CHAPTER 4

# PRESENTATION & DISCLOSURES BASED ACCOUNTING STANDARDS

## UNIT 1: ACCOUNTING STANDARD 1

## DISCLOSURE OF ACCOUNTING POLICIES

### LEARNING OUTCOMES

**After studying this chapter, you would be able to Comprehend the-**

- Fundamental Accounting Assumptions
- Nature of Accounting Policies
- Areas in Which Different Accounting Policies are Encountered.
- Considerations in the Selection of Accounting Policies.

## 1.1 INTRODUCTION

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

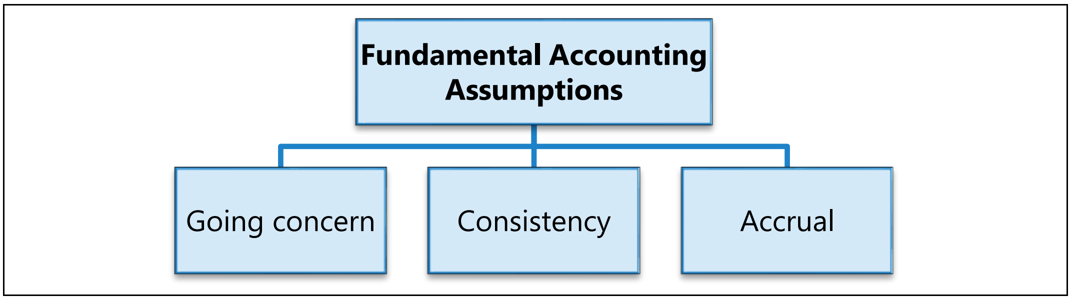
Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

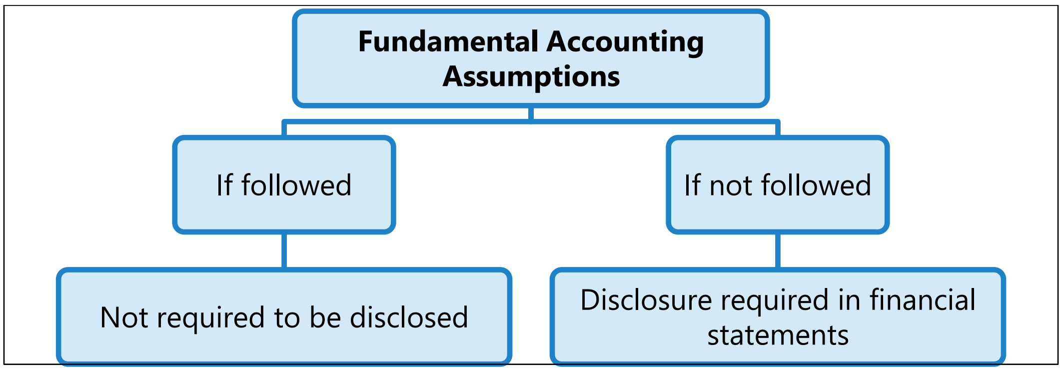
The accounting standards, therefore, permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements, therefore, suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, Accounting Standard 1 requires enterprises to disclose significant accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such financial statements.

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

This Accounting Standard applies to all enterprises.

## 1.2 FUNDAMENTAL ACCOUNTING ASSUMPTIONS




**Going Concern**: The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

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

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

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

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting. Section 128(1) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

## 1.3 ACCOUNTING POLICIES

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

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

| Items to be disclosed | Method of disclosure or valuation |
|---|---|
| Inventories | FIFO, Weighted Average etc. |
| Cash Flow Statement | Direct Method, Indirect Method |

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

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

## 1.4 SELECTION OF ACCOUNTING POLICY

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

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

**Example 1**

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

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

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

*= Sale – Cost of goods sold = (400 x ₹ 15) – (500 x ₹ 10 – 100 x ₹ 10) = ₹ 2,000*

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

*= Sale – Cost of goods sold = (400 x ₹ 15) – (500 x ₹10 – 100 x ₹ 8) = ₹ 1,800*

**Example 2**

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

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

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

(a) A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or ₹1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).

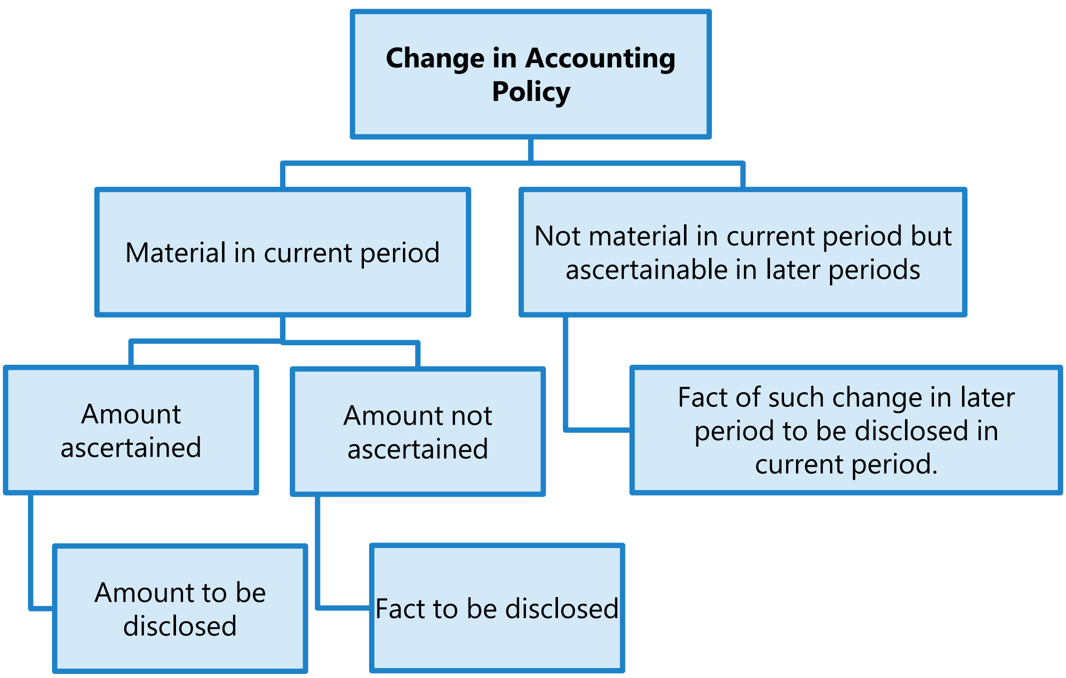
(b) A company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

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

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

## 1.5 DISCLOSURE OF CHANGES IN ACCOUNTING POLICIES

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



**Example 3**

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

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

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

*The above requirement ensures that all important changes in accounting policies are actually disclosed.*

## 1.6 DISCLOSURE OF DEVIATIONS FROM FUNDAMENTAL ACCOUNTING ASSUMPTIONS

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods.

### Illustration 1

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

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

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

### Solution

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

'The company values its inventory at lower of cost and net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 20X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by ₹ 16,000.

### Illustration 2

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

*(i) Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).*

*(ii) Provide for permanent diminution in the value of investments, which had taken place over the past five years, the amount of provision being ₹10 crores.*

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

## Solution

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

## Notes on Accounts:

(i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year has increased by ₹ 20 crores.(ii) The company has decided to provide ₹10 crores for the permanent diminution in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹10 crores.

## Illustration 3

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

**Solution**

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

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

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

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *Which of the following is NOT a major consideration in selection and application of accounting policies?*

   *(a) Prudence*

   *(b) Comparability*

   *(c) Materiality*

   *(d) Substance over form*

2. *Adoption of different accounting policies by different companies operating in the same industry affects which of the qualitative characteristics the most?*

   *(a) Comparability*

   *(b) Relevance*

   *(c) Faithful representation*

   *(d) Reliability*

3. *Which of the following statement would not be correct in relation to disclosures to be made in the financial statements after making any change in an accounting policy?*

   *(a) Any change in an accounting policy which has a material effect should be disclosed.*

   *(b) The amount by which any item in the financial statements is affected by such change should be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.*

   *(c) If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change*

*should be appropriately disclosed in the period in which the change is adopted.*

(d) *If a change is made in an accounting policy which has material effect on the financial statements for the current period and is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed only in the later periods i.e. year(s) next to the year in which the change is adopted.*

## Theoretical Questions

4. *What are the three fundamental accounting assumptions recognised by Accounting Standard (AS) 1? Briefly describe each one of them.*

5. *Has Accounting Standard 1 prescribed the manner in which the accounting policies followed by the entity should be disclosed?*

## Scenario based Questions

6. *State whether the following statements are 'True' or 'False'. Also give reason for your answer.*

   (i) *Certain fundamental accounting assumptions underline the preparation and presentation of financial statements. They are usually specifically stated because their acceptance and use are not assumed.*

   (ii) *If fundamental accounting assumptions are not followed in presentation and preparation of financial statements, a specific disclosure is not required.*

   (iii) *All significant accounting policies adopted in the preparation and presentation of financial statements should form part of the financial statements.*

   (iv) *Any change in an accounting policy, which has a material effect should be disclosed. Where the amount by which any item in the financial statements is affected by such change is not ascertainable, wholly or in part, the fact need not to be indicated.*

7. *Give examples of areas where accounting policies adopted could be different for different enterprises. Would there be any adverse impact due to the adoption of different policies, and if yes, how does Accounting Standard 1 seek to address such issue?*

8. *ABC Ltd. was making provision for non-moving inventories based on issues for the last 12 months up to 31.3.20X1.*

   *The company wants to provide during the year ending 31.3.20X2 based on technical evaluation:*

| | |
|---|---|
| *Total value of Inventory* | *₹ 100 lakhs* |
| *Provision required based on 12 months issue* | *₹3.5 lakhs* |
| *Provision required based on technical evaluation* | *₹ 2.5 lakhs* |

   *Does this amount to change in Accounting Policy?*

   *Can the company change the method of provision?*

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | |
|---|---|---|---|---|---|
| **1** | (b) | **2** | (a) | **3** | (d) |

## Answers to the Theoretical Questions

**4.** Accounting Standard (AS) 1 recognises three fundamental accounting assumptions. These are: (i) Going Concern; (ii) Consistency; and (iii) Accrual basis of accounting.

**5.** Paras 18-20 of Accounting Standard 1, Disclosure of Accounting Policies, lay down the manner in which accounting policies have to be disclosed, which is stated as under:

- To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

- Such disclosure should form part of the financial statements.
- All the disclosures should be made at one place instead of being scattered over several statements, schedules and notes.

## Answers to the Scenario based Question

**6.** (i) False; As per AS 1 "Disclosure of Accounting Policies", certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

(ii) False; As per AS 1, if the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

(iii) True; To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. The disclosure of the significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

(iv) False; Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

**7.** There are various areas where different accounting policies could be adopted by different entities within the same industry. An entity may choose to value its inventories using FIFO method, whereas another entity may choose to value the same using Weighted Average method.

While an entity is free to choose its accounting policy as long as in the financial statements reflect a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended, the application of different accounting policies by different entities affects the comparability of the financial statements of such different entities by stakeholders, analysts, investors etc. To mitigate the loss of comparability, Accounting Standard 1, Disclosure of Accounting Policies requires disclosure of significant accounting policies as a part of the financial statements. This would help users of the financial statements to understand the policies followed by different entities, particularly if they belong to the same industry, and make a correct analysis of each entity resulting in more informed decision-making.

**8.** Accounting policy of a company may require that provision for non-moving inventories should be made. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy.

In the above case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material.

The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 20X1-X2:

"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year-end net assets would have been lower by ₹ 1 lakh."

# UNIT 2: ACCOUNTING STANDARD 3CASH FLOW STATEMENT

## LEARNING OUTCOMES

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

- What are Cash and Cash Equivalents
- Presentation of a Cash Flow Statement
- Reporting Cash Flows from Operating Activities
- Reporting Cash Flows from Investing and Financing Activities
- Reporting Cash Flows on a Net Basis
- Foreign Currency Cash Flows
- Extraordinary Items
- Interest and Dividends
- Taxes on Income
- Non-Cash Transactions.

## 2.1 INTRODUCTION

This Standard is mandatory for Non-SMCs (Non Small & Medium Companies) and the enterprises which fall in the category of Level I (for non-corporate entities), at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements.

