimbursement needs to be considered separately. Ind AS 37 states that an asset (and therefore a reduction in expenses) should only be recognized if reimbursement is virtually certain. Therefore Kallappa is correct not to reflect this in the financial statements.

INTANGIBLE ASSETS – IND AS 38

Definition

Intangible assets - Identifiable, non-monetary assets, without physical substance.
Assets - resources, controlled from past events and with future economic benefits expected.
Research – Original and planned investigation undertaken with the prospect of gaining new specific or technical knowledge and understanding.
Development – 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 before the start of commercial production or use.

Identifiable if either:

- Capable of being separated and sold, licensed, rented, transferred, exchanged or rented separately or
- Arise from contractual or other legal rights

Scope Exclusions

Financial and intangible assets covered by other IND ASs (IND AS 2, IND AS 12, IND AS 17, IND AS 19, IND AS 32, IND AS 104, IND AS 105, and IND AS 106).

Recognition and Measurement

1. **Separate Acquisition:**
   - Probable – expected future economic benefits will flow to the entity; and
   - Cost can be reliably measured - Recognition at cost
2. **Acquired Business Combination:**
   - Probable – always met if fair value (FV) can be determined; FV reflects expectation of future economic benefits
   - Cost – FV at acquisition date
     - Acquirer recognises it separately from goodwill
     - Irrespective of whether the acquiree had recognised it before acquisition
3. **Internally Generated:**
   - Research phase – expense costs as incurred
   - Development phase – Capitalise if all criteria are met:
     - Technical feasibility of completion of intangible asset
     - Intention to complete
     - Ability to use or sell the intangible asset
     - Adequate technical, financial and other resources to complete
     - Probable future economic benefits
     - Expenditure measured reliably
4. **Exchange of Assets:**

- Measure acquired asset at its fair value
- If not possible, at book value of asset given up

5. **Internally Generated Goodwill:**
   Internally generated goodwill is never recognised as it is not an identifiable resource that can be measured reliably. Examples include:
   - Internally generated brands
   - Customer lists
6. **Government Grant:**
   Initially recognised at:
   - Fair value
   - Nominal amount plus directly attributable expenses for preparing the asset for its intended use

   Examples include:
   - License to operate national lottery
   - Radio station

Subsequent Measurement (After Recognition)

I. **Finite Useful Life –** Choose either amortised cost or revaluation model:

II. **Indefinite useful lives**
   - No foreseeable limit to future expected economic benefits
   - Not amortised
   - Test for impairment annually or when an indication exists
   - Review annually if events and circumstances still support indefinite useful life
   - If no longer indefinite change to finite useful life

Amortised Cost Model

- Determine useful life
- Residual value – assumed zero unless active market exists or a commitment by third party to purchase the intangible asset exists
- Amortisation method
  - Review above annually
  - Amortisation begins when available for use
  - Rebuttable presumption that revenue based amortisation is inappropriate
  - Should reflect the pattern in which future economic benefits are expected to be consumed
  - Consistent from period to period

Revaluation Model

- Fair value at revaluation date
- Fair value determined by referring to active market
- If no active market, use cost model
- Revaluation done regularly
- The net carrying amount of the asset is adjusted to the revalued amount and
  - The gross carrying amount is adjusted in a manner consistent with the net carrying amount. Accumulated amortisation is adjusted to equal the difference between the gross and net carrying amount; or

- Accumulated amortisation is eliminated against the gross carrying amount.

- Credit to revaluation surplus net of Deferred Tax
- Transfer to or from retained earnings on realisation

Disclosure

Entity shall disclose for each class of intangible assets; distinguishing between internally generated intangible assets and other intangible assets:

- Whether useful lives are indefinite or finite
- Useful life, amortisation rate and amortisation method for assets having finite useful lives
- The gross carrying amount of intangible asset and any accumulated amortisation
- Any amortisation of intangible asset included in statement of profit and loss
- Reconciliation of the carrying amount at the beginning and end of period showing additions, assets classified as sale, increase / decrease from revaluation, amortisation, any changes in carrying value

Illustration 29

Kasorabe Cabs acquired Taxi Cab card ₹ 1 crores. As government has limited the card holding by only existing holders and no fresh cards will be issued the value will increases every year. Comment on amortization as per AS-26 and Ind AS – 38?

Solution:

AS – 26: Write – off over 10 years. Annual amortization = ₹ 10,00,000.

As per Ind AS – 38 the company should follow Revaluation Model of upward revaluation. No amortization as the asset has infinite life.

Illustration 30

Pandaba Golon Ltd has a license costing ₹ 6,00,000 and patent costing ₹ 7,00,000. Active market available for patents and not for license. Comment on valuation as per Ind AS – 38?

Solution:

Patent should be valued at Revalued figure. License should be recorded at cost as the active market is not available.

Illustration 31

X Limited in a business combination, purchased the net assets of Y Limited for Rs. 4,00,000 on March 31, 2019. The assets and liabilities position of Y Limited just before the acquisition is as follows:

Assets	**Cost (in Rs.)**
Property, Plant & Equipment	1,00,000
Intangible asset 1	20,000
Intangible asset 2	50,000
Cash & Bank	1,30,000
Liabilities	
Trade payable	50,000

The fair market value of the PPE, intangible asset 1 and intangible asset 2 is available and they are Rs. 1,50,000, Rs. 30,000 and Rs. 70,000 respectively. How would X Limited account for the net assets acquired from Y Limited?

Solution

X Limited will account for the assets acquired from Y Limited in following manner:

Assets	Amount in Rs.
Property, Plant & Equipment	150000
Goodwill	50000
Intangible asset 1	30000
Intangible asset 2	70000
Cash & Bank	130000
Liabilities	
Trade payable	50000

Note 1- Goodwill is the difference between fair value of net assets acquired and purchase consideration paid when is calculated as follow:

Goodwill = Rs. 4,00,000 – Rs. (1,50,000 + 70,000 + 30,000 + 1,30,000 - 50,000)= Rs. 70,000.

Illustration 32

P Ltd. acquired Q Ltd. on April 30, 2019. The purchase consideration is Rs. 50,00,000. The fair value of the tangible assets is Rs. 45,00,000. The company estimates the fair value of "In process research projects" at Rs. 10,00,000. No other Intangible asset is acquired by P Ltd. in the transaction. Further, cost incurred by P Ltd. in relation to that research project is as follows:

(a) Rs. 5,00,000 - as research expenses
(b) Rs. 2,00,000 - to establish technological feasibility
(c) Rs. 7,00,000 - for further development cost after technological feasibility is established.

At what amount the intangible asset should be measured under Ind AS 38?

Solution

P Ltd. should initially recognise the acquired "In house research project" at its fair value i.e., Rs. 10,00,000. Research cost of Rs. 5,00,000 and cost of Rs. 2,00,000 for establishing technical feasibility should be charged to profit & loss. Costs incurred from the point of technological feasibility/asset recognition criteria until the time when development costs are incurred are capitalised.

So the intangible asset should be recognised at Rs. 17,00,000 (Rs. 10,00,000 + Rs. 7,00,000).

Illustration 33

X Ltd. purchased a standardised finance software at a list price of Rs. 30,00,000 and paid Rs. 50,000 towards purchase tax which is non refundable. In addition to this, the entity was granted a trade discount of 5% on the initial list price. X Ltd. incurred cost of Rs. 7,00,000 towards customisation of the software for its intended use. X Ltd. purchased a 5 year maintenance contract with the vendor company of Rs. 2,00,000. At what cost the intangible asset will be recognised?

Solution

In accordance with Ind AS 38, the cost of a separately acquired intangible asset is its purchases price and non refundable purchase taxes, after deducting trade discounts and rebates and any directly attributable cost of preparing the asset for its intended use.

Therefore, the initial cost of the asset should be:

	Amount in Rs.
List Price	3000000
Less: Trade Discount (5%)	(150000)
	2850000
Non refundable purchase tax	50000
Customisation Cost	700000
Total Cost	3600000

The maintenance contract of Rs. 2,00,000 is an expense and therefore should be taken as a prepaid expense and charged to profit and loss over a period of 5 years.

MODULE – III
REDEMPTION OF SECURITIES

REDEMPTION OF PREFERENCE SHARES

Introduction

A company limited by shares may (if so authorised by its Articles) issue preference shares which are liable to be redeemed within a period not exceeding 20 years from the date of their issue.

Redeemable preference shares are those shares which are repayable after a fixed period or earlier at the discretion of the company. Section 55(i) of the Companies Act, 2013 prohibits the issue of any preference share that is irredeemable.

Redemption of Preference Shares

Redemption means repayment of capital. Thus, redemption of preference share means repayment of preference share capital to the preference shareholders.

Condition of Redemption of Preference Shares (Provisions of the Companies Act – Sec. 55)

According to Section 55 of the Companies Act, 2013, a company limited by shares, If authorised by its Articles, can redeem the preference shares, subject to the following conditions:

1. The shares to be redeemed must be fully paid up.
2. The shares should redeemed either out of profits of the company available for distribution as dividend or out of the proceeds of fresh issue of shares made for the purpose of redemption.
3. Any premium payable on redemption must be provided out of the profits of the company or out of the company's security premium account (from fresh issue r existing balance). Generally, it is provided out of security premium, if there is existing security premium or premium on fresh issue.
4. Where any such shares are redeemed out of profits available for dividend, an amount equal to the nominal value of shares to be redeemed must be transferred out of the divisible profits to Capital Redemption Reserve Account
5. The capital redemption reserve account can be utilised only for the issue of fully paid up bonus shares. This means that partly paid up shares cannot be made fully paid up out of Capital Redemption Reserve A/c.

Methods of Redemption

There are three methods of redemption of preference shares. They are:

(a) Redemption out of fresh issue of shares.
(b) Redemption out of Profits.
(c) Redemption partly out of fresh issue and partly out of profit.

Accounting Procedure

For solving problems, the following procedure is to be followed:

1. First see whether the redeemable preference shares are fully paid up or partly paid up.

If they are partly paid up, pass the following journal entries to make them fully paid.

(a) Preference Share Final Call A/c Dr

To Preference Share Capital A/c

(b) Bank A/c Dr.

To Preference Share Final Call A/c

2. Make journal entry for fresh issue of shares when company issues new shares:

(a) At Par

Bank A/c Dr.

To Share Capital A/c

(b) At Premium

Bank A/c Dr.

To Share Capital A/c

To Security Premium A/c

(c) At Discount

Bank A/c Dr.

Discount on Issue of Share A/c Dr.

To Share Capital A/c

3. Write journal entry for redemption of preference shares

(a) When Redemption is at Par

Redeemable Preference Share Capital A/c Dr.

To Preference Shareholders A/c

(For transferring the capital to preference shareholders)

Preference Shareholders A/c Dr

To Bank A/c

(For paying the amount due to preference shareholders)

(b) When Redemption is at Premium

Security Premium A/c / Profit and Loss A/c Dr.

To Premium on Redemption of Preference Shares A/c /

(For providing premium on redemption out of security premium or profit and loss)

Redeemable Preference Share Capital A/c Dr.

Premium on Redemption of Preference Share A/c Dr.

To Preference Shareholders A/c

(For transferring the capital and premium to preference shareholders)

Preference Shareholders A/c Dr.

To Bank A/c

(For paying the amount due to preference shareholders)

Note: If the preference shares are redeemed at a premium, such premium on redemption is provided out of Security Premium Account (existing or fresh issue) or Profit and Loss or General Reserve.

Illustration 1 (Fresh Issue of Shares at Par and Redemption, at Par)

A Ltd had 10,000, 8% redeemable preference shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par by issue of sufficient number of equity shares of Rs. 10 each fully paid at par. Write journal entries in the books of the company.

Solution

Face value of share to be redeemed (10,000 x 100) = 10,00,000

Proceeds per new share = Rs. 10

No.of shares to be issued = $\frac{10,00,000}{10}$ = 1,00,000 shares

Illustration 2 (Fresh Issue of Shares at Premium and Redemption at Par)

B Ltd had 3,000, 9% preference shares of f 200 each fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of ordinary shares of Rs. 25 each at a premium of Rs. 2 per share as fully paid. Write journal entries in the books of the company.

Solution

Value of shares to be redeemed (3,000 x 200) = 6,00,000

Proceeds per new share = Rs. 25

No.of shares to be issued = $\frac{6,00,000}{25}$ = 24,000 shares

Illustration 3 (Fresh Issue of Shares at Discount and Redemption at Par)

C Ltd had 9000, 8% Redeemable Preference Shares of 20 each, fully paid up. The company decided to redeem these shares by issue of sufficient No. of equity shares of Rs.10 each fully paid at 10% discount. Pass necessary journal entries in company's book.

Solution

Value of shares to be redeemed (9,000 x 20) = Rs. 1,80,000

When shares are issued at discount, the proceeds must be sufficient to cover the face value of preference shares to be redeemed, i.e., Rs. 1,80,000.

Proceeds per new share = 10 -10% = Rs. 9

No.of Shares = Rs. $\frac{1,80,000}{9}$ = 20,000 shares

or

$\frac{1,80,000}{9} \times \frac{100}{90} = \frac{2,00,000}{10}$ = 20,000 shares

Illustration 4 (Issue of Fresh Equity Shares)

Ahuja Company Ltd. had 5,000, 8% Redeemable Preference Shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution

Journal Entries in the books of Ahuja Company Ltd.

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Equity Share Capital A/c (Being the issue of 50,000 Equity Shares of ₹10 each at par for the purpose of redemption of preference shares)	Dr.	5,00,000	 5,00,000
	8% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account) Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr. Dr.	5,00,000 5,00,000	 5,00,000 5,00,000

Illustration 5 (Issue of Fresh Equity Shares)

A Ltd. had 10,000, 10% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution

Journal Entries in the books of A Ltd.

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	12,00,000	
	To Equity Share Capital A/c			10,00,000
	To Securities Premium A/c			2,00,000
	(Being the issue of 1,00,000 Equity Shares of ₹ 10 each at a premium of ₹ 2 per share)			
	10% Redeemable Preference Share Capital A/c	Dr.	10,00,000	
	To Preference Shareholders A/c			10,00,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c	Dr.	10,00,000	
	To Bank A/c			10,00,000
	(Being the amount paid on redemption			

Note: Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000. Premium received on new issue cannot be used to finance the redemption.

Illustration 6 (Issue of Fresh Equity Shares)

S India Ltd. had 9,000 10% redeemable Preference Shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 9 each fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Solution

In the books of S India Limited Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	90,000	
	To Equity Share Capital A/c			90,000
	(Being the issue of 10,000 Equity Shares of ₹9 each at par)			
	10% Redeemable Preference Shares Capital A/c	Dr.	90,000	
	To Preference Shareholders A/c			90,000
	(Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)			
	Preference Shareholders A/c To	Dr.	90,000	
	Bank A/c			90,000
	(Being the amount paid on redemption of preference shares)			

Redemption out of Profits

Redeemable preference shares can be redeemed out of the divisible profits. Divisible profits for dividend. The examples of divisible or undistributed profits include general reserve, reserve fund, dividend equalisation reserve, investment fluctuation reserve, insurance fund, workmen's compensation fund, workmen's accident fund, debenture redemption reserve, reserve for contingencies, any other revenue reserve, profit and loss account balance etc.