However, the Companies Act, 2013, mandates preparation of Cash flow statement by all companies except one person company, small company and dormant company (refer note below).

Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

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

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

## 2.2 OBJECTIVE

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

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

## 2.3 MEANING OF THE TERM CASH AND CASH EQUIVALENTS FOR CASH FLOW STATEMENTS

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

(a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and

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

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

## 2.4 MEANING OF THE TERM CASH FLOW

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

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

## 2.5 TYPES OF CASH FLOW

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

For the aforesaid reasons, the standard identifies three types of cash flows, i.e.

i. operating cash flows;

ii. investing cash flows; and

iii. financing cash flows.

Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

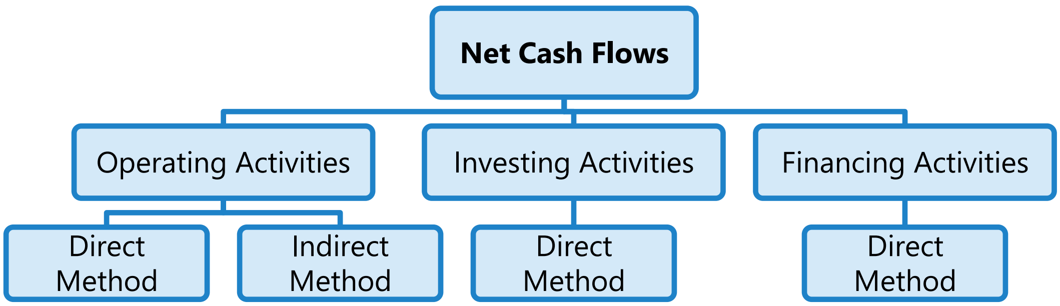
The **operating cash flows** are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from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

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

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

## 2.6 IDENTIFYING TYPE OF CASH FLOWS

**Classification of Cash Flows**




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

### 2.6.1 Loans/Advances given and Interests earned

(a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.

(b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.

(c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.

(d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.

(e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.

(f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

### 2.6.2 Loans/Advances taken and interests paid

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

(b) Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.

(c) Loans and advances taken from subsidiaries and interests paid on them are financing cash flows for all enterprises.

(d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.

(e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.

(f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

### 2.6.3 Investments made and dividends earned

(a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.

(b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.

(c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

### 2.6.4 Dividends Paid

Dividends paid are financing cash outflows for all enterprises.

### 2.6.5 Income Tax

(a) Tax paid on operating income is operating cash outflows for all enterprises

(b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.

(c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

### 2.6.6 Insurance claims received

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

(b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

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

## 2.7 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

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

In **'Direct method'** we take the gross receipts from sales, trade receivables and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions.

In '**Indirect method**' we start from the net profit or loss figure, eliminate the effect of any non-cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

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

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

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

| Particulars | ₹ | ₹ |
|---|---|---|
| Operating Activities: | | |
| Cash received from sale of goods | xxx | |
| Cash received from Trade receivables | xxx | |
| Cash received from sale of services | xxx | xxx |
| Less: Payment for Cash Purchases | xxx | |
| Payment to Trade payables | xxx | |
| Payment for Operating Expenses | xxx | |
| (e.g. power, rent, electricity) | | |
| Payment for wages & salaries | xxx | |
| Payment for Income Tax | xxx | xxx |
| | | xxx |
| Adjustment for Extraordinary Items | | xxx |
| Net Cash Flow from Operating Activities | | xxx |

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

| Particulars | ₹ | ₹ |
|---|---|---|
| Operating Activities: | | |
| Closing balance of Profit & Loss Account | xxx | |
| *Less:* Opening balance of Profit & Loss Account | xxx | |
| | xxx | |

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

### Profit or loss on disposal of fixed assets

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

### Fundamental techniques of cash flow preparation

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

## 2.8 REPORTING CASH FLOWS ON NET BASIS

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

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

(a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

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

(a) Cash flows on acceptance and repayment of fixed deposits with a fixed maturity date

(b) Cash flows on placement and withdrawal deposits from other financial enterprises

(c) Cash flows on advances/loans given to customers and repayments received therefrom.

### Interest and Dividends

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

### Non-Cash transactions

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

## 2.9 BUSINESS PURCHASE

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

(a) The cash flows from disposal and acquisition should not be netted off.

(b) An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

   (i) The total purchase or disposal consideration; and

   (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

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

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

## 2.10 EXCHANGE GAINS AND LOSSES

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

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

## 2.11 DISCLOSURES

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

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

(a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

### Illustration 1

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

*(a) Purchase of Machinery.*

*(b) Proceeds from issuance of equity share capital*

*(c) Cash Sales.*

*(d) Proceeds from long-term borrowings.*

*(e) Cheques collected from Trade receivables.*

*(f)* *Cash receipts from Trade receivables.*

*(g)* *Trading Commission received.*

*(h)* *Purchase of investment.*

*(i)* *Redemption of Preference Shares.*

*(j)* *Cash Purchases.*

*(k)* *Proceeds from sale of investment*

*(l)* *Purchase of goodwill.*

*(m)* *Cash paid to suppliers.*

*(n)* *Interim Dividend paid on equity shares.*

*(o)* *Wages and salaries paid.*

*(p)* *Proceed from sale of patents.*

*(q)* *Interest received on debentures held as investment.*

*(r)* *Interest paid on Long-term borrowings.*

*(s)* *Office and Administration Expenses paid*

*(t)* *Manufacturing Overheads paid.*

*(u)* *Dividend received on shares held as investments.*

*(v)* *Rent Received on property held as investment.*

*(w)* *Selling and distribution expense paid.*

*(x)* *Income tax paid*

*(y)* *Dividend paid on Preference shares.*

*(z)* *Underwritings Commission paid.*

*(aa)* *Rent paid.*

*(bb)* *Brokerage paid on purchase of investments.*

*(cc)* *Bank Overdraft*

*(dd)* *Cash Credit*

*(ee)* *Short-term Deposits*

*(ff) Highly liquid Marketable Securities (without risk of change in value)*

*(gg) Refund of Income Tax received.*

## Solution

(a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

(b) Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

(c) Financing Activities: b, d, i, n, r, y, z, cc & dd.

(d) Cash Equivalent: ff.

## Illustration 2

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

## Solution

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

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

## Illustration 3

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

*(i) Interest paid by financial enterprise*

*(ii) Tax deducted at source on interest received from subsidiary company*

*(iii) Deposit with Bank for a term of two years*

*(iv) Insurance claim received towards loss of machinery by fire*

*(v) Bad debts written off*

---

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

### Solution

(i) Interest paid by financial enterprise

Cash flows from operating activities

(ii) TDS on interest received from subsidiary company

Cash flows from investing activities

(iii) Deposit with bank for a term of two years

Cash flows from investing activities

(iv) Insurance claim received against loss of fixed asset by fire

Extraordinary item to be shown as a separate heading under 'Cash flow from investing activities'

(v) Bad debts written off

It is a non-cash item which is adjusted from net profit/loss under indirect method, to arrive at net cash flow from operating activity.

### Illustration 4

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

**Cash Flow (Abstract)**

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

| | | | |
|---|---|---|---|
| | | *Cash* | *5,000* |
| | | *bank* | *10,000* |
| | *10,00,000* | | *10,00,000* |

*Prepare Cash Flow Statement for the year ended 31st March, 20X1in accordance with Accounting Standard 3.*

## Solution

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

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

### Illustration 5

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

| *Particulars* | *₹* |
|---|---|
| *Plant acquired by the issue of 8% Debentures* | *1,56,000* |
| *Claim received for loss of plant in fire* | *49,600* |
| *Unsecured loans given to subsidiaries* | *4,85,000* |
| *Interest on loan received from subsidiary companies* | *82,500* |
| *Pre-acquisition dividend received on investment made* | *62,400* |
| *Debenture interest paid* | *1,16,000* |
| *Term loan repaid* | *4,25,000* |
| *Interest received on investment* | *68,000* |
| *(TDS of ₹ 8,200 was deducted on the above interest)* | |
| *Book value of plant sold (loss incurred ₹ 9,600)* | *84,000* |

### Solution

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

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

**Note:**

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

***Note:*** For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 11.

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

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *Crown Ltd. wants to prepare its cash flow statement. It sold equipment of book value of ₹ 60,000 at a gain of ₹ 8,000. The amount to be reported in its cash flow statement under operating activities is*

   *(a) Nil*

   *(b) ₹ 8,000*

   *(c) ₹ 68,000*

   *(d) ₹ 60,000*

2. *While preparing cash flows statement, an entity (other than a financial institution) should disclose the dividends received from its investment in shares as*

   *(a) operating cash inflow*

   *(b) investing cash inflow*

   *(c) financing cash inflow*

   *(d) cash & cash equivalent*

3. *XYZ Co. is a financial enterprise. In its cash flow statement, interest paid and dividends received should be*

   (a) *classified as operating cash flows.*

   (b) *classified as financing cash flows.*

   (c) *Not shown in cash flow statement.*

   (d) *classified as investing cash flows.*

4. *In the cash flow statement, 'cash and cash equivalents' donot include*

   (a) *Bank balances .*

   (b) *Short-term investments readily convertible into Cash are subject to an insignificant risk of changes in value.*

   (c) *Cash balances.*

   (d) *Loan from bank.*

5. *While preparing a Cash Flow Statement using the Indirect method as required under AS 3, which of the following will not be deducted from/added to the Net Profit to arrive at the "Cash flow from Operating activities"?*

   (a) *Interest income*

   (b) *Gain on sale of a fixed asset.*

   (c) *Depreciation.*

   (d) *Gain on sale of inventory*

## Theoretical Questions

6. *What are the main features of the Cash Flow Statement?*

7. *Mayuri Ltd. acquired Plant and Machinery for ₹ 25 lakhs. During the same year, it also sold Furniture and Fixtures for ₹ 4 lakhs. Can the company disclose, Net Cash Outflow towards purchase of Fixed Assets ₹ 21 lakhs (i.e., 25 lakhs – 4 lakhs) in the Cash Flow Statement?*

## Scenario based Question

8. *How would the following cash flows be classified in accordance with AS 3?*

   - *Corporate Income Tax paid amounting to ₹ 70 lakhs during the reporting period.*
   - *Payment of advance tax ₹ 8,75,000 out of which ₹ 75,000 was towards capital gains arising on account of sale of assets during the reporting period.*
   - *Fixed Deposits withdrawn by customers of State Bank of India ₹ 3 crores.*

9. *Money Ltd., a non-financial company has the following entries in its Bank Account. It has sought your advice on the treatment of the same for preparing Cash Flow Statement.*

   *(i) Loans and Advances given to the following and interest earned on them:*

   *(1) to suppliers*

   *(2) to employees*

   *(3) to its subsidiaries companies*

   *(ii) Investment made in subsidiary Smart Ltd. and dividend received*

   *(iii) Dividend paid for the year*

   *Discuss in the context of AS 3 Cash Flow Statement.*

10. *From the following information of XYZ Limited, calculate cash and cash equivalent as on 31-03-20X2 as per AS 3.*

| ***Particulars*** | ***Amount (₹)*** |
|---|---|
| *Balance as per the Bank Statement* | *25,000* |
| *Cheque issued but not presented in the Bank* | *15,000* |
| *Short Term Investment in liquid equity shares of ABC Limited* | *50,000* |
| *Fixed Deposit created on 01-11-20X1 and maturing on 15-04-20X2* | *75,000* |
| *Short Term Investment in highly liquid Sovereign Debt Mutual fund on 01-03-20X2 (having maturity period of less than 3 months)* | *1,00,000* |

| | |
|---|---|
| *Bank Balance in a Foreign Currency Account in India* *(Conversion Rate: On the day of deposit ₹ 69/USD as on 31-03-20X2 ₹ 70/USD)* | *$ 1,000* |

11. *Z Ltd. has no Foreign Currency Cash Flow during the reporting period. It held a deposit in a bank in France. The balances as at the beginning of the year and at the end of the year were € 100,000 and € 105,000 respectively. The exchange rate at the beginning of the year was € 1 = ₹ 82, and at the end of the year was € 1 = ₹ 85. The increase in the deposit balance of € 5,000 was on account of interest credited on the last day of the reporting period. The deposit was reported at ₹ 82,00,000 in the opening balance sheet and at ₹ 89,25,000 in the closing balance sheet. You are required to show how these transactions would be presented in the Cash Flow Statement as per AS 3.*