In the case of shares so redeemed should be transferred from divisible profits to ***Capital Redemption Reserve Account.***

Reasons for Creating CRR

CRR is created for the following reasons:

1) **Capital maintenance:** The important purpose of creating CRR is to maintain the capital intact. By creating CRR, it is possible to protect capital structure and components of capital as it is. If much variation is taking place in components and volume of capital, business activities would be reduced. This causes dissatisfaction among shareholders.
2) **Safeguard of creditors:** The other reason for creating CRR is to protect the interest of creditors. If CRR is not created, the directors may distribute the entire amount of profits by way of dividend. This will adversely affect the interest of creditors.

Note: For calculating CRR, the premium on redemption and security premium are totally ignored.

Accounting Treatment

The following journal entries are required to be passed the books of the company.

1. When Shares are Redeemed at Par

(a) On transfer to Capital Redemption Reserve A/c

Profit and Loss A/c / General Reserve A/c Dr.
To Capital Redemption Reserve A/c

(b) On the redemption of shares

Preference Share Capital A/c Dr.
To Preference Shareholders A/c

(c) On Payment to Preference Shareholders

Preference Shareholders A/c Dr.
To Bank A/c

Note: First see whether the preference shares are fully paid up or partly paid up. If the shares are partly paid up they must be made fully paid up. The journal entries have already been given.

2. When Shares are Redeemed at Premium

(a) Same entry as under 1 (a) above for transfer to Capital Redemption Reserve A/c from divisible profits.

(b) On providing Premium Payable on Redemption

Security Premium A/c / Profit & Loss A/c / Capital Reserve A/c Dr.
To Premium on Redemption A/c

(c) On making money due to preference shareholders
Preference Share Capital A/c Dr.
Premium on Redemption A/c Dr.
To Preference Shareholders A/c

(d) On payment to Shareholders
Same entry as under 1(c) above

Illustration 7 (Redemption out of Profits)

The Balance Sheet of Y Ltd. as on 31st March, 2018 is as follows:

Particulars	₹
EQUITY AND LIABILITIES	
1. Shareholders' funds	
a) Share capital	2,90,000
b) Reserves and Surplus	48,000
2. Current liabilities	
Trade Payables	56,500
Total	3,94,500
ASSETS	
1. Fixed Assets	
Tangible asset	3,45,000
Non-current investments	18,500
2. Current Assets	
Cash and cash equivalents (bank)	31,000
Total	3,94,500

The share capital of the company consists of ₹50 each equity shares of ₹2,25,000 and ₹100 each Preference shares of ₹65,000(issued on 1.4.2016). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

a) to sell all the investments for ₹15,000.

b) to finance part of redemption from company funds, subject to, leaving a bank balance of ₹12,000.

c) to issue minimum equity share of ₹50 each at a premium of ₹10 per share to raise the balance of funds required.

You are required to pass: The necessary Journal Entries to record the above transactions and prepare the balance sheet as on completion of the above transactions.

Solution

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Share Application A/c (For application money received on 625 shares @ ₹ 60 per share)	Dr.	37,500	37,500
	Share Application A/c To Equity Share Capital A/c To Securities Premium A/c (For disposition of application money received)	Dr.	37,500	31,250 6,250
	Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (For amount payable on redemption of preference shares)	Dr. Dr.	65,000 6,500	71,500
	Profit and Loss A/c To Premium on Redemption of Preference Shares A/c (For writing off premium on redemption out of profits)	Dr.	6,500	6,500
	Bank A/c Profit and Loss A/c (loss on sale) A/c To Investment A/c (For sale of investments at a loss of ₹ 3,500)	Dr. Dr.	15,000 3,500	18,500
	Profit and Loss A/c To Capital Redemption Reserve A/c (For transfer to CRR out of divisible profits an amount equivalent to excess of nominal value of preference shares over proceeds (face value of equity shares) i.e., ₹ 65,000 - ₹ 31,250)	Dr.	33,750	33,750
	Preference Shareholders A/c To Bank A/c (For payment of preference shareholders)	Dr.	71,500	71,500

Balance Sheet (after redemption)

Date	Particulars	Notes No.	(₹)
	EQUITY AND LIABILITIES		
1.	Shareholders' funds		
	a) Share capital	1	2,56,250
	b) Reserves and Surplus	2	44,250
2.	Current liabilities		
	Trade Payables		56,500
	Total		3,57,000

1.	**ASSETS** Fixed Assets Tangible asset		3,45,000
2.	Current Assets Cash and cash equivalents (bank)	3	12,000
	Total		3,57,000

Notes to accounts

			₹
1.	Share Capital Equity share capital (2,25,000 + 31,250)		2,56,250
2.	Reserves and Surplus Capital Redemption Reserve Profit and Loss Account (48,000 – 6,500 – 3,500 – 33,750) Security Premium		 33,750 4,250 6,250 44,250
3.	Cash and cash equivalents Balances with banks (31,000 + 37,500 +15,000 – 71,500)		12,000

Working Note:

Calculation of Number of Shares:	₹
Amount payable on redemption	71,500
Less: Sale price of investment	(15,000)
	56,500
Less: Available bank balance (31,000 - 12,000)	(19,000)
Funds from fresh issue	37,500

No. of shares = 37,500/60=625 shares

Illustration 8 (Capitalisation of Undistributed Profits)

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2018.

Share capital: 40,000 Equity shares of ₹10 each fully paid – ₹4,00,000; 1,000 10% Redeemable preference shares of ₹100 each fully paid – ₹1,00,000.

Reserve & Surplus: Capital reserve – ₹50,000; Securities premium – ₹50,000; General reserve – ₹75,000; Profit and Loss Account – ₹35,000

On 1st January 2019, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve. *You are required to pass necessary Journal Entries including cash transactions in the books of the company.*

Solution

Journal Entries in the books of ABC Limited

Date	Particulars		Dr. (₹)	Cr. (₹)
2019 Jan 1	10% Redeemable Preference Share Capital A/c	Dr.	1,00,000	
	To Preference Shareholders A/c			1,00,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c To	Dr.	1,00,000	
	Bank A/c			1,00,000
	(Being the amount paid on redemption of preference shares)			
	General Reserve A/c	Dr.	75,000	
	Profit & Loss A/c	Dr.	25,000	
	To Capital Redemption Reserve A/c			1,00,000
	(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)			

Note: Securities premium and capital reserve cannot be utilised for transfer to Capital Redemption Reserve.

Illustration 9 (Capitalisation of Undistributed Profits)

B Limited had 3,000, 12% Redeemable Preference Shares of ₹100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

i) 25,000 Equity Shares of ₹10 each at par,

ii) 1,000 14% Debentures of ₹100 each.

The issue was fully subscribed and all amounts were received in full .The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

Solution

Journal Entries in the books of B Limited

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c	Dr.	2,50,000	
	To Equity Share Capital A/c			2,50,000
	(Being the issue of 25,000 equity shares of ₹ 10 each at par)			
	Bank A/c	Dr.	1,00,000	
	To 14% Debenture A/c			1,00,000
	(Being the issue of 1,000 Debentures of ₹ 100 each)			
	12% Redeemable Preference Share Capital A/c	Dr.	3,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	30,000	
	To Preference Shareholders A/c			3,30,000
	(Being the amount payable on redemption transferred to Preference Shareholders Account)			
	Preference Shareholders A/c To	Dr.	3,30,000	
	Bank A/c			3,30,000
	(Being the amount paid on redemption of preference shares)			

	Profit & Loss A/c To Premium on Redemption of Preference Shares A/c (Being the adjustment of premium on redemption against Profits & Loss Account)	Dr.	30,000	30,000
	Profit & Loss To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	Dr.	50,000	50,000

Working Note:

Amount to be transferred to Capital Redemption Reserve Account

Face value of shares to be redeemed	₹ 3,00,000
Less: Proceeds from new issue	(₹ 2,50,000)
Total Balance	₹ 50,000

Redemption of Partly Paid up Shares

If the preference shares are partly paid, they will have to be made fully paid before redemption. The journal entries have already been given.

In case there are two categories of redeemable preference shares (one fully paid \and another partly paid) and there is no instruction regarding redemption, only fully /paid preference shares may be redeemed.

Sometimes there are calls in arrears in case of redeemable preference shares. In. such a case, it is necessary to follow the instructions given in the question. If nothing is mentioned in the question, there are two options. They are:

(a) Preference shares having calls in arrears should not be redeemed,

(b) It is presumed that calls in arrears are collected and all the preference shares are redeemed.

Illustration 10 (Partly Paid up Shares)

The Balance Sheet of ABC Ltd. as at 31st December, 2018 inter alia includes the following:

₹ 50,000, 8% Preference Shares of ₹100 each, ₹70 paid up	35,00,000
1,00,000 Equity Shares of ₹100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 2019 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on 1st January, 2020. The issue was fully subscribed and allotment made on 1st March, 2019. The money due on allotment were received by 31st March, 2019. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2019 with the corresponding figures as on 31st December, 2018.

Solution

Journal Entries in the books of ABC Ltd.

Date	Particulars		Dr. (₹)	Cr. (₹)
	8% Preference Share Final Call A/c	Dr.	15,00,000	
	To 8% Preference Share Capital A/c			15,00,000
	(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
	Bank A/c	Dr.	15,00,000	
	To 8% Preference Share Final Call A/c			15,00,000
	(For receipt of final call money on preference shares)			
	Bank A/c	Dr.	10,00,000	
	To Equity Share Application A/c			10,00,000
	(For receipt of application money on 50,000 equity shares @ ₹ 20 per share)			
	Equity Share Application A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	(For capitalisation of application money received)			
	Equity Share Allotment A/c	Dr.	17,50,000	
	To Equity Share Capital A/c			12,50,000
	To Securities Premium A/c			5,00,000
	(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)			
	Bank A/c	Dr.	17,50,000	
	To Equity Share Allotment A/c			17,50,000
	(For receipt of allotment money on equity shares)			
	8% Preference Share Capital A/c	Dr.	50,00,000	
	Premium on Redemption of Preference Shares A/c	Dr.	2,50,000	
	To Preference Shareholders A/c			52,50,000
	(For amount payable to preference shareholders on redemption at 5% premium)			
	General Reserve A/c	Dr.	2,50,000	
	To Premium on Redemption A/c			2,50,000
	(For writing off premium on redemption of preference shares)			
	General Reserve A/c	Dr.	27,50,000	
	To Capital Redemption Reserve A/c			27,50,000
	(For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000 - 10,00,000 - 12,50,000)			

	Preference Shareholders A/c To Bank A/c (For amount paid to preference shareholders)	Dr.	52,50,000	52,50,000

Balance Sheet (extracts)

	Particulars	Notes No.	As at 31.3.2019 (₹)	As at 31.12.2018 (₹)
	EQUITY AND LIABILITIES			
1.	Shareholders' funds			
	a) Share capital	1	1,22,50,000	1,35,00,000
	b) Reserves and Surplus	2	77,50,000	75,00,000

Notes to accounts

	Particulars		As at 31.3.2019	As at 31.12.2018
1.	**Share Capital**			
	Issued, Subscribed and Paid up:			
	1,00,000 Equity shares of ₹100 each fully paid up		1,00,00,000	1,00,00,000
	50,000 Equity shares of ₹ 100 each ₹ 45 paid up		22,50,000	-
	50,000, 8% Preference shares of ₹ 100 each, ₹ 70 called up			35,00,000
			1,22,50,000	**1,35,00,000**
2.	**Reserves and Surplus**			
	Capital Redemption Reserve		47,50,000	20,00,000
	Securities Premium (5,00,000 + 5,00,000)		10,00,000	5,00,000
	General Reserve		20,00,000	50,00,000
			77,50,000	**75,00,000**

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares are ₹ 22,50,000 (₹10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital).

REDEMPTION OF DEBENTURES

Introduction

A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest.

Under Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting. Section 71 (2) further provides that no company can issue any debentures which carry any voting rights. Section 71 (4) provides that where debentures are issued by a company, the company should create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilised by the company for any purpose other than the redemption of debentures.

Basic Provisions

If a charge has been created on any or the entire asset of the company,

a. the nature of the charge
b. the assets charged are described therein.

Since the charge is not valid unless registered with the Registrar, his certificate registering the charge is printed on the bond.

It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Redemption of Debentures

Debentures are usually redeemable, but a company may also issue irredeemable debentures. Redeemable debentures may be redeemed

- after a fixed number of years or
- any time after a certain number of years has elapsed since their issue,
- on giving a specified notice, or by annual drawing.

A company may also purchase its debentures, as and when convenient in the open market and when debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them.

Debenture Redemption Reserve

A company issuing debentures is required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they should fall due for payment.

An appropriate amount is transferred from profits every year to Debenture Redemption Reserve and its investment is termed as Debenture Redemption Reserve Investment. These investment earn certain amount of income i.e. interest which is reinvested together with the fixed appropriated amount for the purpose in subsequent years. In last year, the interest earned and the appropriated fixed amount are not invested. In fact, at this stage the Debenture Redemption Reserve Investments are encashed and the amount so obtained is used for the redemption of debentures. Any profit or loss made on the encashment of Debenture Redemption investments is also transferred to Debenture Redemption Reserve Account.

Liability of the Company to Create Debenture Redemption Reserve

Section 71 of the Companies Act 2013 covers the requirement of creating a debenture redemption reserve account. Section 71 states as follows:

(1) Where a company issues debentures under this section, it should create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.

(2) The amounts credited to the debenture redemption reserve should not be utitlised by the company except for the purpose aforesaid.

(3) The company should pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

Journal Entries

The necessary journal entries passed in the books of a company are given below:

1. **At the end of First Year**

   (a) For setting aside the fixed amount of profit for redemption

   Profit and Loss A/c Dr.

   To Debenture Redemption Reserve A/c

   (b) For investing the amount set aside for redemption

   Debenture Redemption Reserve Investment A/c Dr.

   To Bank A/c

2. **At the end of second year and subsequent years other than last year**

   (a) For receipt of interest on Debenture Redemption Reserve Investments

   Bank A/c Dr.

   To Interest on Debenture Redemption Reserve Investment A/c

   (b) For transfer of Interest on Debenture Redemption Reserve Investment (DRRI) to Debenture Redemption Reserve Account

   Interest on Debenture Redemption Reserve Investment A/c Dr.

   To Debenture Redemption Reserve A/c

   (c) For setting aside the fixed amount of profit for redemption

   Profit and Loss A/c Dr.

To Debenture Redemption Reserve A/c

(d) **For investments of the amount set aside for redemption and the interest earned on DRRI**

Debenture Redemption Reserve Investment A/c Dr.

To Bank A/c

3. **At the end of last year**

(a) **For receipt of interest**

Bank A/c Dr.