12. *Following is the Balance Sheet of Fox Ltd. You are required to prepare cash flow statement using Indirect Method.*

| ***Particulars*** | ***Note No.*** | ***31st March,20X2 (₹)*** | ***31st March,20X1 (₹)*** |
|---|---|---|---|
| ***(I) Equity and Liabilities*** | | | |
| *1. Shareholders' Funds* | | | |
| *(a) Share capital* | *1* | *5,60,000* | *3,00,000* |
| *(b) Reserve and Surplus* | *2* | *35,000* | *25,000* |
| *2. Current Liabilities* | | | |
| *(a) Trade payables* | | *1,50,000* | *60,000* |
| *(b) Short-term provisions (Provision for taxation)* | | *8,000* | *5,000* |
| *Total* | | *7,53,000* | *3,90,000* |
| ***(II) Assets*** | | | |
| *1. Non-current assets* | | | |

| | | | |
|---|---|---|---|
| (a) Property, Plant and Equipment | | 3,50,000 | 1,80,000 |
| 2. Current assets | | | |
| (a) Inventories | | 1,20,000 | 50,000 |
| (b) Trade receivables | | 1,00,000 | 25,000 |
| (c) Cash and cash equivalents | | 1,05,000 | 90,000 |
| (d) Other current assets | | 78,000 | 45,000 |
| Total | | 7,53,000 | 3,90,000 |

***Notes to Accounts***

| **Particulars** | **31st March,20X2 (₹)** | **31st March,20X1 (₹)** |
|---|---|---|
| 1. Share capital | | |
| (a) Equity share capital | 4,10,000 | 2,00,000 |
| (b) Preference share capital | 1,50,000 | 1,00,000 |
| | 5,60,000 | 3,00,000 |
| 2. Reserve and surplus | | |
| Surplus in statement of profit and loss at the beginning of the year | 25,000 | |
| Add: Profit of the year | 20,000 | |
| Less: Dividend | (10,000) | |
| Surplus in statement of profit and loss at the end of the year | 35,000 | 25,000 |

*Additional Information:*

1. *Dividend paid during the year ₹ 10,000*
2. *Depreciation charges during the year ₹ 40,000.*

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **1.** | (a) | **2.** | (b) | **3.** | (a) | **4.** | (d) | **5.** | (d) | | |

## Answers to the Theoretical Questions

**6.** According to AS 3 on "Cash Flow Statement", cash flow statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise during the given period from operating, investing and financing activities. Cash flows from operating activities can be reported using either (a) the direct method, or (b) the indirect method. A cash flow statement when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency), and its ability to affect the amount and timing of cash flows in order to adapt to changing circumstances and opportunities.

**7.** As per AS 3, Cash Flow Statements, an enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except in the case of:

- cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and
- cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

In the given case, since the purchase of Plant and Machinery and disposal of Furniture and Fixtures do not fall in the criteria of exception mentioned above, the same should be presented on a gross basis as an outflow of ₹ 25 lakhs and an inflow of ₹ 4 lakhs. Presentation of net cash outflow of ₹ 21 lakhs is not permitted as per AS 3.

## Answers to Scenario based Question

**8.** As per AS 3, the given cash flows shall be recorded as under:

| | |
|---|---|
| Corporate Income Tax paid amounting to ₹ 70 lakhs during the reporting period. | ₹ 70 lakhs: Operating Cash Flows |
| Payment of advance tax ₹ 8,75,000 out of which ₹ 75,000 was towards capital gains arising on account of sale of assets during the reporting period. | ₹ 8,00,000: Operating Cash Flows<br>₹ 75,000: Investing Cash Flows |
| Fixed Deposits withdrawn by customers of State Bank of India ₹ 3 crores. | ₹ 3 crores: Operating Cash Flows for State Bank of India. |

**9.** Treatment as per AS 3 'Cash Flow Statement'

(i) Loans and advances given and interest earned

(1) to suppliers - Cash flows from operating activities

(2) to employees - Cash flows from operating activities

(3) to its subsidiary companies - Cash flows from investing activities

(ii) Investment made in subsidiary company and dividend received

Cash flows from investing activities

(iii) Dividend paid for the year

Cash flows from financing activities

**10. Computation of Cash and Cash Equivalents as on 31st March, 20X2**

| | ₹ |
|---|---|
| Cash balance with bank (₹ 25,000 less ₹ 15,000) | 10,000 |
| Short term investment in highly liquid sovereign debt mutual fund on 1.3.20X2 | 1,00,000 |
| Bank balance in foreign currency account ($1,000 x ₹ 70) | 70,000 |
| | 1,80,000 |

**Note:** Short term investment in liquid equity shares and fixed deposit will not be considered as cash and cash equivalents.

**11.** The Statement of Profit and Loss was credited on account of:

Interest Income: € 5,000 x ₹ 85 = ₹ 4,25,000

Exchange difference = € 100,000 x (₹ 85 – ₹ 82) = ₹ 3,00,000

In preparing the Cash Flow Statement, the exchange difference of ₹ 3,00,000 should be deducted from the Net Profit before taxes, since it is a non-cash item. However, in order to reconcile the opening balance of the Cash and Cash Equivalents with its closing balance, the Exchange Difference of ₹ 3,00,000 should be added to the opening balance in a Note to the Cash Flow Statement.,

Cash Flows arising from transactions in a Foreign Currency shall be recorded in Z Ltd.'s reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow.

**12.** **Fox Ltd.**

**Cash Flow Statement for the year ended 31st March, 20X2**

| | ₹ | ₹ |
|---|---|---|
| Cash flows from operating activities | | |
| Net Profit (35,000 less 25,000) | 10,000 | |
| Add: Dividend | 10,000 | |
| Provision for tax | 8,000 | |
| Net profit before taxation and extraordinary items | 28,000 | |
| Adjustments for: | | |
| Depreciation | 40,000 | |
| Operating profit before working capital changes | | 68,000 |
| Increase in trade receivables | (75,000) | |
| Increase in inventories | (70,000) | |
| Increase in other current assets | (33,000) | |
| Increase in trade payables | 90,000 | (88,000) |

| | | |
|---|---|---|
| *Cash used in operating activities* | | (20,000) |
| Less: Tax paid* | | (5,000) |
| *Net cash used in operating activities* | | (25,000) |
| <u>Cash flows from investing activities</u> | | |
| Purchase of PPE | (2,10,000) | |
| *Net cash used in investing activities* | | (2,10,000) |
| <u>Cash flows from financing activities</u> | | |
| Issue of equity shares for cash | 2,10,000 | |
| Issue of preference shares | 50,000 | |
| Dividends paid | (10,000) | |
| *Net cash generated from financing activities* | | 2,50,000 |
| Net increase in cash and cash equivalents | | 15,000 |
| Cash and cash equivalents at beginning of period | | 90,000 |
| Cash and cash equivalents at end of period | | 1,05,000 |

******Provision for tax of last year considered to be paid in the current year.*

**Working Note**:

| | ₹ |
|---|---|
| Property, plant and equipment acquisitions | |
| W.D.V. at 31.3.20X2 | 3,50,000 |
| *Add back:* | |
| Depreciation for the year | 40,000 |
| | 3,90,000 |
| *Less:* W.D.V. at 31.12.20X1 | 1,80,000 |
| Acquisitions during 20X1-20X2 | 2,10,000 |

# UNIT 3: ACCOUNTING STANDARD 17 SEGMENT REPORTING

## LEARNING OUTCOMES

**After studying this unit, you will be able to comprehend the-**

- Definition and Identification of Reportable Segments
- Primary and Secondary Segment Reporting Formats
- Business and Geographical Segments
- How to identify the Reportable Segments
- Disclosures.

## 3.1 INTRODUCTION

AS 17 is mandatory in respect of non-SMCs (and level I entities in case of non-corporates). Other entities are encouraged to comply with AS 17.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The standard is more relevant for assessing risks and returns of a diversified or multi-locational enterprise which may not be determinable from the aggregated data.

Before we start the standard, let us lay down the areas to be covered from the examination point of view.

**Identify the Segments - Business or Geographical**

**Identify the Reportable Segments**

**Prepare a Segmental Report + Make appropriate Disclosures**

## 3.2 OBJECTIVE

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

(a) Better understand the performance of the enterprise;

(b) Better assess the risks and returns of the enterprise; and

(c) Make more informed judgements about the enterprise as a whole.

## 3.3 SCOPE

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

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

## 3.4 DEFINITION OF THE TERMS USED IN THE ACCOUNTING STANDARD

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

(a) The nature of the products or services

(b) The nature of the production processes

(c) The type or class of customers for the products or services

(d) The methods used to distribute the products or provide the services

(e) If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities

A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

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

(a) Similarity of economic and political conditions.

(b) Relationships between operations in different geographical areas.

(c) Proximity of operations.

(d) Special risks associated with operations in a particular area.

(e) Exchange control regulations and

(f) The underlying currency risks.

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

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

(a) The location of production or service facilities and other assets of an enterprise; or

(b) The location of its customers.

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

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

**Segment revenue** is the aggregate of

(i) The portion of enterprise revenue that is directly attributable to a segment;

(ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment; and

(iii) Revenue from transactions with other segments of the enterprise.

**Segment revenue does not include:**

(a) Extraordinary items as defined in AS 5;

(b) Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

**Segment expense** is the aggregate of

(i) The expense resulting from the operating activities of a segment that is directly attributable to the segment;

(ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment; and

(iii) Including expense relating to transactions with other segments of the enterprise.

**Segment expense does not include:**

(a) Extraordinary items as defined in AS 5;

(b) Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

(c) Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) Income tax expense; and

(e) General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

**Segment result** is segment revenue less segment expense.

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

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

Segment assets do not include:

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

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

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

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

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

Segment liabilities do not include:

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

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

## 3.5 TREATMENT OF INTEREST FOR DETERMINING SEGMENT EXPENSE

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

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

## 3.6 ALLOCATION

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

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

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

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

## 3.7 PRIMARY AND SECONDARY SEGMENT REPORTING FORMATS

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

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

## 3.8 BUSINESS AND GEOGRAPHICAL SEGMENTS

Generally, business and geographical segments are determined on the basis of internal financial reporting to the board of directors and the Chief Executive Officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered:

(a) If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions (that is, an internally reported segment that meets the definition should not be further segmented).

(b) For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and

(c) If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

## 3.9 IDENTIFYING REPORTABLE SEGMENTS (QUANTITATIVE THRESHOLDS)

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

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

(b) Its segment result, whether profit or loss, is 10% or more of –

(i) The combined result of all segments in profit, or

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

Whichever is greater in absolute amount; or

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

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

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

**We can summarize the steps as under:**

**Step I – Apply 10% Test (Materiality Test):**

| **Any 1 Test needs to be met – For Reportable Segment:** | |
|---|---|
| **Revenue Test** | Revenue (External + Internal) of the segment is 10% or more of the Total Revenue of all segments |
| **Profit/Loss Test** | **Case I – All segments have profits:**<br>Profit of the segment is 10% or more of the total profit of all segments |

| | |
|---|---|
| | **Case II – Few segments have profit + Few segments have losses:**<br>1. Add the profits of profitable segments only.<br>2. Add the losses of loss-making segments only.<br>3. Take the figure (from 1 and 2) whichever is greater (in absolute values).<br>4. The segment which has profit/loss equal to 10% or more of the absolute figure computed in Point 3 becomes reportable. |
| **Asset Test** | The segment assets are 10% or more of the total assets of all segments. |
| **Note:**<br>A business segment or a geographical segment which is not a reportable segment as per above steps, **may be designated** as a reportable segment despite its size at the **discretion of the management** of the enterprise. | |

**Step II – Apply 75% Test (Overall Test):**

Ensure that the **total external revenue** attributable to reportable segments constitutes at least 75% of the **total enterprise revenue**.

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

**Notes:**

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

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

thresholds in the preceding period.

## 3.10 SEGMENT ACCOUNTING POLICIES

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

(a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance; and

(b) the basis of measurement for this additional information is clearly described.

## 3.11 PRIMARY REPORTING FORMAT

An enterprise should disclose the following for each reportable segment:

(a) Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) Segment result;

(c) Total carrying amount of segment assets;

(d) Total amount of segment liabilities;

(e) Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

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

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

In presenting the reconciliation:,

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

## 3.12 SECONDARY SEGMENT INFORMATION

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

(a) Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue;

(b) The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments; and

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

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

a. Segment revenue from external customers;

b. The total carrying amount of segment assets; and

c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

## 3.13 OTHER DISCLOSURES

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

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

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

Example could be:

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

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

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

### Illustration 1

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

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

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

### Solution

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

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

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

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

whichever is greater in absolute amount; or

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

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

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

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

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

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

### Illustration 2

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

### Solution

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

### Illustration 3

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

### Solution

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are ₹ 8.8 crores [₹ 10 crores – (₹ 0.5 + ₹ 0.4 +₹ 0.3)]. Segment X holds total assets of ₹ 1.5 crores (₹ 2 crores –₹ 0.5 crores); Segment Y holds ₹ 2.6 crores (₹ 3 crores –₹ 0.4 crores); and Segment Z holds ₹ 4.7 crores (₹ 5 crores –₹ 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

### Illustration4

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

| | ₹ ('000) |
|---|---|
| *Forging Shop Division* | |
| Sales to Bright Bar Division | 4,575 |
| *Other Domestic Sales* | 90 |
| *Export Sales* | 6,135 |
| | 10,800 |
| *Bright Bar Division* | |
| *Sales to Fitting Division* | 45 |
| *Export Sales to Rwanda* | 300 |
| | 345 |
| *Fitting Division* | |
| *Export Sales to Maldives* | 270 |

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

## Solution

**Diversifiers Ltd.**
**Segmental Report**

*(₹ '000)*

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

**Sales Revenue by Geographical Market**

**(₹ '000)**

| | **Home Sales** | **Export Sales (by forging shop division)** | **Export to Rwanda** | **Export to Maldives** | **Consolidated Total** |
|---|---|---|---|---|---|
| External sales | 90 | 6,135 | 300 | 270 | 6,795 |

### Illustration 5

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

### Solution

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

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

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *As per AS 17, reportable segments are those whose total revenue from external sales and inter-segment sales is*

   (a) *10% or more of the total revenue of all segments*

   (b) *10% or more of the total revenue of all external segments*

   (c) *12% or more of the total revenue of all segments*

   (d) *12% or more of the total revenue of all external segments*

2. *Which of the following statements is correct?*

   (a) *Management has a discretion to include a segment as a reportable segment even if it passes the 10% materiality test.*

   (b) *Management has a discretion to include any segment as a reportable segment if it fails the 12% materiality test.*

   (c) *It is mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.*

   (d) *It is not mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.*

3. *Which of the following statements is correct?*

   (a) *The overall test of 75% considers only external revenue to compute the threshold limit.*

   (b) *The overall test of 75% considers only internal revenue to compute the threshold limit.*

   (c) *The overall test of 75% considers both internal and external revenue to compute the threshold limit.*

   (d) *It is management choice whether they want to include both external and internal revenue for computing threshold limit.*

4. *Which of the following statements is correct?*

   (a) *The 10% test computed on the basis of revenue, considers both internal and external revenue to compute the threshold limit.*

   (b) *The 10% test computed on the basis of revenue, considers only external revenue to compute the threshold limit.*

   (c) *The 10% test computed on the basis of revenue, considers only internal revenue to compute the threshold limit.*

   (d) *It is management choice whether they want to include both external and internal revenue for computing threshold limit.*

5. *Which of the following statements is correct?*

   (a) *In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or net* *loss respectively of all segments taken together becomes reportable segment.*

(b) *In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit (after netting the losses) of all segments taken together becomes reportable segment.*

(c) *In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is higher in absolute figures) of all segments taken together becomes reportable segment.*

(d) *In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is lower in absolute figures) of all segments taken together becomes reportable segment.*

## Scenario based Question

6. *Nathan Limited has three segments namely P, Q and R. The assets of the company are ₹ 15 crores. Segment P has 4 crores, Segment Q has 6 crores and Segment R has 5 crores. Deferred tax assets included in the assets of each segment are P - ₹ 1 crore, Q - ₹ 0.90 crores and R - ₹ 0.80 crores. The accountant contends all these three segments are reportable segments. Comment.*

7. *Company A is engaged in the manufacture and sale of products, which constitute two distinct business segments. The products of the Company are sold in the domestic market only. The management information system of the Company is organized to reflect operating information by two broad market segments, rural and urban.*

   *Besides the two business segments, how should Company A identify geographical segments? Do geographical segments exist within the same country? Explain in line with the provisions of AS 17.*

8. *PK Ltd. has identified business segment as its primary reporting format. It has identified India, USA and UK as three geographical segments. It sells its products in the Indian market, which constitutes 70 percent of the Company's*

*sales. 25 per cent is sold in USA and the balance is sold in UK.*

*Is PK Ltd. as part of its geographical secondary segment information, required to disclose segment revenue from export sales, where such sales are not significant?*

9. *XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March, 20X2 have been provided below. You are required to identify from the following whether reportable segments or not reportable segments, on the basis of "profitability test" as per AS-17.*

| Segment | Profit (Loss) ₹ in lakhs |
|---|---|
| A | 225 |
| B | 25 |
| C | (175) |
| D | (20) |
| E | (105) |

10. *ABC Limited has 5 segments namely A, B, C, D and E. The profit/loss of each segment for the year ended March 31st, 20X2 is as follows:*

| Segment | Profit/(Loss) (₹ in crore) |
|---|---|
| A | 780 |
| B | 1,500 |
| C | (2,300) |
| D | (4,500) |
| E | 6,000 |
| Total | 1,480 |

*Identify the Reportable segments.*

11. *Heavy Goods Ltd. has 6 segments namely L-Q (below).*

*The total revenues (internal and external), profits or losses and assets are set out below:*

***(In ₹)***

| Segment | Inter Segment Sales | External Sales | Profit / loss | Total assets |
|---|---|---|---|---|
| L | 4,200 | 12,300 | 3,000 | 37,500 |
| M | 3,500 | 7,750 | 1,500 | 23,250 |
| N | 1,000 | 3,500 | (1,500) | 15,750 |
| 0 | 0 | 5,250 | (750) | 10,500 |
| P | 500 | 5,500 | 900 | 10,500 |
| Q | 1,200 | 1,050 | 600 | 5,250 |
| | 10,400 | 35,350 | 3,750 | 1,02,750 |

*Heavy Goods Ltd. needs to determine how many reportable segments it has.*

*You are required to advice Heavy Goods Ltd. as per the criteria defined in AS 17.*

12. *Calculate the segment results of a manufacturing organization from the following information:*

| Segments | A | B | C | Total |
|---|---|---|---|---|
| Directly attributed revenue | 5,00,000 | 3,00,000 | 1,00,000 | 9,00,000 |
| Enterprise revenue (allocated in 5 :4 : 2 basis) | | | | 1,10,000 |
| Revenue from transactions with other segments | | | | |
| Transaction from B | 1,00,000 | | 50,000 | 1,50,000 |
| Transaction from C | 10,000 | 50,000 | | 60,000 |
| Transaction from A | | 25,000 | 1,00,000 | 1,25,000 |

| | | | | |
|---|---|---|---|---|
| *Operating expenses* | *3,00,000* | *1,50,000* | *75,000* | *5,25,000* |
| *Enterprise expenses (allocated in 5 :4 :2 basis)* | | | | *77,000* |
| *Expenses on transactions with other segments* | | | | |
| *Transaction from B* | *75,000* | | *30,000* | |
| *Transaction from C* | *6,000* | *40,000* | | |
| *Transaction from A* | | *18,000* | *82,000* | |

*13.* The Senior Accountant of AMF Ltd. gives the following data regarding its five segments:

*(₹ in lakhs)*

| **Particulars** | **P** | **Q** | **R** | **S** | **T** | **Total** |
|---|---|---|---|---|---|---|
| | (₹) | (₹) | (₹) | (₹) | (₹) | (₹) |
| Segment Assets | 80 | 30 | 20 | 20 | 10 | 160 |
| Segment Results | (190) | 10 | 10 | (10) | 30 | (150) |
| Segment Revenue | 620 | 80 | 60 | 80 | 60 | 900 |

The Senior Accountant is of the opinion that segment "P" alone should be reported. Is he justified in his view? Examine his opinion in the light of provision of AS-17 'Segment Reporting'.

# ANSWERS/ HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **1.** | (a) | **2.** | (c) | **3.** | (a) | **4.** | (a) | **5.** | (c) |

## Answers to the Scenario based Question

**6.** According to AS 17 "Segment Reporting", segment assets do not include income tax assets.

Therefore, the revised total assets are 12.3 crores [₹ 15 - (₹ 1 +0.9 + 0.8).

*Details of Segment wise assets:*

Segment P holds total assets of ₹ 3 crores (₹ 4 crores - ₹ 1 crores);

Segment Q holds ₹ 5.1 crores (₹ 6 crores - ₹ 0.9 crores);

Segment R holds ₹ 4.2 crores (₹ 5 crores - ₹ 0.8 crores).

Thus, all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Hence, the contention of the Accountant that all three segments are reportable segments is correct.

**7.** AS 17 explains that, "a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country".

Accordingly, to identity geographical segments, Company A needs to evaluate whether the segments reflected in the management information system function in environments that are subject to significantly differing risks and returns irrespective of the fact whether they are within the same country.

The Standard recognizes that, "Determining the composition of a business or geographical segment involves a certain amount of judgement...". Accordingly, while the management information system of the Company provides segment information for rural and urban geographical segments for the purpose of internal reporting, judgement is required to determine whether these segments are subject to significantly differing risks and returns based on the definition of geographical segment. In making such a judgement, aspect like different pricing and other policies, e.g., credit policies, deployment of resources between different regions etc., may be considered for the purpose identifying 'urban and 'rural' as separate geographical segment.

Company A, in making judgment for identifying geographical segments, should also consider the relevance, reliability and comparability over time of segment information that will be reported. The Standard, explains that, "In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in the standard and the qualitative characteristics of financial statements. The qualitative characteristics include the relevance, reliability and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise."

**8.** As per AS 17, if primary format of an enterprise for reporting segment information is business segments, it should also report segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

Therefore, for the purposes of disclosing secondary segment information, PK Ltd. is not required to disclose segment revenue from export sales to UK, since that segment does not meet the 10 per cent or more of enterprise revenue threshold. However, other secondary segment information as per AS 17 should be disclosed in respect of this segment if the thresholds prescribed in the AS 17 are met.

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

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

- The combined result of all segments in profit; i.e. ₹ 250 Lakhs or
- The combined result of all segments in loss; i.e. ₹ 300 Lakhs

Whichever is greater in absolute amount i.e. ₹ 300 Lakhs.

| Operating Segment | Absolute amount of Profit or Loss (₹ In lakhs) | Reportable Segment Yes or No |
|---|---|---|
| A | 225 | Yes |
| B | 25 | No |
| C | 175 | Yes |
| D | 20 | No |
| E | 105 | Yes |

On the basis of the profitability test (result criteria), segments A, C and E are reportable segments (since their results in absolute amount is 10% or more of₹ 300 lakhs i.e. 30 lakhs).

**10.** In compliance with AS 17, the segment profit/loss of respective segment will be compared with the greater of the following:

(i) All segments in profit, i.e., A, B and E - Total profit ₹ 8,280 crores.

(ii) All segments in loss, i.e., C and D - Total loss ₹ 6,800 crores.

Greater of the above - ₹ 8,280 crores.

Based on the above, reportable segments will be determined as follows:

| Segment | Profit/(Loss) | Absolute Profit/Loss as a % of 8,280 | Reportable Segment |
|---|---|---|---|
| A | 780 | 9% | No |
| B | 1,500 | 18% | Yes |
| C | (2,300) | 28% | Yes |
| D | (4,500) | 54% | Yes |
| E | 6,000 | 72% | Yes |
| **Total** | **1,480** | | |

**11.** Quantitative Threshold Test:

**Revenue Test:**

Combined total sales of all the segment = ₹ 10,400 + ₹ 35,350 = ₹ 45,750.

10% thresholds = 45,750 x 10% = 4,575.