To Interest on Debenture Redemption Reserve Investment A/c

(b) **For transfer of interest on Debenture Redemption Reserve Investment to Debenture Redemption Reserve Investment A/c**

Interest on Debenture Redemption Reserve Investment A/c Dr.

To Debenture Redemption Reserve A/c

(c) **For setting aside the fixed amount of profit for redemption**

Profit and Loss A/c Dr.

To Debenture Redemption Reserve A/c

(d) **For encashment of Debenture Redemption Reserve Investments**

Bank A/c Dr.

To Debenture Redemption Reserve Investment A/c

(e) **For the transfer of profit/loss on realisation of Debenture Redemption Reserve Investments**

(i) In case of Profit

Debenture Redemption Reserve Investment A/c Dr.

To Debenture Redemption Reserve A/c

Or

(ii) In case of Loss

Debenture Redemption Reserve A/c Dr.

To Debenture Redemption Reserve Investment A/c

(f) **For amount due to debenture holders on redemption**

Debenture A/c Dr.

To Debenture holder A/c

(g) **For payment to debenture holders**

Debenture holders A/c Dr.

To Bank A/c

Balance in Debenture Redemption Reserve (DRR)

The balance to the credit of Debenture Redemption Reserve, may in certain circumstances may either be more or less as compared to the amount of debentures which are proposed to be redeemed.

- If it is in excess, the amount is transferred to the Capital Reserve, on the assumption that it is a capital profit received on the appreciation in the value of investments or settlement of liability for a lesser amount that what was usually payable.

- On the other hand, if it is short, the deficit is made up by the transfer from Profit and Loss Account. The balance in the account, equal to the amount of debentures redeemed is subsequently transferred to General Reserve.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "cum interest"; but if purchased "ex Interest", the interest to the date of purchase would be payable to the seller in addition. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. Thus, in result, a balance in the Account would be left, equal to the interest for the period the debentures were held by the company.

Methods of Redemption of Debentures

Redemption of debentures must be done according to the terms of issue of debentures and any deviation there from will be treated as a default by the company. Redemption by paying off the debt on account of debentures issued can be done in one of the three methods viz:

1) By Payment in Lumpsum

Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period.

2) By Payment in Instalments

Under payment in instalments method, the payment of specified portion of debenture is made in instalments at specified intervals.

3) Purchase of Debentures in Open Market

Debentures sometimes are purchased in open market; where there is a Debenture Redemption Reserve out of the reserve and, if there is none, as a general investment; the Debenture Investment Account or Own Debenture Account is debited.

Illustration 11

Suppose a company has issued 8% debentures for ₹ 10,00,000, interest being payable on 31st March and 30th September. The company purchases ₹ 50,000 debentures at ₹ 96 on 1st August 2018. This means that the company will have to pay ₹ 48,000 as principal plus ₹ 1,333 as interest for 4 months.

Solution

Entry		₹	₹
Own Debentures (50,000 x 96/ 100)	Dr.	48,000	
Interest Account (50,000 x 8% x 4/12)	Dr.	1,333	
To Bank			49,333

It should be noted that even though ₹ 50,000 debentures have been purchased for ₹ 48,000 there is no profit. On purchase of anything, profit does not arise; only on sale, and in this case on cancellation of debentures, profit could arise.

On 30th September, the company will have to pay ₹ 38,000 as interest to outsiders, i.e. 8% on ₹ 9,50,000 for six months. But since the company is keeping the debentures alive, it means, it has saved interest for two months. Therefore, ₹ 667 should be debited to Debentures Interest Account and credited to the Profit and Loss Account. If this entry is passed, it will be noted that the debenture interest account will be debited by the full amount of ₹ 40,000 which is interest for six months on ₹ 10 lakhs. This should be so since in the balance sheet it will be a liability of ₹ 10,00,000. ₹ 50,000 own debentures will be shown on the assets side of the Balance Sheet. However, in the amount column only ₹ 48,000 will be entered.

Illustration 12

Suppose out of those debentures ₹ 30,000 is sold at ₹ 98 cum interest on 1st March, 2019 and the remaining ₹ 20,000 is cancelled on 31st March, 2019. The journal entries to be passed will be the following:

Solution

	₹	₹
1st March, 2019 Dr. (1) Bank (30,000 x 98/ 100) To Own Debentures A/c To Interest A/c (30,000 x 8% x 5/12) (Sale of ₹ 30,000 Debenture @ ₹ 98 cum interest for 5 months credited to Interest A/c, the balance being the own debentures A/c)	29,400	 28,400 1,000
(2) Profit and Loss A/c Dr. To Own Debentures A/c (The loss on ₹ 30,000 Own Debentures whose purchase price was ₹ 28,800 @ 96)	400	 400
31st March, 2019 8% Debentures A/c Dr. To Own Debentures A/c To Capital Reserve A/c (Cancellation of ₹ 20,000 Debentures)	 20,000	 19,200 800

It should be noted that the profit on cancellation or redemption of debentures should be treated as a capital profit and, therefore, credited to the capital reserve.

Illustration 13

On January 1, R Ltd., had 500 Debentures of ₹ 100 each outstanding in its books carrying interest at 6% per annum. In accordance with the powers in the deed, the directors acquired debentures from the open market for immediate cancellation as follows:

March 1	₹ 5,000 at ₹ 98.00 (cum interest)
Aug. 1	₹ 10,000 at ₹ 100.25 (cum interest)
Dec. 15	₹ 2,500 at ₹ 98.50 (ex-interest)

Debenture interest is payable half-yearly, on 30th June and 31st Dec. Show ledger accounts of Debentures, Debenture interest and profit or loss on cancellation, ignoring income-tax.

Solution

6% Debentures A/c

1st Half Year

		₹	₹			₹
Mar. 1	To Bank-Debentures Purchased [(5,000 x 98/ 100) – 50]	4,850		Jan. 1	By Balance b/d	50,000
	To Profit & Loss on cancellation of debenture A/c (5,000 – 4,850)	150	5,000			
June 30	To Balance c/d		45,000			
			50,000			50,000

Profit & Loss on Cancellation of Debentures

June 30	To Capital Reserve (transfer)	₹ 150	Mar. 1	By Debenture Account	₹ 150

Debenture Interest Account

		₹		₹
Mar. 1	To Bank-Interest for 2 months on ₹ 5,000 Debentures @ 6%	50	June 30 By Profit & Loss A/c	1,400
June 30	To Debenture-holders (Interest) A/c (45,000 x 6% x 6/12)	1,350		
		1,400		1,400

Debenture-holders (Interest) Account

		₹			₹
June 30	To Cash	1,350	June 30	By Debenture interest Account (Interest on ₹ 45,000 @ 6% upto 30th June)	1,350

2nd Half Year

6% Debentures Account

			₹			₹
Aug 1	To Debenture Purchased [(10000×100.25/100) - 50]		9975	Jul-01	By Balance b/d	45000
	To P & L A/c on Cancellation (10000 - 9975)		25			
Dec-15	To Bank - Deb. Purchased (2500×98.50/100)	2462.5				
	P & L on cancellation of Deb. (2500 - 2462.50)	37.5	2500			
Dec-31	To Balance c/d		32500			
			45000			45000

Profit & Loss on Cancellation of Debentures Account

		₹			₹
Dec. 31	To Capital Reserve — Transfer	62.50	Aug. 1 Dec. 15	By Debenture A/c By Debenture A/c	25.00 37.50
		62.50			62.50

Debenture Interest Account

		₹			₹
Aug. 1	To Bank - Interest for one month on ₹ 10,000 @ 6%	50.00	Dec.	By P & L Account	1,093.75
Dec. 15	To Bank (2,500 x 6% x 5.5/ 12)	68.75			
Dec. 31	To Debenture holders (32,500 x 6% x 6/12)	975.00			
		1,093.75			1,093.75

Debenture-holders (Interest) Account

		₹			₹
Dec. 31	To Bank	975.00	Dec. 31	By Debenture Interest (on ₹ 32,500 @ 6% for 6 months)	975.00

Tutorial Notes:

(i) Profit or loss on redemption of debenture arises only on sale or cancellation; if debentures are purchased but not cancelled the total amount paid (minus the interest to the date of purchase, if the transaction is cum-interest) should be debited to Own Debentures Account and shown as investment in the Balance Sheet. On cancellation, the account will be credited and Debenture Account debited: the difference between the nominal value of the debentures cancelled and the amount standing to the debit on Own Debentures Account will be profit or loss on redemption of debentures.

(ii) If debentures are straightway cancelled on purchase, the profit or loss on redemption of debentures will be ascertained by comparing (i) the nominal value of debentures cancelled, and (ii) the price paid less interest to the date of purchase (if the transaction is cum-interest).

(iii) In case the transaction is ex-interest, the interest to the date of transaction will be paid in addition to the settled price and hence profit on redemption will be nominal value minus the settled price.

Illustration 14

The following balances appeared in the books of a company as on December 31,2018: 6% Mortgage 10,000 debentures of ₹ 100 each; Debenture Redemption Reserve (for redemption of debentures) ₹ 10, 42,000; Investment ₹ 5,28,000, 4% Government Loan purchased at par and ₹ 5,60,000, 3-1/2% Government paper purchased for ₹ 5,42,000.

The Interest on debentures had been paid up to December 31, 2018.

On February 28, 2019, the investments were sold at ₹ 90 and ₹ 87 respectively and the debentures were paid off at 101, together with accrued interest.

Write up the ledger accounts concerned. The Debenture Redemption Reserve is non-cumulative.

Solution

6% Mortgage Debentures Account

2019		₹	2019		₹
Feb. 28	To Debenture-holders A/c	10,00,000	Jan. 1	By Balance b/d	10,00,000

Premium on Redemption of Debentures Account

2019		₹	2019		₹
Feb. 28	To Debenture-holders A/c	10,000	Feb. 28	By D.R.R. A/c	10,000

Debentures Redemption Reserve Investment Account

2019		₹	2019		₹
Jan. 1	To Balance b/d (5,28,000 + 5,42,000)	10,70,000	Feb. 28	By Bank ₹ 5,28,000 Govt. Loan @ ₹ 90	4,75,200
				By Bank ₹ 5,60,000 Govt. Paper @ ₹ 87	4,87,200
				By D.R.R. (Loss)	1,07,600
		10,70,000			10,70,000

Debenture Interest Account

2019		₹	2019		₹
Feb. 28	To Cash (10,000 x 100 x 6% x 2/12)	10,000	Feb. 28	By Profit & Loss A/c	10,000

Cash Account

2019		₹	2019		₹
Feb.	To Balance b/d	?	Feb. 28	By Debenture-holders (10,000 x 101)	10,10,000
	To Debentures Redemption Reserve investment A/c (4,75,200 + 4,87,200)	9,62,400		By Deb. Interest A/c	10,000
				By Balance c/d	?

Debenture Redemption Reserve Account

2019		₹	2019		₹
Feb.	To D.R.R. Investment Account (Loss)	1,07,600	Jan. 1	By Balance b/d	10,42,000
	To Premium on Redemption of Debentures A/c	10,000		By Profit & Loss (b.f.)	75,600
	To General Reserve	10,00,000			
		11,17,600			11,17,600

Illustration 15

Sathyam Limited issued ₹ 1,50,000 5% Debentures on which interest is payable half yearly on 31st March and 30th September. The company has power to purchase debentures in the open market for cancellation thereof. The following purchases were made during the year ended 31st December, 2018 and the cancellation were made on the following 31st March:

1st March ₹ 25,000 nominal value purchased for ₹ 24,725 ex-interest.

1st September ₹ 20,000 nominal value purchased for ₹ 20,125 cum-interest.

You are required to draw up the following accounts up to the date of cancellation:

(i) Debentures Account;

(ii) Own Debenture Investment Account; and

(iii) Debenture Interest Account.

Ignore taxation and make calculations to the nearest rupee.

Solution

Sathyam Limited Debenture Account

2018		₹	2018		₹
Dec. 31	To Balance c/d	1,50,000	Jan. 1	By Balance b/d	1,50,000
2019			2019		
Mar. 31	To Own Debenture A/c	45,000	Jan. 1	By Balance b/d	1,50,000
	To Balance c/d	1,05,000			
		1,50,000			1,50,000
			April. 1	By Balance b/d	1,05,000

Own Debenture Investment Account

2018		Nominal Cost ₹	Interest ₹	Cost ₹	2018		Nominal Cost ₹	Interest ₹	Cost ₹
Mar. 1	To Bank	25,000	521	24,725	Mar. 31	By Debenture Interest A/c	—	625	—
Sep. 1	To Bank	20,000	417	19,708					
Dec. 31	To P & L A/c (b.f.)		1,375		Sep. 30	By Debenture Interest A/c	—	1,125	—
					Dec. 31	By Debenture Interest A/c	—	563	—
						By Balance c/d	45,000	—	44,433
		45,000	2,313	44,433			45,000	2,313	44,433

2019					2019				
Jan. 1	To Balance b/d	45,000		44,433	Mar. 31	By Debenture Interest A/c	—	563	—
Mar. 31	To Capital Reserve (Profit on cancellation) (b.f.)	—	—	567		By 5% Deb. A/c	45,000	—	45,000
	To P & L A/c	—	563	—					
		45,000	563	45,000			45,000	563	45,000

1. March 1 – To Bank – Interest = 25,000 × 5% × 5/12 = 521
2. September 1 – To bank – Interest = 20,000 × 5% × 5/12 = 417
3. Cost = 20125 – 417 = 19708

Debenture Interest Account

2018		₹	2018		₹
Mar-31	To Bank (on ₹ 125000 @ 5% for 6 months)	3125	Jan. 1	By Accrued Interest (on ₹ 150000 @ 5% for 3 months)	1,875
	To Interest on own Debentures (25000 × 5% × 6/12)	625	Dec. 31	By P & L A/c	7,500
Sep-30	To Bank (on ₹ 105000 @ 5% for 6 months)	2625			
	To Interest on own Debentures (25000 × 5% × 6/12)	1125			
	To Interest accrued (on ₹ 1,05,000 for 3 months @ 5%)	1312			
	To Interest on own debentures (on ₹ 45,000 for 3 months @ 5%)	563			
		9375			**9375**
2019			2019		
Mar-31	To Bank (on ₹ 105000 @ 5% for 6 months)	2625	Jan-01	By Interest Accrued	1,312
	To Interest on own debentures (on ₹ 45,000 for 3 months @ 5%)	563	Mar-31	By P & L A/c	1876
		3188			**3188**

Illustration 15

SS Ltd. had the following among their ledger opening balances on January 1, 2018:

	₹
11% Debentures A/c (2000 issue)	50,00,000
Debenture Redemption Reserve A/c	45,00,000
13.5% Debentures in XX Ltd. A/c (Face Value ₹ 20,00,000)	19,50,000
Own Debentures A/c (Face value ₹ 20,00,000)	18,50,000

As 31st December, 2018 was the date for redemption of the 2000 debentures, the company started buying own debentures and made the following purchases in the open market:

1-2-2018 2,000 debentures at ₹ 98 cum-interest.

1-6-2018 2,000 debentures at ₹ 99 ex-interest.