**Profitability Test:**

In the given situation, combined reported profit = ₹ 6,000 and combined reported loss (₹ 2,250). Hence, for 10% thresholds ₹ 6,000 will be considered.

10% thresholds = ₹ 6,000 x 10% = ₹ 600

**Asset Test:**

Combined total assets of all the segment = ₹ 1,02,750

10% thresholds = ₹ 1,02,750 x 10% = 10,275

***Accordingly, quantitative thresholds are calculated below:***

| Segments | L | M | N | O | P | Q | Reportable segments |
|---|---|---|---|---|---|---|---|
| % segment sales to total sales | 36.66% | 24.59% | 9.84% | 11.48% | 13.11% | 4.92% | L, M,O,P |
| % segment profit to total profits | 50% | 25% | 25% | 12.5% | 15% | 10% | L,M,N,O,P,Q |
| % segment assets to total assets | 36.50% | 22.63% | 15.33% | 10.22% | 10.22% | 5.11% | L,M,N,O,P |

**Conclusion:**

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments.

Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment.

Segment Q does not satisfy the revenue or the assets test but is does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence all segments i.e. L, M, N, O, P and Q are reportable segments.

**12.**

**Computation of segment result:**

| Segments | A ₹ | B ₹ | C ₹ | Total ₹ |
|---|---|---|---|---|
| Directly attributed revenue | 5,00,000 | 3,00,000 | 1,00,000 | 9,00,000 |
| Enterprise revenue (allocated in 5 :4 :2 basis) | 50,000 | 40,000 | 20,000 | 1,10,000 |

| | | | | |
|---|---|---|---|---|
| **Revenue from transactions with other segments** | | | | |
| Transaction from B | 1,00,000 | | 50,000 | 1,50,000 |
| Transaction from C | 10,000 | 50,000 | | 60,000 |
| Transaction from A | | 25,000 | 1,00,000 | 1,25,000 |
| **Total segment revenue (1)** | **6,60,000** | **4,15,000** | **2.70,000** | **13,45,000** |
| Operating expenses | 3,00,000 | 1,50,000 | 75,000 | 5,25,000 |
| Enterprise expenses (allocated in 5 :4 :2 basis) | 35,000 | 28,000 | 14,000 | 77,000 |
| Expenses on transactions with other segments | | | | |
| Transaction from B | 75,000 | | 30,000 | 1,05,000 |
| Transaction from C | 6,000 | 40,000 | | 46,000 |
| Transaction from A | | 18,000 | 82,000 | 1,00,000 |
| **Total segment expenses (2)** | **4,16,000** | **2,36,000** | **2,01,000** | **8,53,000** |
| **Segment result (1-2)** | **2,44,000** | **1,79,000** | **69,000** | **4,92,000** |

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

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

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

(1) The combined result of all segments in profit; or

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

whichever is greater in absolute amount; or

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

Accordingly,

(a) On the basis of revenue from sales criteria, segment P is a reportable segment.

(b) On the basis of the result criteria, segments P & T are reportable segments (since their results in absolute amount is 10% or more of ₹ 200 Lakhs).

(c) On the basis of asset criteria, all segments except T are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported upon in accordance with AS 17. Hence, the opinion of chief accountant that only segment 'P' is reportable is wrong.

# UNIT 4: ACCOUNTING STANDARD 18 RELATED PARTY DISCLOSURES

## LEARNING OUTCOMES

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

- Need for disclosure of related party relationship;
- How to identify the related party relationships;
- Which parties are not treated as related party;
- Exemption from Related Party Disclosure in certain situations;
- Disclosure requirements under AS-18.

## 4.1 INTRODUCTION

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

## 4.2 RELATED PARTY ISSUE – WHY DISCLOSURE IS NEEDED?

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

There is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into.

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

Also, sometimes the operating results and financial position of an enterprise may be affected by a related party relationship *even if* related party transactions **do not occur.** The *mere existence of the relationship* may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another - for example, a subsidiary may be instructed by its holding company not to engage in research and development.

Likewise, in certain cases transactions *would not have taken place* if the related party relationship had not existed. For example, a company that sold a large proportion of its production to its holding company *at cost* might not have found an alternative customer if the holding company had not purchased the goods.

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

## 4.3 RELATED PARTY RELATIONSHIPS, AS CONTEMPLATED UNDER AS-18

Related Party - As per AS-18, parties are considered to be related if *at any time during the reporting period* one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

It is worthwhile to note that AS-18 provides a definitive list of related party relationships to which AS-18 applies. Accordingly, **AS 18 deals only with the following five types of related party relationships described in (a) to (e) below**:

(a) Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

> ***Note:*** This is the case when there is a parent-subsidiary relationship (including relationship among fellow subsidiaries), as illustrated later in this chapter. For meaning of the term control, refer to subsequent discussion under this chapter.

(b) Associates and joint ventures of the reporting enterprise *and* the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

(c) Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, *and* relatives of any such individual.

(d) Key management personnel *and* relatives of such personnel; and

(e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises *owned by* directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

## 4.4 WHO ARE NOT DEEMED TO BE RELATED PARTIES UNDER AS-18?

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

(a) Two companies are not related parties simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings). Accordingly, if the common director is able to influence the policies of **both the companies in their mutual dealings** – then related party relationship exists.

(b) A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business *merely* by virtue of the ***resulting economic dependence***; and

(c) The parties listed below, in the course of their *normal dealings with an enterprise* by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) Providers of finance

(ii) Trade unions

(iii) Public utilities

(iv) Government departments and government agencies including government sponsored bodies

## 4.5 EXEMPTION FROM RELATED PARTY DISCLOSURE IN CERTAIN SITUATIONS

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

   Put differently, in cases where a statute or a regulator or a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is *not warranted.* For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard *would not override* the obligation to preserve the confidentiality of customers' dealings.

2. **Consolidated financial statements:** No disclosure is required in consolidated financial statements in respect of intra-group transactions - since disclosure of transactions between members of a group is unnecessary in consolidated financial statements. This is mainly because consolidated financial statements present information about the holding and its subsidiaries *as a single reporting enterprise*.

3. **State-controlled enterprises:** No disclosure is required in the financial

statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

## 4.6 DEFINITIONS OF OTHER TERMS USED IN AS 18

**Related party transaction:**AS-18 defines related party transaction as, "A transfer of resources or obligations between related parties, regardless of whether or not a price is charged".

**Control:** As per AS-18 Control means:

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

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power **and** the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

It is pertinent to note that the above definition of control under AS-18 is relatively wider than that under AS-21 *Consolidated Financial Statements*. This is so because - clause (c) in the definition of control under AS-18 is an addition, which is not found in AS-21 *Consolidated Financial Statements*.

Also, AS-18 clarifies that for the purpose of AS 18, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of the governing body of that company/enterprise. Put differently, control to the composition of the Board of directors is determined with reference to the **authority of an enterprise** *to appoint or remove all or majority of directors of another enterprise* ***without concurrence of any other person*****.**

Further, an enterprise is **deemed** to have the power to appoint a director/ member of the governing body, if *any of the following conditions* is satisfied:

(a) A person cannot be appointed as director/member of the governing body without the exercise in his favour by that enterprise of such a power as aforesaid or

(b) A person's appointment as director/member of the governing body follows necessarily from his appointment to a position held by him in that enterprise or

(c) The director/member of the governing body is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

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

**Associate:** AS-18 defines an Associate as an enterprise in which an *investing reporting party* has significant influence and which is neither a subsidiary nor a joint venture of that party. Therefore, an associate should not be a *subsidiary neither a joint venture of that investing reporting enterprise*.

**And, the term Significant influence** is defined by AS-18 as *"Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies"***.**

Further,AS-18 clarifies that significant influence may be exercised in several ways, for example, (1) by representation on the board of directors;, (2) participation in the policy making process; (3) material inter-company transactions, (4) interchange of managerial personnel or (5) dependence on technical information.

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

**Key Management Personnel:** As per AS-18, Key Management Personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

For example, in the case of a company, (1) the managing director(s), (2) whole time director(s), (3) manager and (4) any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are *usually considered* key management personnel.

AS-18 further provides an explanation that a non-executive director of a company -is not considered as a key management person under this Standard by virtue of *merely* his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

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

**Relative:** As per AS-18, a Relative in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

**Joint Venture** - AS-18 defines a Joint Venture as a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

**Joint Control**–AS-18 defines a Joint Control as the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it. Accordingly, when two or more parties *contractually* agree to share power to govern the financial and operating policies of an economic activity, this contractual agreement is termed as joint control.

It is pertinent to note that joint venture ***does not*** depend upon *voting power of the parties involved*. Rather, it is linked to the ***ability to exercise joint control over an economic activity.***

**Holding Company**–AS-18 defines Holding Company as a company having one or more subsidiaries

**Subsidiary** AS 18 defines a Subsidiary – as a company:

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

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

**Fellow Subsidiary**–AS-18 clarifies that a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

### Illustration 1

*Identify the related parties in the following case as per AS 18:*

*A Ltd. holds 51% of B Ltd.*

*B Ltd holds 51% of O Ltd.*

*Z Ltd holds 49% of O Ltd.*

### Solution

In relation to Reporting enterprise - A Ltd.

♦ B Ltd. (subsidiary) is a related party

♦ O Ltd.(subsidiary) is a related party

In relation to Reporting enterprise - B Ltd.

♦ A Ltd. (holding company) is a related party

♦ O Ltd. (subsidiary) is a related party

In relation to Reporting enterprise - O Ltd.

♦ A Ltd. (ultimate holding company) is a related party

♦ B Ltd. (holding company) is a related party

♦

- Z Ltd. (investor/ investing party) is a related party (O Ltd being Associate of Z Ltd)

Reporting enterprise - Z Ltd.

- O Ltd. (Associate) is a related party

### Illustration 2

*Consider a scenario wherein:*

- *A Ltd. has 60% voting right in B Ltd.*
- *A Ltd. also has 22% voting right in C Ltd.; and*
- *B Ltd. has 30% voting right in C Ltd.*

*Whether C Ltd. is to be treated under AS-18 as a party related to A Ltd.?*

### Solution

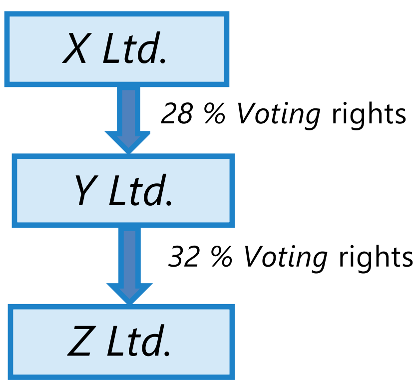
Yes – in relation to A Ltd. (the reporting enterprise), C Ltd. is a related party under AS-18. This is because A Ltd. *indirectly controls* C Ltd.

In this case, A Ltd. (together with its subsidiary B Ltd.) controls *more than one half of the voting rights* of C Ltd.

### Illustration 3

*Consider a scenario wherein:*

- *X Ltd. holds 28% voting right in Y Ltd. (and hence Y Ltd. is an associate of X Ltd.)*
- *Y Ltd. holds 32% voting right in Z Ltd. (and hence Z Ltd. is an associate of Y Ltd.)*



*In the above case, since Y Ltd. is an associate of X Ltd. – Y Ltd. is a related party to X Ltd.*

*Likewise, since Z Ltd. is an associate of Y Ltd. - Z Ltd. is a related party to Y Ltd.*

*The question is: Whether Z Ltd. is to be treated under AS-18 as a party related to X Ltd.?*

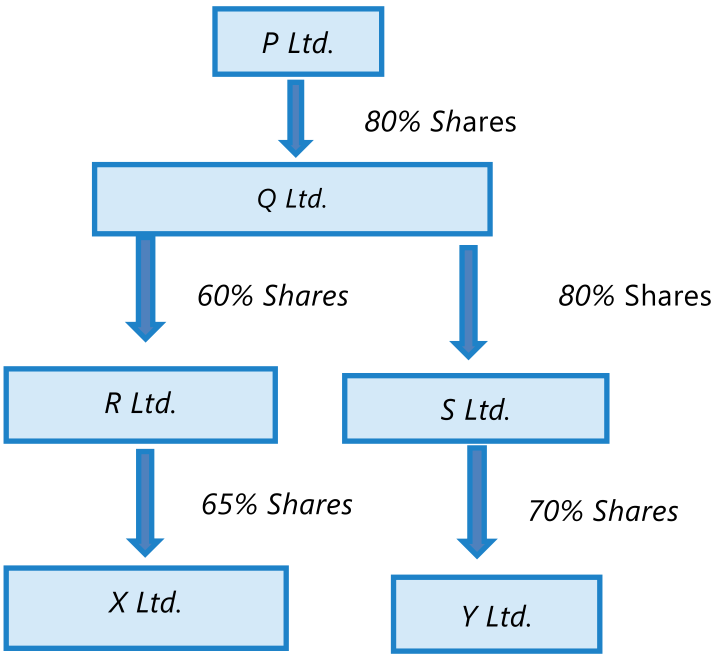
### Solution

No – in relation to X Ltd. (the reporting enterprise), Z Ltd. is a **not** a related party.

This is because as per the requirements of AS-18, '*associate of an associate*' is **not** a related party.

### Illustration 4

*Consider the following organization structure related to P Ltd.*




*Given the above structure: Identify related party relationships, if R Ltd. is the reporting enterprise*

### Solution

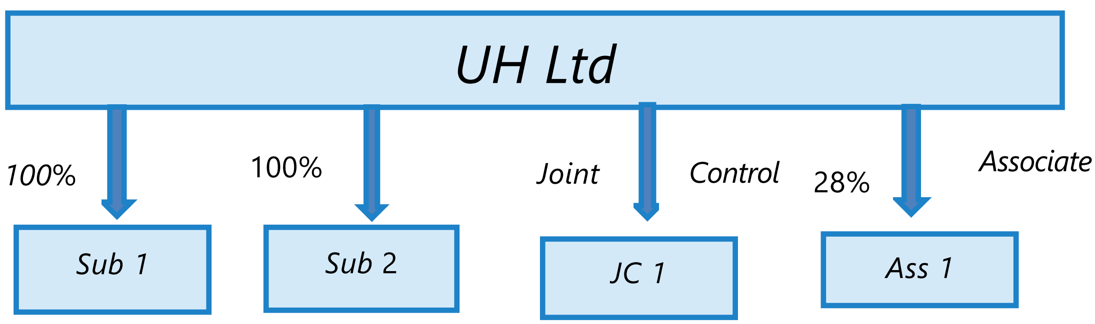
The following table identifies the related party relationships for R Ltd. (being the reporting enterprise):

| Party Name | Relationship under AS-18 |
|---|---|
| **P Ltd.** | ♦ P Ltd. has *indirect control* on R Ltd. (through Q Ltd.)<br>♦ Hence R Ltd. is related to P Ltd. |
| **Q Ltd.** | ♦ Q Ltd. has direct control of R Ltd.<br>♦ Hence R Ltd. is related to Q Ltd. |
| **S Ltd.** | ♦ R Ltd. and S Ltd. are under common control of Q Ltd.<br>♦ Hence R Ltd. is related to S Ltd. |
| **X Ltd.** | ♦ X Ltd. is controlled by R Ltd.<br>♦ Hence R Ltd. is related to X Ltd. |
| **Y Ltd.** | ♦ Y Ltd. is the sub-subsidiary of Q Ltd.<br>♦ Both R Ltd. and Y Ltd. are under common control of Q Ltd.<br>♦ Hence R Ltd. is related to Y Ltd. |

## Illustration 5

*Consider the following organization structure related to UH Ltd. (the ultimate parent company of a Group), wherein UH Ltd. has made the following investments:*

- *Investment in two of the wholly owned subsidiaries, viz. Sub 1 and Sub 2*
- *Investment in JC 1, in which UH Ltd. has a joint control*
- *20% investment in Ass 1 (and hence, Ass 1 is an associate of UH Ltd.)*




*Given the above structure: Identify related party relationships for each of the above entities under AS-18.*

### Solution

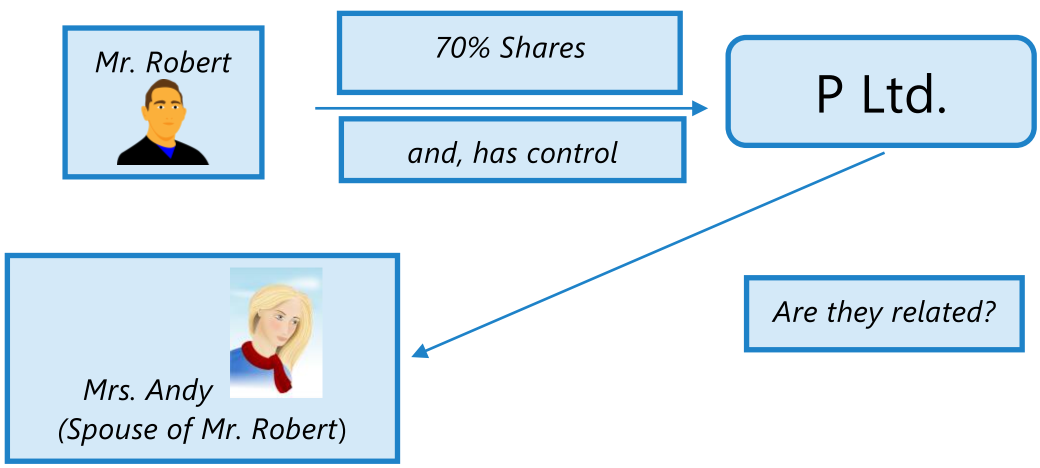
The following table identifies the related party relationships for each of the entities in the Group:

| Reporting enterprise | Related Party as per AS-18 |
|---|---|
| **UH Ltd.** | All the four entities (viz. Sub 1, Sub 2, JC 1 and Ass 1) |
| **Sub 1** | Only two of the entities in the Group (viz. UH Ltd. and Sub 2) |
| **Sub 2** | Only two of the entities in the Group (viz. UH Ltd. and Sub 1) |
| **JC 1** | Only UH Ltd. |
| **Ass 1** | Only UH Ltd. |

### Illustration 6

*Consider a scenario wherein:*

- *Mr. Robert holds 70% shares and voting rights in P Ltd*




*Determine: Whether Andy (spouse of Mr. Robert) is a related party to P Ltd. under AS-18?*

### Solution

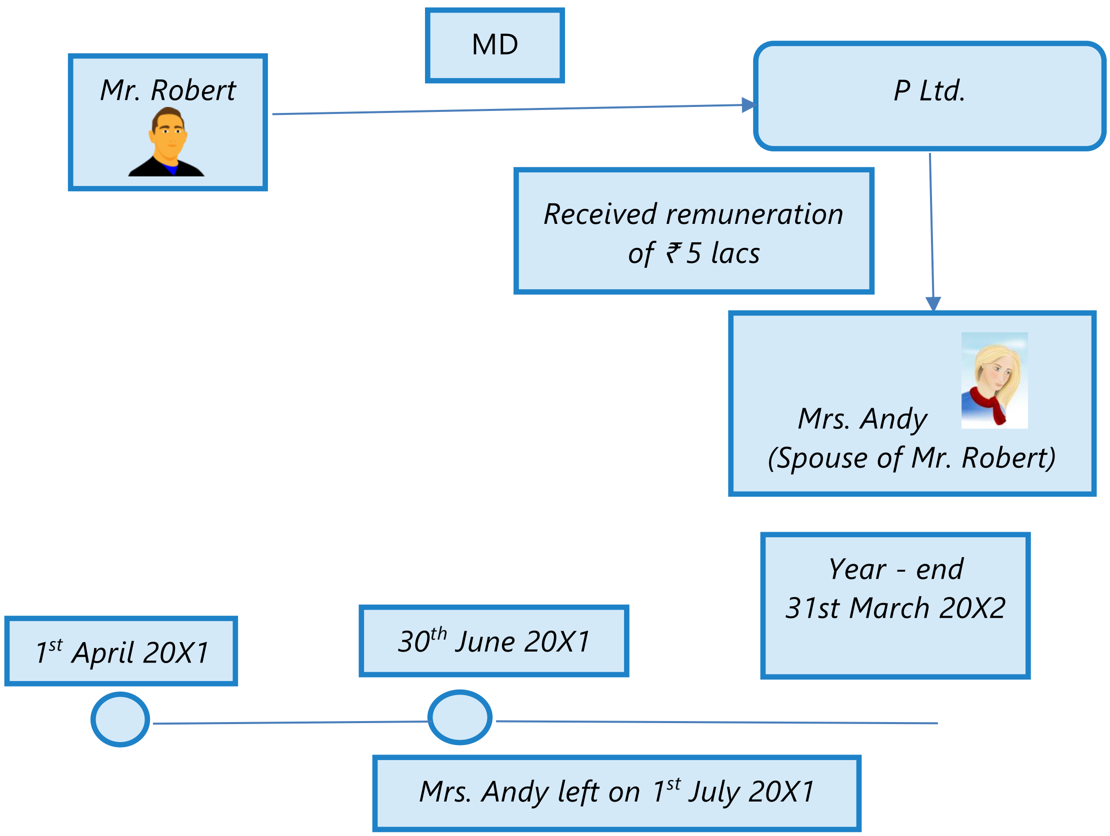
Yes – Andy is a related party to P Ltd., in view of the requirements of AS-18.

It may be recalled that under AS-18 'relatives of individuals owning an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise' are considered as related parties.

### Illustration 7

*Consider a scenario wherein:*

- *Mr. Robert is a Managing Director of P Ltd.*
- *Andy (spouse of Robert) received a remuneration of Rs 5 lacs from P Ltd. – for the services she rendered to P Ltd. for the period 1st April 20X1 through 30th June 20X1*
- *Andy left the services of P Ltd. on 1st July 20X1*
- *Consider 31st March 20X2 as the year-end date for P Ltd.*



*Whether Andy is to be identified as related party at the year-end date (31st March 20X2) for the purposes of AS-18?*

## Solution

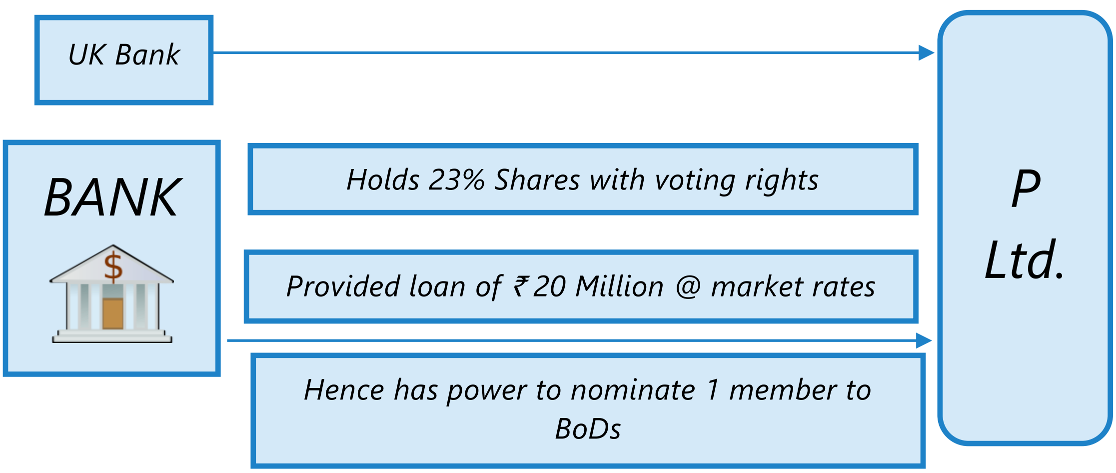
Yes – This is because as per AS-18, parties are considered to be related if *at any time during the reporting period* one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence Andy (being the spouse *and* relative of the KMP of P Ltd.) **needs to be reported** as related party at the year-end date (i.e. 31st March 20X2). This is because the remuneration Andy received from P Ltd. (for the period April 20X1 to 30 June 20X1) *falls within the reporting year April 20X1 to March 20X2.*

## Illustration 8

*Consider a scenario wherein:*

- *UK Bank holds 23% equity shares with voting rights in P Ltd.*
- *The bank has provided a loan of Rs. 20 million to P Ltd. at market interest rate*
- *As per the terms and conditions of the loan agreement, the bank has appointed one person as its nominee to the board of directors of P Ltd. and any major transaction to be entered into by P Ltd. will require the consent of the Bank*



*Determine: Whether under AS-18 - UK Bank is a related party to P Ltd. (the reporting enterprise)?*

## Solution

In the instant case, the UK Bank holds 23% shares with voting rights in P Ltd. and hence is deemed to exercise significant influence over P Ltd.