Half yearly interest is due on the debentures on the 30th June and 31st December in the case of both the companies.

On 31st December, 2018, the debentures in XX Ltd. were sold for ₹ 95 each ex-interest. On that date, the outstanding debentures of SS Ltd. were redeemed by payment and by cancellation.

Show the entries in the following ledger accounts of SS Ltd. during 2018:

(a) Debenture Redemption Reserve A/c

(b) Own Debentures A/c

The face value of a debenture was ₹ 100 (Round off calculations to the nearest rupee.)

Solution

(a) **Debenture Redemption Reserve Account**

2018		₹	2018		₹
Dec. 31	To 13.5% Deb. in XX Ltd. (Loss on sale of investment)	50,000	Jan. 1	By Balance b/d	45,00,000
			Dec. 31	By 13.5% Deb. in XX Ltd.	2,70,000
				By Own Deb. A/c (Int. on own Deb.)	2,53,000
	To General Reserve (transfer) (b.f.)	49,73,000			
		50,23,000			50,23,000

11% Debentures Account

2018		₹	2018		₹
Dec. 31	To Own Debentures A/c	24,00,000	Jan. 1	By Balance b/d	50,00,000
	To Bank	26,00,000			
		50,00,000			50,00,000

(b) **Own Debentures Account**

		Nominal	Int.	Amt.			Nominal	Int.	Amt.
2018		₹	₹	₹	2018		₹	₹	₹
Jan. 1	To Balance b/d	2000000	-	1850000	June 30	By Debenture Int. A/c		132000	
Feb. 1	To Bank	200000	1833	194167	Dec. 31	By Debenture Int. A/c		132000	
June 1	To Bank	2,00000	9167	198000		By 11% Deb Account (cancellation)	2400000		2400000
Dec. 31	To Capital Res. (profit on cancellation) (b.f.)			157833					
	To Deb. Redemption Reserve (b.f.)		253000						
		2400000	264000	2400000			2400000	264000	2400000

1. Feb-1 – Bank – Interest = 2 ,00,000 x 11% x 1/12 = 1833
2. Feb-1 – Bank – Amount = (2,000 x 98) – 1,833 = 194167
3. Jun-30 – Debenture Interest – Interest = 24,00,000 x 11% x 6/12 = 132000
4. Jun-1 – Bank – Interest = 2,00,000 x 11% x 5/12 = 9167
5. Jun-1 – Bank – Amount = 2,000 x 99 = 198000
6. Dec-31 – Debenture Interest – Interest = 24,00,000 x 11% x 6/12 = 132000

Working Note:

13.5% Debentures in XX Ltd.

		Interest	Amount			Interest	Amount
2018		₹	₹	2018		₹	₹
Jan. 1	To Balance b/d (20,00,000)		1950000	June 30	By Bank (20,00,000 × 13.5% × 6/12)	135000	
				Dec. 31	By Bank (20,00,000 × 13.5% × 6/12)	135000	
Dec. 31	To Debenture Redemption. Reserve (1,35,000 + 1,35,000)	270000			By Bank (20,00,000 × 95/ 100)		1900000
					By Debenture Redemption Reserve (Loss on sale) (19,50,000 – 19,00,000)		50000
		270000	1950000			270000	1950000

Illustration 16

The following balances appeared in the books of P Ltd on 1-4-2018:

(i) 12 % Debentures ₹ 7,50,000

(ii) Balance of DRR ₹ 6,00,000

(iii) DRR Investment 6,00,000 represented by 10% ₹ 6,50,000 secured bonds of government of India.

Annual contribution to the DRR was ₹ 1,20,000 made on 31st March each year. On 31-3-2019, balance at bank was ₹ 3,00,000 before receipt of interest. The company sold the investment at 90% of cost, for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st march, 2019:

(1) Debentures Account

(2) DRR Account

(3) DRR Investment Account

(4) Bank Account

(5) Debenture Holders Account.

Solution

1. **12% Debentures Account**

Date	Particulars	₹	Date	Particulars	₹
31st March, 2019	To Debenture holders A/c	7,50,000	1st April, 2018	By Balance b/d	7,50,000
		7,50,000			7,50,000

2. **DRR Account**

Date	Particulars	₹	Date	Particulars	₹
31st March, 2019	To 10% Secured Bond A/c (loss) (6,00,000 – 5,85,000)	15,000	1st April, 2018	By Balance b/d	6,00,000
31st March, 2019	To General reserve A/c (Bal. fig.)	7,70,000	31st March, 2019	By Profit and loss A/c	1,20,000
				By Interest on DRR A/c [(Interest on 10% stock (₹ 6,50,000 x 10%)]	65,000
		7,85,000			7,85,000

3. **10% Secured Bonds of Govt. (DRR Investment) A/c**

		₹			₹
1st April, 2018	To Balance b/d	6,00,000	31st March, 2019	By Bank A/c (6,50,000 x 90%) = 5,85,000)	5,85,000
				By DDR A/c	15,000
		6,00,000			6,00,000

4. **Bank A/c**

		₹			₹
31st March, 2019	To Balance b/d To Interest (6,50,000 x 10%) To DRR Investment A/c	3,00,000 65,000 5,85,000	31st March, 2019	By 12% Debenture By Balance c/d	8,25,000 1,25,000
		9,50,000			9,50,000

5. **Debenture holders A/c**

		₹			₹
31st March, 2019	To Bank A/c	8,25,000	31st March, 2019	By 12% Debentures By Premium on redemption of debentures @ 10%	7,50,000 75,000
		8,25,000			8,25,000

Illustration 17

The Summary Balance Sheet of X Co. Ltd. on 31st March, 2018 read as under:

Liabilities	₹	Assets	₹
Share Capital :		Freehold property	1,15,000
Authorised:		Stock	135000
30,000 Equity Shares of ₹ 10 each	3,00,000	Trade receivables	75,000
Issued and Subscribed:		Cash	30,000
20,000 Equity Shares of ₹ 10 each fully paid	2,00,000	Balance at Bank	2,00,000
Profit and Loss Account	120000		
12% Debentures	120000		
Trade payables	1,15,000		
	5,55,500		5,55,000

At the Annual General Meeting it was resolved:

(a) To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution), this option being taken up by all shareholders.

(b) To issue one bonus share for every four shares held.

(c) To repay the debentures at a premium of 3%.

Give the necessary journal entries and the company's Balance Sheet after these transactions are completed.

Solution

Journal of X Co. Ltd.

		Dr. (₹)	Cr. (₹)
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
(Application money received on 5,000 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c To Securities Premium A/c			50,000 25,000
(Share application money on 5,000 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account)			
Securities Premium A/c Profit & Loss A/c	Dr. Dr.	25,000 25,000	
To Bonus to Shareholders A/c			50,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:4 (refer note below)			
Bonus to Shareholders A/c	Dr.	50,000	
To Equity Share Capital A/c			50,000
(Issue of bonus shares in the ratio of 1 for 4)			
12% Debentures A/c	Dr.	1,20,000	
Premium Payable on Redemption A/c @ 3%	Dr.	3,600	
To Debenture holders A/c			1,23,600
(Amount payable to debentures holders)			
Profit & Loss A/c	Dr.	3,600	
To Premium Payable on Redemption A/c			3,600
(Premium payable on redemption charged to Profit & Loss A/c)			
Debenture holders A/c	Dr.	123,600	123,600
To Bank A/c			
(Amount paid to debenture holders on redemption)			

Note:

The number of bonus shares issued has been calculated on the basis of issued capital before rights issued i.e., 20,000 shares (and not 25,000 shares after rights issue).

Balance Sheet of X Co. Ltd. as on. (after completion of transactions)

Particulars	Note No	₹
I. Equity and liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	3,00,000
(b) Reserves and Surplus	2	91,400
(2) Current Liabilities		
(a) Trade payables		1,15,000
Total		5,06,400
II. Assets		

(1) Non-current assets		
(a) Fixed assets		
(i) Tangible Assets	3	1,15,000
(2) Current assets		
(a) Inventories		1,35,000
(b) Trade receivables		75,000
(c) Cash and bank balances	4	1,81,400
Total		5,06,400

Notes to Accounts

		₹	₹
1.	Share Capital 30,000 shares of ₹ 10 each fully paid (5,000 shares of ₹ 10 each, fully paid issued as bonus shares out of securities premium and P&L Account)		3,00,000
2.	Reserve and Surplus Profit & Loss Account (1,20,000 – 3,600)	1,16,400	
3.	Tangible assets Freehold Property		1,15,000
4.	Cash and bank balances Cash at Bank (2,00,000 + 75,000 – 1,23,600) Cash in Hand	1,51,400 30,000	1,81,400

Illustration 18

The summarised Balance Sheet of Zee Limited, as on 30th June, 2018, stood as follows:

Liabilities	₹
Share Capital : 5,00,000 equity shares of ₹ 10 each fully paid	50,00,000
General Reserve	75,00,000
Debenture Redemption Reserve	50,00,000
13.5% Convertible Debentures, 1,00,000 Debentures of ₹ 100 each	1,00,00,000
Other loans	50,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000
Assets :	
Fixed Assets (at cost less depreciation)	1,60,00,000
Debenture Redemption Reserve Investments	40,00,000
Cash and bank Balances	50,00,000
Other Current Assets	2,00,00,000
	4,50,00,000

The debentures are due for redemption on 1st July, 2018. The terms of issue of debentures provided that they were redeemable at a premium 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares at a predetermined price of ₹ 15.75 per share and the payment in cash.

Assuming that:

i) except for 100 debenture holders holding totally 25,000 debentures, the rest of them exercised the option for maximum conversion.

ii) the investments realise ₹ 44 lakhs on sale; and

iii) all the transactions are put through, without any lag, on 1st July, 2018.

Redraft the balance sheet of the company as on 1st July, 2018 after giving effect to the redemption. Show your calculations in respect of the number of equity shares to be allotted and the cash payment necessary.

Solution

Zee Limited Balance Sheet as on July 1, 2018

Particulars	Note No	Figures as at the end of current reporting period
		₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	60,00,000
(b) Reserves and Surplus	2	1,29,75,000
(2) Non-Current Liabilities		
(a) Long-term borrowings - Unsecured Loans		50,00,000
(3) Current Liabilities		
(a) Short-term provisions		1,25,00,000
Total		3,64,75,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(b) Tangible assets		1,60,00,000
(2) Current assets		
(a) Cash and bank balances		4,75,000
(b) Other current assets		2,00,00,000
Total		3,64,75,000

Notes to Accounts

			₹
1	Share Capital		
	6,00,000 Equity Shares (5,00,000 + 1,00,000) of ₹ 10 each		60,00,000

2	Reserves and Surplus		
	General Reserve	75,00,000	
	Add : Debenture Redemption Reserve transfer	50,00,000	
		1,25,00,000	
	Add: Profit on sale of investments (44,00,000 – 40,00,000)	4,00,000	
		1,29,00,000	
	Less: Premium on redemption of debentures	(5,00,000)	1,24,00,000
	Securities Premium Account (1,00,000 x 5.75)		5,75,000
			1,29,75,000

Working Notes

(i) **Calculation of number of shares to be allotted:**

Total number of debentures	1,00,000
Less: Number of debentures not opting for conversion	(25,000)
	75,000
20% of 75,000	15,000
Redemption value of 15,000 debentures (15,000 x 105)	₹ 15,75,000

Number of Equity Shares to be allotted:

$\frac{15,75,000}{15.75}$ = = 1,00,000 shares of ₹ 10 each.

(ii) **Calculation of cash to be paid:**

	₹
Number of debentures	1,00,000
Less: number of debentures to be converted into equity shares	(15,000)
	85,000
Redemption value of 85,000 debentures (85,000 × ₹ 105)	₹ 89,25,000

(iii) **Cash and Bank Balance:**

Balance before redemption	50,00,000
Add: Proceeds of investments sold	44,00,000
	94,00,000
Less: Cash paid to debenture holders	(89,25,000)
	4,75,000

Note: The premium on redemption of debentures can also be adjusted against Securities Premium Account.

MODULE – IV

PREPARATION OF FINANCIAL STATEMENTS

IND AS 1 – Presentation of Financial Statements

Components of Financial Statements

A complete set of financial statements comprises:

- A balance sheet at the end of the period
- Statement of profit and loss for the period
- Statement of changes in equity for the period
- Statement of cash flows for the period
- Notes comprising a summary of significant accounting policies and other explanatory information
- Comparative information in respect of the preceding period as specified in paragraphs 38 and 38A
- A balance sheet as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements in accordance with paragraphs 40A–40D

All statements are required to be presented with equal prominence.

Overall Considerations (General Features)

1. **True and fair presentation and compliance with IND ASs,** Financial statements are required to be presented fairly as set out in the framework and in accordance with IND AS and are required to comply with all requirements of IND ASs.

2. **Going concern:** Financial statements are required to be prepared on a going concern basis (unless entity is in liquidation or has ceased trading or there is an indication that the entity is not a going concern).

3. **Accrual basis of accounting:** Entities are required to use accrual basis of accounting except for cash flow information.

4. **Presentation Consistency:** An entity is required to retain presentation and classification from one period to the next.

5. **Materiality and aggregation:** An entity shall present separately:
   - each material class of similar items
   - items of a dissimilar nature or function unless they are immaterial except when required by law separately**.**
6. **Offsetting:** Offsetting of assets and liabilities or income and expenses is not permitted unless required by other IND Ass.

7. **Comparative information:** At least 1 year of comparative information.

Structure and Contents of Financial Statements

Identification of Financial Statements

Financial statements must be clearly identified and distinguished from other information in the same published document, and must identify:

- Name of the reporting entity
- Whether the financial statements cover the individual entity or a group of entities
- The date of financial statements (or the period covered)
- The presentation currency
- The level of rounding used

Notes to the Financial Statements

- Statement of compliance with IND ASs.
- Significant accounting policies, estimates, assumptions, and judgements must be disclosed
- Additional information useful to users understanding / decision making to be presented
- Information that enables users to evaluate the entity's objectives, policies and processes for managing capital

Balance sheet

The balance sheet shall include line items that present the following amounts:

(a) Property, plant and equipment;
(b) investment property;
(c) intangible assets;
(d) financial assets (excluding amounts shown under (e), (h) and (i));
(e) investments accounted for using the equity method;
(f) biological assets within the scope of Ind AS 41 Agriculture;
(g) inventories;
(h) trade and other receivables;
(i) cash and cash equivalents;
(j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations;
(k) trade and other payables;
(l) provisions;
(m) financial liabilities (excluding amounts shown under (k) and (l));
(n) liabilities and assets for current tax, as defined in Ind AS 12, Income Taxes;
(o) deferred tax liabilities and deferred tax assets, as defined in Ind AS 12;
(p) liabilities included in disposal groups classified as held for sale in accordance with Ind AS 105;
(q) non-controlling interests, presented within equity; and
(r) issued capital and reserves attributable to owners of the parent.

When an entity presents current and non-current assets, and current and noncurrent liabilities, as separate classifications in its balance sheet, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).