The bank is also a provider of finance to P Ltd. (the reporting enterprise) and as per AS-18, parties like providers of finance are deemed ***not to be considered*** as a related party in the course of *normal dealings with an enterprise* by virtue ***only of those dealings.*** However, this exemption will not be available to UK Bank in this case – since it exercises significant influence over P Ltd. (by virtue of holding 23% shares with voting rights in P Ltd.)

Accordingly, for P Ltd. (the reporting enterprise), the UK Bank is a related party and it will be required to disclose the transactions with UK Bank in its financial statements.

# 4.7 DISCLOSURE REQUIREMENTS UNDER AS-18

At the outset, it is to be noted that AS-18 prescribe related party disclosure requirements.

(a) name of the related party *and* (b) nature of the related party relationship ***where control exists*** should be disclosed - *irrespective of* whether or not there have been transactions between the related parties.

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

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

(i) The name of the transacting related party;

(ii) A description of the relationship between the parties;

(iii) A description of the nature of transactions;

(iv) Volume of the transactions either as an amount or as an appropriate proportion;

(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

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

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

## 4.8 LIST OF RELATED PARTY TRANSACTIONS, TO BE DISCLOSED (WHAT NEEDS TO BE DISCLOSED?)

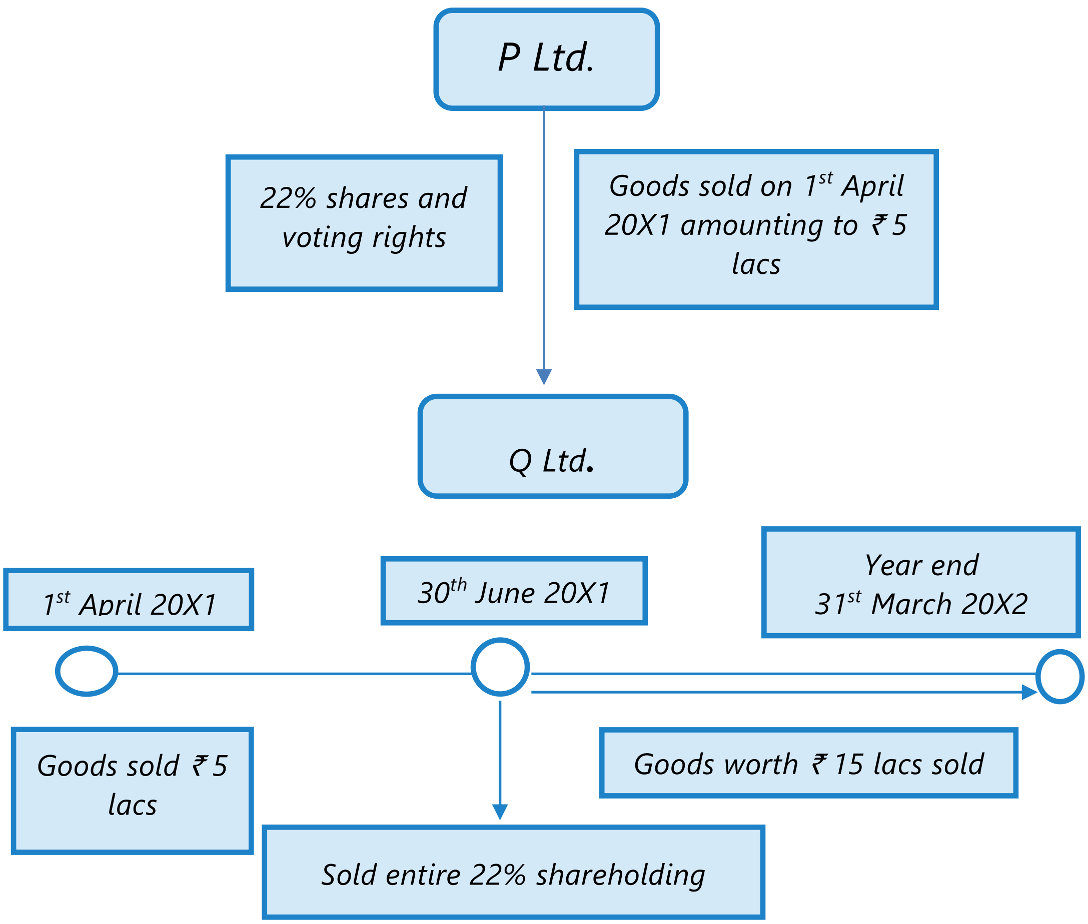
AS-18 gives following ***examples*** of related party transactions, in respect of which disclosures may be made by a reporting enterprise:

1. purchases or sales of goods (finished or unfinished)
2. purchases or sales of fixed assets
3. rendering or receiving of services
4. agency arrangements
5. leasing or hire purchase arrangements
6. transfer of research and development
7. licence agreements
8. finance (including loans and equity contributions in cash or in kind)
9. guarantees and collaterals
10. management controls including for deputation of employees.

## Illustration 9

*Consider a scenario wherein:*

- *P Ltd. hold 22% shares and voting rights in Q Ltd. (and hence Q Ltd. is an associate of P Ltd.)*
- *On 1st April 20X1, P Ltd. sold certain goods to Q Ltd. amounting to Rs. 5 lacs*
- *On 30th June 20X1, P Ltd. sold its entire 22% stake in Q Ltd. (and hence the related party relationship ceased to exist after 30th June 20X1)*
- *However, P Ltd. continued supply goods to Q Ltd. subsequent to 30th June 20X1 (just like any other customer) and sold goods worth Rs. 15 lacs during 9-month period ended 31st March 20X2*
- *Consider 31st March 20X2 as the year-end date for P Ltd.*



*Determine whether the transaction for the entire year (ending on 31st March 20X2) is required to be disclosed under AS-18 as related party transaction.*

## Solution

No – This is because as per AS-18, the disclosure requirements under the Standard relate *only to the period* ***during related party relationship existed.***

Accordingly, only *transactions between P Ltd and Q Ltd till 30th June 20X1* (being sale of goods worth Rs. 5 lacs) are required to be reported / disclosed under AS-18.

Transactions entered into after 30th June 20X1 are **NOT required** to be disclosed under AS-18.

## Illustration 10

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

## Solution

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

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

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

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *According to AS-18 Related Party Disclosures, which ONE of the following is not a related party of Skyline Limited?*

   (a) *A shareholder of Skyline Limited owning 30% of the ordinary share capital*

   (b) *An entity providing banking facilities to Skyline Limited in the normal course of business*

   (c) *An associate of Skyline Limited*

   (d) *Key management personnel of Skyline Limited*

2. *Are the following statements in relation to related parties true or false, according to AS-18 Related Party Disclosures?*

   (A) *A party is related to another entity that it is jointly controlled by.*

   (B) *A party is related to another entity that it controls.*

| | Statement (A) | Statement (B) |
|---|---|---|
| (a) | False | False |
| (b) | False | True |
| (c) | True | False |
| (d) | True | True |

3. *Which of the following is <u>not</u> a related party as envisaged by AS-18 Related Party Disclosures?*

   (a) *A director of the entity*

   (b) *The parent company of the entity*

   (c) *A shareholder of the entity that holds 1% stake in the entity*

   (d) *The spouse of the managing director of the entity*

4. *According to AS-18 Related Party Disclosures, related party transaction is a transfer of resources or obligations between related parties – provided a price is charged for such transfer.*

   *(a) True*

   *(b) False*

5. *According to AS-18 Related Party Disclosures, parties are considered to be related, if and only if at the end of the reporting period - one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.*

   *(a) True*

   *(b) False*

## Theoretical Questions

6 *Who are related parties under AS 18? What are the related party disclosure requirements?*

7 *ABC Limited is in the business of manufacturing textiles. It has certain commercial contracts with its customers and those customer contracts carry various clauses, imposing restriction on ABC Limited for disclosure of certain information. Accordingly, the company doesn't intend to provide related party disclosure under AS-18 in its ensuing financial statements. Is this correct?*

8 *Should the related parties be identified as at the reporting date (i.e. balance sheet date) for the purposes of AS-18? In disclosing transactions with related parties, are the transactions of the entire reporting period to be disclosed or only those for the period during which related party relationship exists?*

## Scenario based Question

9. *Mr. Raj, a relative of key management personnel, received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.20X1 to 30.6.20X1. On 1.7.20X1, he left the service of the company.*

   *Should the relative be identified as at the closing date i.e. on 31.3.20X2 for the purposes of AS 18?*

10. *X Ltd. sold goods to its associate company during the 1st quarter ended 30.6.20X1. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.*

11. *You are required to identify the related parties in the following cases as per AS 18:*

    *M Ltd. holds 61 % shares of S Ltd.*

    *S Ltd. holds 51 % shares of F Ltd.*

    *C Ltd. holds 49% shares of F Ltd.*

    *(Give your answer - Reporting Entity wise for M Ltd., S Ltd., C Ltd. and F Ltd.)*

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **1.** | (b) | **2.** | (d) | **3.** | (c) | **4.** | (b) | **5.** | (b) |

## Answers to the Theoretical Questions

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

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

(i) The name of the transacting related party;

(ii) A description of the relationship between the parties;

(iii) A description of the nature of transactions;

(iv) Volume of the transactions either as an amount or as an appropriate proportion;

(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

**7.** As per AS-18 stipulate that related party disclosure requirements under AS-18 ***do not apply*** in circumstances, where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality, as specifically required in terms of a statute or by any regulator or similar competent authority.

In case, where (1) a statute or (2) a regulator or (3) a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information, which is required to be disclosed as per AS 18, disclosure of such information is ***not warranted.*** For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and AS-18 would not override the obligation to preserve the confidentiality of customers' dealings.

However, this exemption is ***not available*** in respect of *confidentiality provisions in a commercial contract between two enterprises* - where confidentiality is not specifically required in terms of (1) a statute or (2) by any regulator or (3) similar competent authority.

Therefore, in the given case AS-18 related party disclosures would have to be made by ABC Limited in its ensuing financial statements.

**8.** As per the definition of related parties in AS-18, the *existence* of a related party relationship should be identified at all points during the year (<u>*and*</u> not only at the close of the financial year). However, AS 18 requires disclosure of transactions with these parties *only during the existence of* the related party relationship.

## Answers to the Scenario based Question

**9.** According to AS 18 on 'Related Party Disclosures', parties are considered to be related if *at any time during the reporting period* one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence Mr. Raj, a relative of key management personnel, should be identified as related party for disclosure in the financial statements for the year ended 31.3.20X2.

**10.** As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.20X1 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist would not be reported.

**11.**

| Reporting Entity | Related Party |
|---|---|
| M Ltd. | S Ltd. (subsidiary)<br>F Ltd.(subsidiary) |
| S Ltd. | M Ltd. (holding company)<br>F Ltd. (subsidiary) |
| F Ltd. | M Ltd. (ultimate holding company)<br>S Ltd. (holding company)<br>C Ltd. (investor/ investing party) |
| C Ltd. | F Ltd. (associate) |

# UNIT 5: ACCOUNTING STANDARD 20 EARNINGS PER SHARE

## LEARNING OUTCOMES

**After studying this unit, you will be able to comprehend the following:**

- Basic Earnings Per Share
  - Issues related to Numerator – Earnings
  - Issues related to Denominator – Weighted average number of shares
- Diluted Earnings Per Share
  - Issues related to Numerator – Earnings
  - Issues related to Denominator – Weighted average number of shares
- Dilutive Potential Equity Shares
- Restatement of Earnings per share
- Disclosures

## 5.1 INTRODUCTION

The objective of AS 20 is to describe principles for determination (i.e. computation) and presentation (i.e. presentation in the Statement of Profit and Loss) of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

| Computation | Presentation | Results in |
|---|---|---|
| i.e. Determination | Where - In the Income Statement | Inter firm comparision |
| Of - Basic & Diluted EPS | On the Face of the P&L A/c | Intra Firm comparision |

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

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

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

## 5.2 DEFINITION OF THE TERMS USED IN AS 20

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

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

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

**A financial asset** is any asset that is

a. Cash;

b. A contractual right to receive cash or another financial asset from another enterprise;

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

d. An equity share of another enterprise.