Current assets

- Expected to be realised in, or is intended for sale or consumption in the entity's normal operating cycle
- Held primarily for trading
- Expected to be realised within 12 months
- Cash or cash equivalents.

All other assets are required to be classified as non-current.

Current liabilities

- Expected to be settled in the entity's normal operating cycle
- Held primarily for trading
- Due to be settled within 12 months
- The entity does not have an unconditional right to defer settlement of the liability for at least 12 months.

All other liabilities are required to be classified as non-current.

Current/non-current distinction

Whichever method of presentation is adopted, an entity shall disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled:

(a) no more than twelve months after the reporting period, and
(b) more than twelve months after the reporting period.

Reporting Period

- Accounts presented at least annually
- If longer or shorter, entity must disclose that fact.

Statement of Cash Flows

Provides users of financial statements with cash flow information

Statement of Profit/Loss

- An entity shall present a single statement of profit and loss, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the profit or loss section presented first followed directly by the other comprehensive income section

- Entities shall present an analysis of expense recognised in profit or loss using a classification based on the nature of expense method

- Line items within other comprehensive income are required to be categorised into two categories: - Those that could subsequently be reclassified to profit or loss - Those that cannot be re-classified to profit or loss.

Third Balance Sheet

An entity shall present a third balance sheet as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38A if:

- it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

- the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the balance sheet at the beginning of the preceding period.

Statement of Changes in Equity

Information required to be presented:

- Total comprehensive income for the period, showing separately attributable to owners or the parent and non-controlling interest.

- For each component of equity, the effects of retrospective application / restatement recognised in accordance with IND AS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

- For each component in equity a reconciliation between the carrying amount at the beginning and end of the period, separately disclosing each change.

- Amount of dividends recognised as distributions to owners during the period (can alternatively be disclosed in the notes.

- Analysis of each item of OCI (alternatively to be disclosed in the notes).

Illustration 1

From the following information, prepare Statement of Changes in Equity of XYZ LTD. for the period ended 31st March, 2017:

Share Capital in the beginning	₹ 200 crores
Retained Earnings in the beginning	₹ 400 crores
Securities Premium in the beginning	₹ 200 crores
Capital Redemption Reserve in the beginning	₹ 200 crores
Revaluation Reserve in the beginning	₹ 200 crores
Prior period errors resulting in increase in profits	₹ 20 crores
Changes in Accounting Policy resulting in increase in profits	₹ 40 crores
Net profit for the period	₹ 80 crores
Revaluation Gain on Non-current Fixed Assets	₹ 40 crores
Fair value changes of financial assets held as available for sale	₹ 80 crores
Effective portion of upward change in fair value of hedging instruments in cash flow hedges	₹ 20 crores
Actuarial gain on defined benefit plans	₹ 20 crores
Dividends payments	₹ 20 crores
Issue of 2 crore new shares of ₹ 10 each at ₹ 100 each	
Buy back of 80 lacs shares of ₹ 10 each at ₹ 50 each out of Securities Premium	
Issue of bonus shares out of capital redemption reserve	₹180 crores

Solution

Statement of Changes in Equity of XYZ Ltd. for the period ended 31st March, 2017

Particulars	Share Capital	Reserves & Surplus				Total Equity
		Retained Earnings	Securities Premium	Capital Red. Reserve	Revaluation Reserve	
A. Balance in the beginning	200	400	200	200	200	1200
B. Corrections of prior period errors		20				20
C. Changes in Accounting Policy		40				40
D. Re-stated Bal. in the beginning. (A+B+C)	200	460	200	200	200	1260
E. Net Income for the period		80				80
F. Effect of Revaluation						
(i) Revaluation of Non-Current Fixed Assets					40	40
(ii) Change in re-measuring of financial assets held as available for sale					80	80
(iii) Effective portion of change in fair value of hedging instruments in cash flow hedges					20	20
(iv) Actuarial gains and losses on defined benefit plans					20	20
Total (F)	0	0	0	0	160	160
G. Transaction with Shareholders						
(i) Dividends		(20)				(20)
(ii) Issue of New Shares	20		180			200
(iii) Buy Back of Shares	(8)	(8)	(32)	8		(40)
(iv) Issue of Bonus Shares	180			(180)		0
Total (G)	192	(28)	148	(172)	0	140
H. Balance at the end (D + E + F + G)	392	512	348	28	360	1640

Illustration 2

ML Ltd presents you the summarized trail balance for the year 31/3/2015. (₹ crores).

Debit item	Amount (₹)	Credit item	Amount (₹)
Employee cost	50.45	Share Capital (₹1)	100.00
Depreciation	46.30	P/L 1/4/2014	10.00
Cost of materials consumed	110.44	Securities Premium	16.41
Other expenses	14.33	Revaluation reserve	7.33
Current assets	130.42	Current liabilities	75.64
Fixed Assets	445.60	Debentures	10.00
		Sales and Services	578.16
	797.54		**797.54**

Adjustments:

1) Employee cost includes ₹ 2.30 on account of actuarial loss.
2) On 31/3 fixed assets were upward revalued by 20% (not yet accounted)
3) During the year Equity shares were raised 10 crores shares @ premium of ₹1.
4) Dividend declared 12% (not yet accounted).

Draw P/L including OCI, Statement of changes in Equity and Balance Sheet as per Ind AS – 1.

Solution

P/L as on 31/3/2015

Particulars	₹ in *crores*
Sales and Services	578.16
Expenditure:	
Employee cost (excluding actuarial loss)	(48.15)
Depreciation	(46.30)
Cost of materials consumed	(110.44)
Other expenses	(14.33)
NP from ordinary activities..................(a)	**358.94**
Other Comprehensive Income	
Revaluation reserve	89.12
Actuarial loss	(2.30)
Total ....(b)	**86.82**
Net Profit c/f .... (a+b)	**445.76**

Note: Share of Non - Controlling Interest is not applicable.

Statement of Changes in Equity

Particulars	Share Capital	Securities Premium	Revaluation Reserves	Revenue Reserves	Total
As on 1/4/2014	90	6.41	7.33	10	113.74
Fresh issue	10	10			20
Addition			89.12	356.64	445.76
Less: Dividends				(12)	(12)
Net	100	16.41	96.45	354.64	567.50

Balance Sheet as on 31/3/2015

	Amount (₹)
Share Capital (₹1)	100
Reserves and Surplus (W.N 1)	467.5
Debentures	10
Current liabilities	75.64
Provisions – Dividend	12
Total (E+L) =	665.14
Fixed Assets (445.60+20% of 445.60)	534.72
Current Assets	130.42
	665.14

Working Note 1:

Reserves and Surplus

	Amount (₹)
P/L balance	354.64
Securities Premium	16.41
Revaluation reserve	96.45
Total	467.5

Illustration 3

The following is the Trial Balance of Triveni Limited as on 31.3.2018:

(Figures in ₹ '000)

	Debit		*Credit*
Land at cost	*220*	*Equity Capital (Shares of ₹ 10 each)*	*300*
Plant & Machinery at cost	*770*	*10% Debentures*	*200*
Trade Receivables	*96*	*General Reserve*	*130*
Inventories (31.3.18)	*86*	*Profit & Loss A/c*	*72*
Bank	*20*	*Securities Premium*	*40*
Adjusted Purchases	*320*	*Sales*	*700*
Factory Expenses	*60*	*Trade Payables*	*52*
Administration Expenses	*30*	*Provision for Depreciation*	*172*
Selling Expenses	*30*	*Suspense Account*	*4*
Debenture Interest	*20*		
Interim Dividend Paid	*18*		
	1670		*1670*

Additional Information:

(i) *The authorised share capital of the company is 40,000 shares of ₹ 10 each.*

(ii) *The company on the advice of independent valuer wish to revalue the land at ₹ 3,60,000.*

(iii) *Declared final dividend @ 10%.*

(iv) *Suspense account of ₹ 4,000 represents cash received for the sale of some of the machinery on 1.4.2017. The cost of the machinery was ₹ 10,000 and the accumulated depreciation thereon being ₹ 8,000.*

(v) *Depreciation is to be provided on plant and machinery at 10% on cost.*

You are required to prepare Triveni Limited's Balance Sheet as on 31.3.2018 and Statement of Profit and Loss with notes to accounts for the year ended 31.3.2018 as per Schedule III. Ignore previous years' figures & taxation.

Solution

Triveni Limited
Balance Sheet as at 31st March, 2018

Particulars	*Note No.*	*(₹ in 000)*
Equity and Liabilities		
1. Shareholders' funds		
a Share capital	1	300
b Reserves and Surplus	2	500
2. Non-Current liabilities		
a Long term borrowings	3	200
3. Current liabilities		
a Trade Payables		52
b Other Current Liability	4	30
Total		**1082**
Assets		
1. Non-current assets		
a. PPE (Property, Plant & Equipment)		
i. Tangible assets	5	880
2. Current assets		
a Inventories		86
b Trade receivables		96
c Cash and bank balances		20
Total		**1082**

Triveni Limited

Statement of Profit and Loss for the year ended 31st March, 2018

	Particulars	*Notes*	*(₹ in 000)*
I.	Revenue from operations		700
II.	Other Income	6	2
III	**Total Revenue**		**702**
IV	Expenses:		
	Purchases		320
	Finance costs	7	20
	Depreciation [10% of 760]		76
	Other expenses	8	120
	Total Expenses		**536**
V.	**Profit (Loss) for the period** (III – IV)		**166**

Notes to accounts

				(₹ in 000)
1.	**Share Capital** Equity share capital			
	Authorised 40,000 shares of ₹ 10 each			400
	Issued & subscribed & called up 30,000 shares of ₹ 10 each			300
	Total			**300**
2.	**Reserves and Surplus**			
	Securities Premium Account			40
	Revaluation reserve (360 – 220)			140
	General reserve			130
	Profit & loss Balance			
	Opening balance	72		
	Profit for the period	166	238	
	Less: Appropriations			
	Interim Dividend		(18)	
	Final Dividend (300 x 10%)		(30)	190
				500
3.	**Long term borrowing**			
	10% Debentures			200

4.	**Other Current Liability**		
	Dividend		30
5.	**Tangible assets**		
	Land		
	Opening balance	220	
	Add: Revaluation adjustment	140	
	Closing balance		360
	Plant and Machinery		
	Opening balance	770	
	Less: Disposed off	(10)	
		760	
	Less: Depreciation (172-8+76)	(240)	
	Closing balance		520
	Total		880
6.	**Other Income**		
	Profit on sale of machinery:		
	Sale value of machinery	4	
	Less: Book value of machinery (10-8)	(2)	2
7.	**Finance costs**		
	Debenture interest		20
8.	**Other expenses:**		
	Factory expenses	60	
	Selling expenses	30	
	Administrative expenses	30	120

Illustration 4

You are required to prepare Balance sheet and statement of Profit and Loss from the following trial balance of Care Chemicals Ltd. for the year ended 31st March, 2018.

Care Chemicals Ltd.
Trial Balance as at 31st March, 2018

Particulars	₹	*Particulars*	₹
Inventory	*6,80,000*	*Equity Shares*	
Furniture	*2,00,000*	*Capital (Shares of ₹ 10 each)*	*25,00,000*
Discount	*40,000*	*11% Debentures*	*5,00,000*
Loan to Directors	*80,000*	*Bank loans*	*6,45,000*

Advertisement	*20,000*	*Trade payables*	*2,81,000*
Bad debts	*35,000*	*Sales*	*42,68,000*
Commission	*1,20,000*	*Rent received*	*46,000*
Purchases	*23,19,000*	*Transfer fees*	*10,000*
Plant and Machinery	*8,60,000*	*Profit & Loss account*	*1,39,000*
Rentals	*25,000*	*Depreciation provision:*	
Current account	*45,000*	*Machinery*	*1,46,000*
Cash	*8,000*		
Interest on bank loans	*1,16,000*		
Preliminary expenses	*10,000*		
Fixtures	*3,00,000*		
Wages	*9,00,000*		
Consumables	*84,000*		
Freehold land	*15,46,000*		
Tools & Equipments	*2,45,000*		
Goodwill	*2,65,000*		
Trade receivables	*4,40,000*		
Dealer aids	*21,000*		
Transit insurance	*30,000*		
Trade expenses	*37,000*		
Distribution freight	*54,000*		
Debenture interest	*55,000*		
	85,35,000		*85,35,000*

Additional information: Closing Inventory on 31-3-2018: ₹ 8,23,000.

Solution

Care Chemicals Ltd.
Balance Sheet as at 31st March, 2018

	Schedule	Rupees as at the No. 31st March 2018
Equity and Liabilities		
(1) Shareholders' Funds		
(a) Share Capital	1	2500000
(b) Reserves and Surplus	2	740000
(2) Non Current Liabilities		
(a) Long term borrowing	3	1145000
(3) Current Liabilities		
(a) Trade payables		281000
Total		**4666000**

Assets (1) Non Current Assets PPE: (a) Tangible assets (b) Intangible assets (Goodwill) (2) Current assets (a) Inventories (b) Trade receivables (c) Cash and bank balances (d) Short term loans and advances	 4	 3005000 265000 823000 440000 553000 680000
Total		**4666000**

Care Chemicals Ltd.
Statement of Profit and Loss for the year ended 31st March, 2018

	Schedule	*Figures*	
Revenue from operations		42,68,000	
Other income	7	56,000	
Total (A)		43,24,000	
Expenses			
Cost of materials consumed	8	23,19,000	
Change in inventory of finished goods	9	(1,43,000)	
Employee benefit expenses	10	9,00,000	
Finance cost	11	1,71,000	
Other expenses	12	4,76,000	
Total (B)		37,23,000	
Profit before tax (A – B)			6,01,000
Provision for tax			Nil
Profit for the period			**6,01,000**

Notes to Accounts

1	**Share capital**	₹	₹
	Authorised:		
	Equity share capital of ₹ 10 each		25,00,000
	Issued and Subscribed:		
	Equity share capital of ₹ 10 each		25,00,000
2	**Reserves and Surplus**		
	Balance as per last balance sheet	1,39,000	

	Balance in profit and loss account		6,01,000	7,40,000
3	**Long term Borrowings**			
	11% Debentures			5,00,000
	Bank loans (assumed long-term)			6,45,000
				11,45,000
4	**Tangible Assets**			
		Gross block	***Depreciation***	***Net Block***
	Freehold land	15,46,000		15,46,000
	Furniture	2,00,000		2,00,000
	Fixtures	3,00,000		3,00,000
	Plant & Machinery	8,60,000	1,46,000	7,14,000
	Tools & Equipment	2,45,000		2,45,000
	Total	31,51,000	1,46,000	30,05,000
5	**Cash and bank balances**			
	Cash and cash equivalents			
	Current account balance			45,000
	Cash			8,000
	Other bank balances			Nil
				53,000
6	**Short-term loans and Advances**			
	Loan to directors			80,000
7	**Other Income**			
	Rent received			46,000
	Transfer fees			10,000
				56,000
8	**Cost of materials consumed**			
	Purchases			23,19,000
9	**Changes in inventory of finished goods, WIP & Stock in trade**			
	Opening inventory		6,80,000	
	Closing inventory		8,23,000	(1,43,000)
10	**Employee benefit expense**			
	Wages			9,00,000
11	**Finance cost**			
	Interest on bank loans			1,16,000
	Debenture interest			55,000
				1,71,000
12	**Other Expenses**			
	Consumables			84,000
	Preliminary expenses			10,000
	Bad debts			35,000

	Discount	40,000
	Rentals	25,000
	Commission	1,20,000
	Advertisement	20,000
	Dealers' aids	21,000
	Transit insurance	30,000
	Trade expenses	37,000
	Distribution freight	54,000
		4,76,000

STATEMENT OF CASH FLOWS – IND AS 7

The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities. This statement provides relevant information in assessing a company's liquidity, quality of earnings and solvency.

Definitions

Cash:

Comprises of cash on hand and demand deposits (not necessarily include demand deposits with banks)

Cash & Cash Equivalents:

- Short term (where the original maturity is 3 months or less)
- Highly liquid investments
- Readily convertible to known amounts of cash
- Subject to insignificant risk of changes in value.

Held for meeting short term cash commitments and not for Investment or other purposes.

Components of Cash Flows

1. **Operating activities**
   Principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
2. **Investing activities**
   Activities that relate to the acquisition and disposal of long-term assets and other investments that are not included in cash equivalents. Only expenditure that results in recognition of an asset in the balance sheet are eligible for classification as Investing Activities.
3. **Financing activities**
   Activities that results in changes to contributed equity and borrowings of an entity. These are the activities that result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise.

Reporting Cash Flows from Operating Activities

Cash flows from operating activities result from the transactions and other events that enter into the determination of net profit or loss. Cash flows from operating activities can be reported using the direct or indirect method.

1. Direct Method

(a) Gross receipts and gross cash payments may be obtained from the accounting records to ascertain cash flows from operating activities.

(b) For example,

(i) information about cash received from trade receivables,

(ii) payment to trade payables, cash expenses etc., which may be obtained by an analysis of cash book.

(c) In actual practice, the relevant information is obtained by adjusting sales, cost of sales and other items in the profit and loss accounts for:

- Changes during the period in inventories and operating receivables and payables;
- Other non-cash items such as depreciation on fixed assets, goodwill written off, preliminary expenses written off, loss or gain on sale of fixed assets etc.; and
- Other items for which the cash effects are investing or financing cash flows. Examples are interest received and paid, dividend received and paid etc., which are related to financing or investing activities and are shown separately in the cash flow statement.

2. Indirect Method

The net cash flow from operating activities is determined by adjusting profit or loss for the effects of:

- Changes during the period in inventories and operating receivables and payables.
- Non-cash items (e.g. depreciation, provisions, deferred taxes, unrealised foreign currency gains and losses etc.)
- Other items of income / expense associated with investing or financing cash flows. (e.g. Interest / Dividend paid)

Classifications of Activities

- Bank Overdrafts which are integral part of an entities cash management are included in as a component of cash & cash equivalent and not as a part of financing activity.

- A single transaction may include cash flows that are classified differently. For eg. in case if a Fixed Asset is acquired on deferral payment basis, then the instalment payment in respect of such fixed asset should be split and interest element on such fixed asset should be classified as financing activity and repayment of loan amount to be classified as investing activity.

- In case an asset is acquired / manufactured for the purpose of being held for rentals to others, then in such a case, payments to acquire / manufacture such asset, receipts from such rents and subsequent sales proceeds from disposal of such assets are disclosed as cash flows from operating activities.

- Interest & Dividend:

  For Financial institutions: Interest Paid & Interest & Dividend received are to be classified as Operating Activities. Dividend paid is to be classified as financing activity.

  For other entities: Interest & dividend received are to be classified as investing activity, interest and dividend paid are required to be classified as Financing activity.

- Total interest paid during a period is to be disclosed in the statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with IND AS 23 Borrowing Costs.

- Cash flows from Taxes on Income shall be classified as cash flows from operating activities unless they can specifically be identified with Financing / Investment activities.

- Cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be classified as investing activities.

- Cash flows arising from changes in ownership interests in a subsidiary without loss of control should be classified as cash flows from financing activities in consolidated cash flow statement as they are accounted for as Equity transactions.

Other Considerations

- Cash flows must be reported on "gross" basis. Presentation on Net basis is permitted only in very limited cases like cash receipts / payments made on behalf of customers (eg. Rent collected on behalf of and paid over to owners of property), or where cash receipts / payments are for items in which turnover is quick, amounts are large and maturities are short (eg. Purchase or sale of investments).

- Cash flows from transactions in foreign currency shall be recorded in entities Functional currency by applying to the foreign currency, exchange rate between the functional currency and foreign currency at the date of cash flow.

- Presentation of items as Extraordinary is not permitted under IND-AS.

- Where the equity method is used for accounting of Investments in Joint Ventures and Associates or cost method for investments in subsidiaries, the statement of cash flows should only reflect cash flows between the entity and the investee.

- Where a jointly controlled entity is proportionately consolidated, the entity should, in consolidated statement of cash flows, include only its proportionate share of the cash flows in the jointly controlled entity.

- Non-cash investing and financing transactions are not to be disclosed in the statement of cash flows though information relevant may be provided elsewhere in the Financial Statements.

Proforma of 'Cash Flow from Operating Activities' by indirect method

		₹
Net Profit for the year		-
Add: Non-Cash and Non-Operating Expenses:	-	
Depreciation	-	
Loss on Sale of Assets	-	
Provision for taxation, etc.	-	
Less: Non-Cash and Non-Operating Incomes:		
Profit on Sale of Assets	-	
Net Profit after Adjustment for Non-Cash Items		(-)

Cash from operation	=	Net Profit (after adjustment for Non-cash Items)
	-	Increase in Current Assets
	+	Decrease in Current Assets
	+	Increase in Current Liabilities
	-	Decrease in Current Liability

Calculation of Cash Flows from Investing Activities

1. These activities are related to the acquisition and disposal of long-term assets, non-operating current assets and investments which results in outflow of cash.
2. Disposal of the aforesaid assets results in inflow of cash.
3. Thus, inflows and outflows related to acquisition and disposal of assets, other than those related to operating activities, are shown under this category.

Calculation of Cash Flows from Financing Activities

1. These activities are basically related to the changes in capital and borrowing of the enterprise which affect flow of cash.
2. Redemption of shares and repayment of borrowings results in outflow of cash.
3. Thus inflows and outflows related to the amount of capital and borrowings of the enterprise are shown under this head.

Illustration 5

Prepare cash flow statement of M/s ABC Ltd. for the year ended 31st March, 2018 with the help of the following information:

(1) Company sold goods for cash only.

(2) Gross Profit Ratio was 30% for the year, gross profit amounts to ₹ 3,82,500.

(3) Opening inventory was lesser than closing inventory by ₹ 35,000.

(4) Wages paid during the year ₹ 4,92,500.

(5) *Office and selling expenses paid during the year ₹ 75,000.*

(6) *Dividend paid during the year ₹ 30,000 (including dividend distribution tax.)*

(7) *Bank loan repaid during the year ₹ 2,15,000 (included interest ₹ 15,000)*

(8) *Trade payables on 31st March, 2017 exceed the balance on 31st March, 2018 by ₹ 25,000.*

(9) *Amount paid to trade payables during the year ₹ 4,60,000.*

(10) *Tax paid during the year amounts to ₹ 65,000 (Provision for taxation as on 31.03.2018 ₹ 45,000).*

(11) *Investments of ₹ 7,00,000 sold during the year at a profit of ₹ 20,000.*

(12) *Depreciation on fixed assets amounts to ₹ 85,000.*

(13) *Plant and machinery purchased on 15th November, 2017 for ₹ 2,50,000.*

(14) *Cash and Cash Equivalents on 31st March, 2017 ₹ 2,00,000.*

(15) *Cash and Cash Equivalents on 31st March, 2018 ₹ 6,07,500.*

Solution

M/s ABC Ltd.

Cash Flow Statement for the year ended 31st March, 2018 (Using direct method)

Particulars	₹	₹
Cash flows from Operating Activities		
Cash sales (₹ 3,82,500/.30)		12,75,000
Less: Cash payments for trade payables	(4,60,000)	
Wages Paid	(4,92,500)	
Office and selling expenses	(75,000)	(10,27,500)
Cash generated from operations before taxes		2,47,500
Income tax paid		(65,000)
Net cash generated from operating activities (A)		1,82,500
Cash flows from investing activities		
Sale of investments (7,00,000 + 20,000)	7,20,000	
Payments for purchase of Plant & machinery	(2,50,000)	
Net cash used in investing activities (B)		4,70,000
Cash flows from financing activities		
Bank loan repayment(including interest)	(2,15,000)	
Dividend paid(including dividend distribution tax)	(30,000)	
Net cash used in financing activities (C)		(2,45,000)
Net increase in cash (A+B+C)		4,07,500

Cash and cash equivalents at beginning of the period		2,00,000
Cash and cash equivalents at end of the period		6,07,500

Illustration 6

The following data were provided by the accounting records of RR Ltd. at yearend, March 31, 2018:

Income Statement

		₹
Sales		*6,98,000*
Cost of Goods Sold		*(5,20,000)*
Gross Margin		*1,78,000*
Operating Expenses (including Depreciation Expense of ` 37,000)		*(1,47,000)*
		31,000
Other Income / (Expenses)		
Interest Expense paid	*(23,000)*	
Interest Income received	*6,000*	
Gain on Sale of Investments	*12,000*	
Loss on Sale of Plant	*(3,000)*	
		(8,000)
		23,000
Income tax		*(7,000)*
		16,000

Comparative Balance Sheets ₹

	31st March	***31st March***
Assets		
Plant Assets	*7,15,000*	*5,05,000*
Less: Accumulated Depreciation	*(1,03,000)*	*(68,000)*
	6,12,000	*4,37,000*
Investments (Long term)	*1,15,000*	*1,27,000*
Current Assets:		
Inventory	*1,44,000*	*1,10,000*
Accounts receivable	*47,000*	*55,000*
Cash	*46,000*	*15,000*
Prepaid expenses	*1,000*	*5,000*
	9,65,000	*7,49,000*

Liabilities		
Share Capital	*4,65,000*	*3,15,000*
Reserves and surplus	*1,40,000*	*1,32,000*
Bonds	*2,95,000*	*2,45,000*
Current liabilities:		
Accounts payable	*50,000*	*43,000*
Accrued liabilities	*12,000*	*9,000*
Income taxes payable	*3,000*	*5,000*
	9,65,000	*7,49,000*

Analysis of selected accounts and transactions during 2017-18

1. *Purchased investments for ₹ 78,000.*
2. *Sold investments for ₹ 1,02,000. These investments cost ₹ 90,000.*
3. *Purchased plant assets for ₹ 1,20,000.*
4. *Sold plant assets that cost` 10,000 with accumulated depreciation of ₹ 2,000 for ₹ 5,000.*
5. *Issued ₹ 1,00,000 of bonds at face value in an exchange for plant assets on 31st March, 2018.*
6. *Repaid ₹ 50,000 of bonds at face value at maturity.*
7. *Issued 15,000 shares of ₹ 10 each.*
8. *Paid cash dividends ₹ 8,000.*

Prepare Cash Flow Statement, using indirect method.

Solution

RR Ltd.

Cash Flow Statement for the year ending 31st March, 2018

	₹	₹
Cash flows from operating activities		
Net profit before taxation	23,000	
Adjustments for:		
Depreciation	37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Interest expense	23,000	
Interest income	(6,000)	
Operating profit before working capital changes	68,000	
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	

Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Cash generated from operations	56,000	
Income taxes paid*	(9,000)	
Net cash generated from operating activities		47,000
Cash flows from investing activities		
Purchase of plant	(1,20,000)	
Sale of plant	5,000	
Purchase of investments	(78,000)	
Sale of investments	1,02,000	
Interest received	6,000	
Net cash used in investing activities		(85,000)
Cash flows from financing activities		
Proceeds from issuance of share capital	1,50,000	
Repayment of bonds	(50,000)	
Interest paid	(23,000)	
Dividends paid	(8,000)	
Net cash from financing activities		69,000
Net increase in cash and cash equivalents		31,000
Cash and cash equivalents at the beginning of the period		15,000
Cash and cash equivalents at the end of the period		46,000

***Working Note:**

	₹
Income taxes paid:	
Income tax expense for the year	7,000
Add: Income tax liability at the beginning of the year	5,000
	12,000
Less: Income tax liability at the end of the year	(3,000)
	9,000

Illustration 7

Given below is the Statement of Profit and Loss of XYZ Ltd. and relevant Balance Sheet information:

XYZ Ltd.
Cash Flow Statement for the year ending
31st March, 2018

	₹ ***in lakhs***

Revenue:	
Sales	*4,150*
Interest and dividend	*100*
Stock adjustment	*20*
Total (A)	*4,270*
Expenditure:	
Purchases	*2,400*
Wages and salaries	*800*
Other expenses	*200*
Interest	*60*
Depreciation	*100*
Total (B)	*3,560*
Profit before tax (A – B)	*710*
Tax provision	*200*
Profit after tax	*510*
Balance of Profit and Loss account brought forward	*50*
Profit available for distribution (C)	*560*
Appropriations:	
Transfer to general reserve	*200*
Declared dividend (including CDT)	*330*
Total (D)	*530*
Balance (C – D)	*30*

Relevant Balance Sheet information	***31.3.2018 ₹ in lakhs***	***31.3.2017 ₹ in lakhs***
Trade receivables	*400*	*250*
Inventories	*200*	*180*
Trade payables	*250*	*230*
Outstanding wages	*50*	*40*
Outstanding expenses	*20*	*10*
Advance tax	*195*	*180*
Tax provision	*200*	*180*

Compute cash flow from operating activities using both direct and indirect method.

Solution

By direct method
Computation of Cash Flow from Operating Activities

	₹ in lakhs		*₹ in lakhs*
Cash Receipts:			
Cash sales and collection from Trade receivables			
Sales + Opening Trade receivables – Closing Trade receivables (A)	4,150 + 250 − 400		4,000
Cash payments:			
Cash purchases & payment to Trade payables			
Purchases + Opening Trade payables – Closing Trade payables	2,400 + 230 − 250		2,380
Wages and salaries paid	800 + 40 − 50		790
Cash expenses	200 + 10 – 20		190
Taxes paid – Advance tax			195
(B)			3,555
Cash flow from operating activities (A – B)			445
By indirect method			
Profit before tax			710
Add: Non-cash items : Depreciation			100
Add: Interest : Financing cash outflow			60
Less: Interest and Dividend : Investment cash inflow			(100)
Less: Tax paid			(195)
Working capital adjustments			
Trade receivables	250 − 400	(150)	
Inventories	180 − 200	(20)	
Trade payables	250 – 230	20	
Outstanding wages	50 – 40	10	
Outstanding expenses	20 − 10	10	(130)
Cash flow from operating activities			445

MODULE V
ACCOUNTING RATIOS

Meaning of Accounting Ratios

Accounting ratios are an important tool of financial statement analysis. A ratio is a mathematical number calculated as a reference to relationship of two or more numbers and can be expressed as a fraction, proportion, percentage, and a number of times. When the number is calculated by referring to two accounting numbers derived from the financial statements, it is termed as accounting ratio.

For example, if the gross profit of the business is Rs. 10,000 and the sales are Rs. 1,00,000, it can be said that the gross profit is 10% (10,000/1,00,000) of the sales. This ratio is termed as gross profit ratio. Similarly, inventory turnover ratio may be 6 which implies that inventory turns into sales six times in a year.

It needs to be observed that accounting ratios exhibit relationship, if any between accounting numbers extracted from financial statements, they are essentially derived numbers and their efficacy depends a great deal upon the basic numbers from which they are calculated. Hence, if the financial statements contain some errors, the derived numbers in terms of ratio analysis would also present an erroneous scenario. Further, a ratio must be calculated using numbers which are meaningfully correlated. A ratio calculated by using two unrelated numbers would hardly serve any purpose.

For example, the furniture of the business is Rs. 1,00,000 and Purchases are Rs. 3,00,000. The ratio of purchases to furniture is 3 (3,00,000/1,00,000) but it hardly has any relevance. The reason is that there is no relationship between these two aspects.

Objectives of Ratio Analysis

Ratio analysis is indispensable part of interpretation of results revealed by the financial statements. It provides users with crucial financial information and points out the areas which require investigation. Ratio analysis is a technique. Which involves regrouping of data by application of arithmetical relationships, though its interpretation is a complex matter. It requires a fine understanding of the way and the rules used for preparing financial statements. Once done effectively, it provides a wealth of information which helps the analyst:

1. To know the areas of the business which need more attention;
2. To know about the potential areas which can be improved with the effort in the desired direction;
3. To provide a deeper analysis of the profitability, liquidity, solvency and efficiency levels in the business;
4. To provide information for making cross sectional analysis by comparing the performance with the best industry standards;
5. To provide information derived from financial statements useful for making projections and estimates for the future.

Advantages of Ratio Analysis

The ratio analysis if properly done improves the user's understanding of the efficiency with which the business is being conducted. The numerical relationships throw light on many latent aspects of the business. If properly analysed, the ratios make us understand various problem areas as well as the bright spots of the business. The knowledge of problem areas help management take care of them in future. The knowledge of areas which are working better helps you improve the situation further. It must be emphasised that ratios are means to an end rather than the end in themselves. Their role is essentially indicative and that of a whistle blower. There are many advantages derived from the ratio analysis. These are summarised as follows:

1. ***Helps understand efficacy of decisions:*** The ratio analysis helps you understand whether the business firm has taken the right kind of operating, investing and financing decisions. It indicates how far they have helped in improving the performance.
2. ***Simplify complex figures and establish relationships:*** Ratios help in simplifying the complex accounting figures and bring out their relationships. They help summarise the financial information effectively and assess the managerial efficiency, firm's credit worthiness, earning capacity, etc.,
3. ***Helpful in comparative analysis:*** The ratios are not be calculated for one year only. When many year figures are kept side by side, they help a great deal in exploring the trends visible in the business. The knowledge of trend helps in making projections about the business which is a very useful feature.
4. ***Identification of problem areas:*** Ratios help business in identifying the problem areas as well as the bright areas of the business. Problem areas would need more attention and bright areas will need polishing to have still better results.
5. ***Enables SWOT analysis:*** Ratios help a great deal in explaining the changes occurring in the business. The information of change helps the management a great deal in understanding the current threats and opportunities and allows business to do its own SWOT (Strength-Weakness-Opportunity-Threat) analysis.
6. ***Various comparisons:*** Ratios help comparisons with certain bench marks to assess as to whether firm, performance is better or otherwise. For this purpose, the profitability, liquidity, solvency, etc. of a business may be compared:
    - i) over a number of accounting periods with itself (Intra-firm Comparison/Time Series Analysis),
    - ii) with other business enterprises (Inter-firm Comparison/Cross-sectional Analysis), and
    - iii) with standards set for that firm/industry (comparison with standard (or industry) expectations).

Limitations of Ratio Analysis

Since the ratios are derived from the financial statements, any weakness in the original financial statements will also creep in the derived analysis in the form of ratio analysis. Thus, the limitations of financial statements also form the limitations of the ratio analysis. Hence, to interpret the ratios, the user should be aware of the rules followed in the preparation of financial statements and also their nature and limitations. The limitations of ratio analysis which arise primarily from the nature of financial statements are as under:

1. ***Limitations of Accounting Data:*** Accounting data give an unwar-ranted impression of precision and finality. In fact, accounting data "reflect a combination of recorded facts, accounting conventions and personal judgements and the judgements and conventions applied affect them materially. For example, profit of the business is not a precise and final figure. It is merely an opinion of the accountant based on application of accounting policies. The soundness of the judgement necessarily depends on the competence and integrity of those who make them and on their adherence to Generally Accepted Accounting Principles and Conventions". Thus, the financial statements may not reveal the true state of affairs and so the ratios will also not give the true picture.
2. ***Ignores Price-level Changes:*** The financial accounting is based on stable money measurement principle. It implicitly assumes that price level changes are either non-existent or minimal. But the truth is otherwise. We are normally living in inflationary economies where the power of money declines constantly. A change in the price level makes analysis of financial statement of different accounting years meaningless because accounting records ignore changes in value of money.
3. ***Ignore Qualitative or Non-monetary Aspects:*** Accounting provides information about quantitative (or monetary) aspects of business. Hence, the ratios also reflect only the monetary aspects, ignoring completely the non-monetary (qualitative) factors.
4. ***Variations in Accounting Practices:*** There are differing accounting policies for valuation of stock, calculation of depreciation, treatment of intangibles, definition of certain financial variables, etc. available for various aspects of business transactions. These variations leave a big question mark on the cross sectional analysis. As there are variations in accounting practices followed by different business enterprises, a valid comparison of their financial statements is not possible.
5. ***Forecasting:*** Forecasting of future trends based only on historical analysis is not feasible. Proper forecasting requires consideration of non-financial factors as well.

Now let us talk about the limitations of the ratios. The various limitations are:

1. ***Means and not the End:*** Ratios are means to an end rather than the end by itself.
2. ***Lack of ability to resolve problems:*** Their role is essentially indicative and of whistle blowing and not providing a solution to the problem.
3. ***Lack of standardised definitions:*** There is a lack of standardised definitions of various concepts used in ratio analysis. For example, there is no standard definition of liquid liabilities. Normally, it includes all current liabilities, but sometimes it refers to current liabilities less bank overdraft.
4. ***Lack of universally accepted standard levels:*** There is no universal yardstick which specifies the level of ideal ratios. There is no standard list of the levels universally acceptable, and, in India, the industry averages are also not available.
5. ***Ratios based on unrelated figures:*** A ratio calculated for unrelated figures would essentially be a meaningless exercise. For example, creditors of Rs. 1,00,000 and furniture of Rs. 1,00,000 represent a ratio of 1:1. But it has no relevance to assess efficiency or solvency.

Hence, ratios should be used with due consciousness of their limitations while evaluate the performance of an organisation and planning the future strategies for its improvement.

Types of Ratios

There is a two way classification of ratios:

(1) Traditional classification, and

(2) Functional classification.

The traditional classification has been on the basis of financial statements to which the determinants of ratios belong. On this basis the ratios are classified as follows:

1. **Income Statement Ratios:** A ratio of two variables from the income statement is known as Income Statement Ratio. For example, ratio of gross profit to sales known as gross profit ratio is calculated using both figures from the income statement.

2. **Balance Sheet Ratios:** In case both variables are from balance sheet, it is classified as Balance Sheet Ratios. For example, ratio of current assets to current liabilities known as current ratio is calculated using both figures from balance sheet.

3. **Composite Ratios:** If a ratio is computed with one variable from income statement and another variable from balance sheet, it is called Composite Ratio. For example, ratio of credit sales to debtors and bills receivable known as debtor turnover ratio is calculated using one figure from income statement (credit sales) and another figure from balance sheet (debtors and bills receivable).

Although accounting ratios are calculated by taking data from financial statements but classification of ratios on the basis of financial statements is rarely used in practice. It must be recalled that basic purpose of accounting is to throw useful light on the financial performance (profitability) and financial position (its capacity to raise money and invest them wisely) as well as changes occurring in financial position (possible explanation of changes in the activity level).

As such, the alternative classification (functional classification) based on the purpose for which a ratio is computed, is the most commonly used classification which reach as follows:

1. **Liquidity Ratios:** To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. They are essentially short-term in nature.

2. **Solvency Ratios:** Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. They are essentially long-term in nature, and

3. **Activity (or Turnover) Ratios:** This refers to the ratios that are calculated for measuring the efficiency of operation of business based on effective utilisation of resources. Hence, these are also known as 'efficiency ratios'.

4. **Profitability Ratios:** It refers to the analysis of profits in relation to sales or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as 'Profitability Ratios'.

1. Liquidity Ratio

Liquidity ratio helps in measuring the cash sufficiency of an enterprise to pay off its short-term liabilities. A High liquidity ratio ensures the company is in a good position to pay its creditors. The liquid ratio of 2 or more is considered acceptable. Listed below are some of the commonly used liquidity ratios:

Sl.No	Ratio Name	Formula	Used for	Detail
1	Current Ratio	{(Current Assets)/(Current Liabilities)}	1. One of the commonly used liquidity ratios is the current ratio which compares the current assets to current liabilities held by the business	Current assets include cash, inventory, accounts receivable etc.,
			2. This ratio is used to check if the company will be able to pay its debts which are due in next 12 months	Current liabilities include accounts payable, income tax payable and any other current liabilities
2	Quick Ratio	{(Quick Assets)/(Current Liabilities)}	1. It is similar to current ratio except that this uses only quick assets which are easy to liquidate.	To calculate the Quick assets, inventory and prepaid expenses which are difficult to liquidate are to be removed from the current assets.
			2. This is also known as Acid test	
3	Cash Ratio	{(Cash + Marketable securities)/(Current Liabilities)}	1. This ratio considers only those current assets which are immediately available to the company to pay its debts.	Only cash and marketable securities are considered for current assets.

			2. Business is considered as financially sound if it has a cash ratio of 1 or more.	

2. Profitability Ratio

Profitability ratio is generally used to determine how well the business is generating profits from its operations. Profit is the balance of income earned after deducting all related expenses. Given below are some of the commonly used profitability ratios:

Sl.No	Particular	Formula	Used for	Detail
1	Gross Profit Margin	{(Revenue – Cost of Goods Sold (COGS))/(Revenue)}	1. Higher the gross profit margin, more efficient is the business operation.	Revenue is the sales income and COGS includes raw material, labour, and other production expenses
			2. Gross Profit ratio is used to compare the business performance with its previous period or even with its competitors	
2	Operating Margin	{(Gross Profits-Operating Expense)/(Revenue)}	1. Unlike Gross profit ratio, this includes more expenses and hence it is used to ascertain companies profitability more efficiently	From the gross profits, operating expenses such as selling and distribution cost, administration cost etc are deducted to arrive at operating margin
3	Profit Margin	{(Revenue – Operating expense + non-operating income-Interest Expense- Income taxes)/(Revenue)}	1. This ratio helps an investor to know how much profit is generated from the total revenue of the business	As the formula itself explains, the profit margin is arrived from the revenue after adjusting all operating

			2. The overall functional efficiency of an enterprise can be ascertained apart from its core business	and non-operating expense and income
4	Earnings per Share (EPS)	{(Net Income – Preferred Dividend)/(Weighted Average Outstanding Shares)}	EPS is more important to shareholders since it helps in determining the return on investment	Generally weighted average Outstanding shares are used since outstanding shares can change over time
			Higher the EPS, higher is the stock price of the company	Sometime Diluted EPS are used which includes options, convertible securities and warrants outstanding which affects outstanding shares

3. Leverage Ratio

Leverage ratio measures the utilization of borrowed money by the business. It helps to identify the financial stability of the business by analyzing the total debt of the company.

Sl.No	Particular	Formula	Used for	Example
1	Debt to Equity Ratio	{(Total Debt)/(Total Equity)}	1. Business with high debt Equity ratio indicates that it is more dependent on debts for operation	Total Debt includes both long term and short term debts held by the company.
			2. This is also known as Gearing ratio which is used by Investors and Creditors to analyze the company's financial leverage	

2	Debt to Asset Ratio	{(Total Debt)/(Total Asset)}	1. Debt to Asset ratio can be used to determine if the business will be able to pay all of its debts if the business is closed immediately 2. A company having a debt to asset ratio of less than 1 is considered as good for investment. If the ratio is greater than 1, the company is considered as highly leveraged	It includes all the debt and assets of the company but there are different variations of this formula where only certain assets or specific liabilities are included
3	Debt Ratio	{(Total Liabilities)/(Total Asset)}	1. The liabilities to assets ratio is also known as solvency ratio indicates how much of a company's assets are made of liabilities 2. A high liability to assets ratio indicates the business might face potential solvency issues	Total long-term debt and total assets (tangible and intangible) are reported on the balance sheet are considered
4	Interest Coverage Ratio	{(Earnings before interest and taxes (EBIT))/(Interest Expense)}	1. This ratio is used to measure the company's ability to meet its interest – payment obligation 2. A higher ratio indicates a better financial position of the business	Net Income before deducting interest and taxes by the company's interest expense and taxes are considered as a percentage on interest expense

4. Activity Ratio / Efficiency Ratio

Activity ratio indicates the return generated from a particular type of asset using the sales, cost and asset data. This ratio helps the business to identify effective utilization of the assets and thereby facilitates efficient management:

Sl.No	Particular	Formula	Used for	Example

1	Receivable Ratio	{(Annual Sales Credit)/(Accounts Receivable)}	1. Receivables Turnover ratio measures how soon the firms collect its receivables	For the ratio calculation, monthly average receivables and sales on credit terms are used generally
			2. A high receivable ratio indicates that the business sales collection process is working well	Average collection period can be determined using this ratio
2	Inventory Turnover Ratio	{(Cost of Goods Sold)/(Average Inventory)}	1. It is used to ascertain the rate at which the company's inventory is converted to cash	It is generally measured using inventory period which is the average inventory divided by average cost of goods is sold
			2. A company with higher inventory ratio is considered to have an effective sales strategy	
3	Asset Turnover Ratio	{(Net Revenue)/(Assets)}	1. This ratio indicates the value of revenue as a percentage of the value of investment	This can have different variants depending upon the asset category used for the calculation
			2. A higher ratio indicates better asset management and utilization by the business	

Liquidity Ratios:

(a) Current Ratio

Current Ratio = Current Assets : Current Liabilities or Current Assets / Current Liabilities

Current assets include current investments, inventories, trade receivables (debtors and bills receivables), cash and cash equivalents, short-term loans and advances and other current assets such as prepaid expenses, advance tax and accrued income, etc.

Current liabilities include short-term borrowings, trade payables (creditors and bills payables), other current liabilities and short-term provisions.

Illustration 1

From the following information, calculate current ratio.

Trade receivables (debtors)	1, 00,000	Bills payable	20,000
Prepaid Expenses	10,000	Sundry Creditors	40,000
Cash and cash equivalents	30,000	Debentures	2,00,000
Short term investments	20,000	Inventories	40,000
Machinery	7,000	Expenses Payable	40,000

Solution*:*

Current Ratio = Current Assets / Current Liabilities = 2, 00,000 / 1, 00,000 = 2 : 1
Current Assets = Trade Receivables (sundry Debtors) + Prepaid Expenses + Cash and cash Equivalents + Short Term Investments + Inventories
= 1,00,000 + 10,000 + 30,000 + 20,000 + 40,000 = 2,00,000
Current Liabilities: Trade Payables (Bills Payable + Sundry Creditors) + Expenses payable

= 20,000 + 40,000 + 40,000 = 1, 00,000

(b) Quick Ratio/Liquid Ratio

It is the ratio of quick (or liquid) asset to current liabilities. It is expressed as

Quick ratio = Quick Assets: Current Liabilities or Quick Assets / Current Liabilities

Illustration 2

Calculate 'Liquidity Ratio' from the following information:

Current liabilities = Rs. 50,000
Current assets = Rs. 80,000
Inventories = Rs. 20,000
Advance tax = Rs. 5,000
Prepaid expenses = Rs. 5,000

Solution

Liquidity Ratio = Liquid Assets/Current Liabilities
Liquidity Assets = Current assets − (Inventories + Prepaid expenses + Advance tax)
= Rs. 80,000 − (Rs. 20,000 + Rs. 5,000 + Rs. 5,000) = Rs. 50,000
Liquidity Ratio = Rs. 50,000 / 50,000 = 1 : 1.

Illustration 3

X Ltd., has a current ratio of 3.5 : 1 and quick ratio of 2 : 1. If excess of current assets over quick assets represented by inventories is Rs. 24,000, calculate current assets and current liabilities.

Solution

Current Ratio = 3.5 : 1   Quick Ratio = 2 : 1
Let Current liabilities = x

Current assets = 3.5x and
Quick assets = 2x
Inventories = Current assets − Quick assets
24,000 = 3.5x − 2x
24,000 = 1.5x
Current Liabilities = Rs. 16,000
Current Assets = 3.5x = 3.5 × Rs. 16,000 = Rs. 56,000.

Verification:

Current Ratio = Current assets : Current liabilities
= Rs. 56,000 : Rs. 16,000
= 3.5: 1
Quick Ratio = Quick assets : Current liabilities
= Rs. 32,000 : Rs. 16,000 = 2 : 1

Solvency Ratios

(a) Debt-Equity Ratio: Debt-Equity Ratio measures the relationship between long-term debt and equity. If debt component of the total long-term funds employed is small, outsiders feel more secure.

Debt-Equity Ratio = Long term Debts / Shareholders' Funds

Where:

Shareholders' Funds (Equity) = Share capital + Reserves and Surplus + Money received against share warrants

Share Capital = Equity share capital + Preference share capital

Or

Shareholders' Funds (Equity) = Non-current assets + Working capital − Non-current liabilities
Working Capital = Current Assets − Current Liabilities

Illustration 4

From the following information calculate Debt equity Ratio:-

Share capital: 10,000 shares of 10 each	100000	Debentures	75,000
General Reserve	45000	Long term provision	25,000
Surplus	30,000	Outstanding Expenses	10,000

Solution

Debt to equity ratio = Debt / Equity (shareholder funds)

= 1,00,000 / 1,75,000 = 0.57 : 1

Debt = Debentures + Long term provisions

= 75,000 + 25,000 = 1,00,000
Equity = Share Capital + General Reserve + Surplus

= 1,00,000 + 45,000 + 30,000 = 1,75,000

(b) Total Assets to Debt Ratio: This ratio measures the extent of the coverage of long-term debts by assets

Total assets to Debt Ratio = Total assets/Long-term debts

Illustration 5

Shareholders' funds Rs. 1,40,000
Total Debts (Liabilities) Rs. 18,00,000
Current Liabilities = Rs. 2,00,000.

Calculate total assets to debt ratio.

Solution

Total Assets to debt ratio = Total Assets / Long term Debts
= 32,00,000 / 16,00,000 = 2 : 1
Long term debts = total debts (Liabilities) − Current Liabilities
= 18,00,000 − 2,00,000 = 16,00,000
Total assets = shareholder funds + total debts (liabilities)

(c) Proprietary Ratio: Proprietary ratio expresses relationship of proprietor's (shareholders) funds to net assets and is calculated as follows:

Proprietary Ratio = Shareholders, Funds / Capital employed (or net assets)

Significance: Higher proportion of shareholders' funds in financing the assets is a positive feature as it provides security to creditors. This ratio can also be computed in relation to total assets instead of net assets (capital employed)

(d) Interest Coverage Ratio: It is a ratio which deals with the servicing of interest on loan. It is a measure of security of interest payable on long-term debts. It expresses the relationship between profits available for payment of interest and the amount of interest payable.

It is calculated as follows:

Interest Coverage Ratio = Net Profit before Interest and Tax / Interest on long-term debts

Significance: It reveals the number of times interest on long-term debts is covered by the profits available for interest. A higher ratio ensures safety of interest on debts.

Illustration 6

From the following details, calculate interest coverage ratio:

Net Profit after tax Rs. 60,000; 15% Long-term debt 10,00,000; and Tax rate 40%.

Solution

Net Profit after Tax	= Rs. 60,000
Tax Rate	= 40%
Net Profit before tax	= Net profit after tax × 100/ (100 − Tax rate)
	= Rs. 60,000 × 100/(100 − 40)
	= Rs. 1,00,000

Interest on Long-term Debt = 15% of Rs. 10,00,000 = Rs. 1,50,000
Net profit before interest and tax = Net profit before tax + Interest
= Rs. 1,00,000 + Rs. 1,50,000 = Rs. 2,50,000
Interest Coverage Ratio = Net Profit before Interest and Tax/Interest on long-term debt

= Rs. 2,50,000/Rs. 1,50,000
= 1.67 times

Activity (or Turnover) Ratio

These ratios indicate the speed at which, activities of the business are being performed. The activity ratios express the number of times assets employed. Higher turnover ratio means better utilisation of assets and signifies improved efficiency and profitability, and as such is known as efficiency ratios.

(a) Inventory Turnover Ratio: It determines the number of times inventory is converted into revenue from operations during the accounting period under consideration. It expresses the relationship between the cost of revenue from operations and average inventory

The formula for its calculation is as follows:

Inventory Turnover Ratio = Cost of Revenue from Operations / Average Inventory

Illustration 7

From the following information, calculate inventory turnover ratio:

Inventory in the beginning = 18,000
Inventory at the end = 22,000
Net purchases = 46,000
Wages = 14,000
Revenue from operations = 80,000
Carriage inwards = 4,000

Solution

Inventory Turnover Ratio = Cost of Revenue from Operations / Average Inventory
Cost of Revenue from Operations = Inventory in the beginning + Net Purchases + Wages + Carriage inwards − Inventory at the end
= Rs. 18,000 + Rs. 46,000 + Rs. 14,000 + Rs. 4,000 − Rs. 22,000

= Rs. 60,000

Average Inventory = Inventory in the beginning + Inventory at the end / 2
= Rs. 18,000 + Rs. 22,000/ 2 = Rs. 20,000
∴ Inventory Turnover Ratio = Rs. 60,000/ Rs. 20,000 = 3 Times

(b) Trade Receivables Turnover Ratio: It expresses the relationship between credit revenue from operations and trade receivable. It is calculated as follows:

Trade Receivable Turnover ratio = Net Credit Revenue from Operations / Average Trade Receivable

Where Average Trade Receivable = (Opening Debtors and Bills Receivable + Closing Debtors & Bills Receivable)/2

Illustration 8

Calculate the Trade receivables turnover ratio from the following information:

Total Revenue from operations 4,00,000
Cash Revenue from operations 20% of Total Revenue from operations
Trade receivables as at 1.4.2014 40,000
Trade receivables as at 31.3.2015 1,20,000

Solution

Trade Receivables Turnover Ratio = Net Credit Revenue from Operations / Average Trade Receivables

Credit Revenue from operations = Total revenue from operations − Cash revenue from Operations

Cash Revenue from operations = 20% of Rs. 4,00,000 = Rs. 4,00,000 × 20 / 100

= Rs. 80,000

Credit Revenue from operations = Rs. 4,00,000 − Rs. 80,000 = Rs. 3,20,000

Average Trade Receivables = Opening Trade Receivables + Closing Trade Receivables / 2

= Rs. 40,000 + Rs. 1,20,000 / 2 = Rs. 80,000

= Net Credit Revenue Form Operations / Average Inventory
= Rs. 3,20,000 / Rs. 80,000 = 4 times.

(c) Trade Payable Turnover Ratio: Trade payables turnover ratio indicates the pattern of payment of trade payable. As trade payable arise on account of credit purchases, it expresses relationship between credit purchases and trade payable.

It is calculated as follows:

Trade Payables Turnover ratio = Net Credit purchases / Average trade payable

Where,
Average Trade Payable = (Opening Creditors and Bills Payable + Closing Creditors and Bills Payable)/2
Average Payment Period = No. of days/month in a year ÷Trade Payables Turnover Ratio

Illustration 9

Calculate the Trade payables turnover ratio from the following figures:

Credit purchases during 2014-15 = 12,00,000
Creditors on 1.4.2014 = 3,00,000
Bills Payables on 1.4.2014 = 1,00,000
Creditors on 31.3.2015 = 1,30,000
Bills Payables on 31.3.2015 = 70,000

Solution

Trade Payables Turnover Ratio = Net Credit Purchases / Average Trade Payables
Average Trade Payables = Creditors in the beginning + Bills payables in the beginning + Creditors at the end + Bills payables at the end / 2
= Rs. 3,00,000 + Rs. 1,00,000 + Rs. 1,30,000 + Rs. 70,000 2
= Rs. 3,00,000
∴ Trade Payables Turnover Ratio = Rs. 12,00,000 / Rs. 3,00,000
= 4 times

Illustration 10

From the following information, calculate –

i. Trade receivables turnover ratio
ii. Average collection period
iii. Trade payable turnover ratio

Given:

Revenue from Operations	8,75,000
Creditors	90,000
Bills receivable	48,000
Bills payable	2,000
Purchases	4,20,000
Trade debtors	59,000

Solution

i. Trade Receivables Turnover Ratio = Net Credit Revenue from operation / Average Trade Receivable

= Rs. 8, 75,000 / (Rs. 59,000 + Rs. 48,000) = 8.18 times

ii. Average Collection Period = 365 / Trade Receivables

Turnover Ratio = 365 / 8.18 = 45 days

iii. Trade Payable Turnover Ratio = Purchases / Average Trade Payables

= Purchases / Creditors + Bills payable
= 4,20,000 / 90,000 + 52,000
= 4,20,000 / 1,42,000 = 2.96 times

(d) Working Capital Turnover Ratio: It reflects relationship between revenue from operations and net assets (capital employed) in the business.

Working capital turnover ratio = Net Revenue from Operation / Working Capital

Profitability Ratios

Profitability ratios are calculated to analyse the earning capacity of the business which is the outcome of utilisation of resources employed in the business. There is a close relationship between the profit and the efficiency with which the resources employed in the business are utilised.

(a) Gross Profit Ratio: Gross profit ratio as a percentage of revenue from operations is computed to have an idea about gross margin. It is computed as follows:

Gross Profit Ratio = Gross Profit / Net Revenue of Operations × 100

Illustration 11

Following information is available for the year 2014-15, calculate gross profit ratio:

Revenue from Operations: Cash	25,000
Credit	75,000

Purchases: Cash	15,000
Credit	60,000
Carriage Inwards	2,000
Salaries	25,000
Decrease in Inventory	10,000
Return Outwards	2,000
Wages	5,000

Solution

Revenue from Operations = Cash Revenue from Operations + Credit Revenue from Operation

= Rs.25, 000 + Rs.75, 000 = Rs. 1,00,000

Net Purchases = Cash Purchases + Credit Purchases − Return Outwards

= Rs. 15,000 + Rs. 60,000 − Rs. 2,000 = Rs. 73,000

Cost of Revenue from = Purchases + (Opening Inventory − Closing Inventory) + operations Direct Expenses

= Purchases + Decrease in inventory + Direct Expenses

= Rs. 73,000 + Rs. 10,000 + (Rs. 2,000 + Rs. 5,000)

= Rs. 90,000

Gross Profit = Revenue from Operations − Cost of Revenue from Operation

= Rs. 1,00,000 − Rs. 90,000 = Rs. 10,000

Gross Profit Ratio = Gross Profit/Net Revenue from Operations × 100

= Rs.10,000/Rs.1,00,000 × 100 = 10%

(b) Operating Ratio: It is computed to analyse cost of operation in relation to revenue from operations.

It is calculated as follows:

Operating Ratio = (Cost of Revenue from Operations + Operating Expenses)/ Net Revenue from Operations × 100

(c) Operating Profit Ratio: It is calculated to reveal operating margin. It may be computed directly or as a residual of operating ratio. It is calculated as under:

Operating Profit Ratio = Operating Profit/ Revenue from Operations × 100

Where,

Operating Profit = Revenue from Operations − Operating Cost

Illustration 12

Given the following information:

Revenue from Operations	3,40,000

Cost of Revenue from Operations	1,20,000
Selling expenses	80,000
Administrative Expenses	40,000

Calculate Gross profit ratio and Operating ratio.

Solution

Gross Profit = Revenue from Operations − Cost of Revenue from Operations

= Rs. 3,40,000 − Rs. 1,20,000

= Rs. 2,20,000

Gross Profit Ratio = Gross Profit / Revenue from operation × 100

= Rs. 2,20,000 / Rs. 3,40,000 × 100 = 64.71%

Operating Cost = Cost of Revenue from Operations + Selling Expenses + Administrative Expenses

= Rs. 1,20,000 + 80,000 + 40,000 = Rs. 2,40,000

Operating Ratio = Operating Cost / Net Revenue from Operations × 100

= Rs. 2,40,000 / Rs. 3,40,000 x 100 = 70.59%

(d) Net Profit Ratio: It relates revenue from operations to net profit after operational as well as non-operational expenses and incomes.

It is calculated as under:

Net Profit Ratio = Net profit / Revenue from Operations × 100

(e) Return on Capital Employed or Investment: Capital employed means the long-term funds employed in the business and includes shareholders' funds, debentures and long-term loans.

Capital employed may be taken as the total of non-current assets and working capital. Profit refers to the Profit before Interest and Tax (PBIT) for computation of this ratio.

Thus, it is computed as follows:

Return on Investment (or Capital Employed) = Profit before Interest and Tax / Capital Employed × 100

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