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

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

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

**Note:**

*A partly paid-up share where the holder is **not** entitled to dividends is treated as a potential equity share for the purposes of computing Diluted EPS.*

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

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

**Basic Earnings Per Share**

Basic earnings per share is calculated as

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

## 5.3 EARNINGS-BASIC

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

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

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

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

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

**Note:**

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

[In other words, there will be more than 1 Basic EPS for such a company; i.e. EPS for each class of equity shares]

A quick recap of adjustments to be made to the numerator will be as under:

| Particulars | Adjusted in the numerator of Basic EPS |
|---|---|
| Tax expense<br>(Current and Deferred Tax) | Yes |
| Exceptional items as per AS 5 | Yes |
| Extraordinary items as per AS 5 | Yes |
| Changes in Accounting estimates as per AS 5 | Yes |
| Changes in Accounting Policy as per AS 5 | Yes |
| Amount of preference dividends and any attributable tax thereto<br>(a) Non-cumulative preference<br>(b) Cumulative preference shares | **Yes – only if** it has been provided in the books<br>Yes – irrespective, whether or not the dividends have been provided for in the books |

## 5.4 PER SHARE- BASIC

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

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

The time-weighting factor is:

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

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

### Illustration 1

| *Date* | *Particulars* | | | *Balance* |
|---|---|---|---|---|
| *1st January* | *Balance at beginning of year* | *1,800* | *-* | *1,800* |
| *31st May* | *Issue of shares for cash* | *600* | *-* | *2,400* |
| *1st November* | *Buy Back of shares* | *-* | *300* | *2,100* |

*Calculate Weighted Number of Shares.*

### Solution

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

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

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

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

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

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

## 5.5 SHARES ISSUED IN A SCHEME OF AMALGAMATION

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

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

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

### Illustration 2

| *Date* | *Particulars* | *No. of Shares* | *Face Value* | *Paid up Value* |
|---|---|---|---|---|
| *1st January* | *Balance at beginning of year* | *1,800* | *₹ 10* | *₹ 10* |
| *31st October* | *Issue of Shares* | *600* | *₹ 10* | *₹ 5* |

*Calculate Weighted Number of Shares.*

### Solution

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

Computation of weighted average would be as follows:

(1,800 x 12/12) + (300 x 2/12) = 1,850 shares.

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

### Contingently Issuable Shares

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

### Bonus Issue, Share split and Right issue

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

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of shares).

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

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

## Illustration 3

| | |
|---|---|
| *Net profit for the year 20X1* | *₹ 18,00,000* |
| *Net profit for the year 20X2* | *₹ 60,00,000* |
| *No. of equity shares outstanding until 30th September 20X2* | *20,00,000* |

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

*Calculate Basic Earnings Per Share.*

## Solution

No. of Bonus Issue 20,00,000 x 2 = 40,00,000 shares

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

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

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

The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a **rights issue**, on the other hand, the **exercise price is often less than the fair value of the shares**. Therefore, a rights issue usually includes a bonus element.

[Thus, it may be noted that if a company makes a right issue at fair value itself, then there will be no bonus element in the right issue].

The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

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

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

### Illustration 4

| | |
|---|---|
| *Net profit for the year 20X1* | *₹ 11,00,000* |
| *Net profit for the year 20X2* | *₹ 15,00,000* |
| *No. of shares outstanding prior to rights issue* | *5,00,000 shares* |
| *Rights issue price* | *₹ 15.00* |
| *Last date to exercise rights* | *1st March 20X2* |

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

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

### Solution

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

$$\frac{(₹\ 21.00 \times 5{,}00{,}000 \text{ shares}) + (₹\ 15.00 \times 1{,}00{,}000 \text{ Shares})}{5{,}00{,}000 \text{ Shares} + 1{,}00{,}000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

*Computation of adjustment factor:*

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

*Computation of earnings per share:*

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

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

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

(5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = ₹ 2.55

## 5.6 DILUTED EARNINGS PER SHARE

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

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

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

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

**Note:**

*As mentioned earlier, a partly paid-up share where the holder is* ***not*** *entitled to dividends is treated as a potential equity share for the purposes of computing Diluted EPS.*

## 5.7 EARNINGS-DILUTED

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

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

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

### Illustration 5

| | |
|---|---|
| *Net profit for the current year* | *₹ 1,00,00,000* |
| *No. of equity shares outstanding* | *50,00,000* |
| *Basic earnings per share* | *₹ 2.00* |
| *No. of 12% convertible debentures of ₹ 100 each* | *1,00,000* |
| *Each debenture is convertible into 10 equity shares* | |
| *Interest expense for the current year* | *₹ 12,00,000* |
| *Tax relating to interest expense (30%)* | *₹ 3,60,000* |

*Compute Diluted Earnings Per Share.*

**Solution**

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

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

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

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

## 5.8 PER SHARE- DILUTED

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

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

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

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

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

A quick recap of the timing factor when these potential equity shares will be considered as a part of the denominator for weighted average computations.

| Particulars | From which date | Till which date |
|---|---|---|
| Potential equity shares which were issued last year and not yet converted into equity shares in current year | Beginning of the year | End of the year |
| Potential equity shares which were issued last year and have been converted into equity shares in current year | Beginning of the year | End of the year<br>(Till date of conversion as a potential equity share and after conversion both as a part of Basic and Diluted EPS) |
| Potential equity shares which were issued in the current year and not yet converted into equity shares in current year | Date of issue | End of the year |
| Potential equity shares which were issued last year and have been cancelled or have lapsed in current year | Beginning of the year | Till the date of cancellation or when they lapse |

### Diluted EPS in case of share options

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

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

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

### Illustration 6

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

*Compute Basic and Diluted Earnings Per Share.*

## Solution

**Computation of earnings per share**

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

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

## 5.9 DILUTIVE POTENTIAL EQUITY SHARES

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

Thus, it is important to note that the 'control factor' is the profit from **continuing ordinary activities.**

In simple words, we can conclude as under:

| Particulars | Remarks | Is it to be taken as a part of Diluted EPS or not? |
|---|---|---|
| Conversion to equity shares would **decrease earnings** per share from continuing ordinary activities. | Dilutive | Yes |
| Conversion to equity shares would **increase earnings** per share from continuing ordinary activities. | Anti-dilutive | No |
| Conversion to equity shares would **increase loss** per share from continuing ordinary activities. | Dilutive | Yes |
| Conversion to equity shares would **decrease loss** per share from continuing ordinary activities. | Anti-dilutive | No |

## Illustration 7

*X Limited, during the year ended March 31, 20X1, has income from continuing ordinary operations of ₹ 2,40,000, a loss from discontinuing operations of ₹ 3,60,000 and accordingly a net loss of ₹ 1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 20X1.*

*You are required to compute Basic and Diluted EPS?*

## Solution

As per AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations".

As income from continuing ordinary operations, ₹ 2,40,000 would be considered and not ₹ (1,20,000), for ascertaining whether 200 potential equity shares are dilutive or anti-dilutive. Accordingly, 200 potential equity shares would be dilutive potential equity shares since their inclusion would decrease the net profit per share from continuing ordinary operations from ₹ 240 to ₹ 200. Thus, the basic E.P.S would be ₹ (120) and diluted E.P.S. would be ₹ (100).

**In case there are more than 1 potential equity shares:**

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

## 5.10 RESTATEMENT

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

## 5.11 PRESENTATION

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

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

## 5.12 DISCLOSURE

An enterprise should disclose the following:

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

b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

d. The nominal value of shares along with the earnings per share figures.

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

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *AB Company Ltd. had 1,00,000 shares of common stock outstanding on January 1. Additional 50,000 shares were issued on July 1, and 25,000 shares were re-acquired on September 1. The weighted average number of shares outstanding during the year on Dec. 31 is*

   *(a) 1,40,000 shares*

   *(b) 1,25,000 shares*

   *(c) 1,16,667 shares*

   *(d) 1,20,000 shares*

2. *As per AS 20, potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would*

   *(a) Decrease net profit per share from continuing ordinary operations.*

   *(b) Increase net profit per share from continuing ordinary operations.*

   *(c) Make no change in net profit per share from continuing ordinary operations.*

   *(d) Decrease net loss per share from continuing ordinary operations.*

3. *As per AS 20, equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements are*

   *(a) Dilutive potential equity shares*

   *(b) Contingently issuable shares*

   *(c) Contractual issued shares*

   *(d) Potential equity shares*

4. *In case potential equity shares have been cancelled during the year, they should be:*

   *(a) Ignored for computation of Diluted EPS.*

   *(b) Considered from the beginning of the year till the date they are cancelled.*

(c) *The company needs to make an accounting policy and can follow the treatment in (a) or (b) as it decides.*

(d) *Considered for computation of diluted EPS only if the impact of such potential equity shares would be material.*

5. *Partly paid up equity shares are:*

   (a) *Always considered as a part of Basic EPS.*

   (b) *Always considered as a part of Diluted EPS.*

   (c) *Depending upon the entitlement of dividend to the shareholder, it will be considered as a part of Basic or Diluted EPS as the case may be.*

   (d) *Considered as part of Basic/ Diluted EPS depending on the accounting policy of the company.*

## Theoretical Questions

6. *In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date weight is to be considered:*

   (i) *Equity Shares issued in exchange of cash,*

   (ii) *Equity Shares issued as a result of conversion of a debt instrument,*

   (iii) *Equity Shares issued in exchange for the settlement of a liability of the enterprise,*

   (iv) *Equity Shares issued for rendering of services to the enterprise,*

   (v) *Equity Shares issued in lieu of interest and/or principal of an other financial instrument,*

   (vi) *Equity Shares issued as consideration for the acquisition of an asset other than in cash.*

   *Also define Potential Equity Share.*

7. *Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others*

*would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS.*

*Should only completely vested options be included for computation of Diluted EPS? Is this in accordance with the provisions of AS 20? Explain.*

8. *Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?*

## Scenario based Question

9 *NAT, a listed entity, as on 1st April, 20X1 had the following capital structure:*

| *Particulars* | ₹ |
|---|---|
| *10,00,000 Equity Shares having face value of ₹ 1 each* | *10,00,000* |
| *10,00,000 8% Preference Shares having face value of ₹ 10 each* | *1,00,00,000* |

*During the year 20X1-20X2, the company had profit after tax of Rs. 90,00,000.*

*On 1st January, 20X2, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December, 20X1.*

*On 1st January, 20X2, NAT issued 2,00,000 equity shares of Rs. 1 each at their full market price of Rs. 7.60 per share.*

*NAT's shares were trading at Rs. 8.05 per share on 31st March, 20X2.*

*Further it has been provided that the basic earnings per share for the year ended 31st March, 20X1 was previously reported at Rs. 62.30.*

***You are required to:***

(i) *Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March, 20X2 including the comparative figure, in accordance with AS-20 Earnings Per Share.*

(ii) *Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?*

10. *X Ltd. supplied the following information. You are required to compute the basic earnings per share:*

| (Accounting year 1.1.20X1– 31.12.20X1) | | |
|---|---|---|
| Net Profit | : | Year 20X1: ₹ 20,00,000 |
| | : | Year 20X2: ₹ 30,00,000 |
| No. of shares outstanding prior to Right Issue | : | 10,00,000 shares |
| Right Issue | : | One new share for each four outstanding i.e., 2,50,000 shares.<br>Right Issue price – ₹ 20<br>Last date of exercise rights– 31.3.20X2. |
| Fair rate of one Equity share immediately prior to exercise of rights on 31.3.20X2 | : | ₹ 25 |

11. *On 1st April, 20X1 a company had 6,00,000 equity shares of ₹ 10 each (₹ 5 paid up by all shareholders). On 1st September, 20X1 the remaining ₹ 5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 20X2 was ₹ 21,96,000 after considering dividend on preference shares of ₹ 3,40,000.*

    *You are required to compute Basic EPS for the year ended 31st March, 20X2 as per Accounting Standard 20 "Earnings Per Share".*

12. *No. of equity shares outstanding = 30,00,000*

    *Basic earnings per share ₹ 5.00*

    *No. of 12% convertible debentures of ₹ 100 each; 50,000*

    *Each debenture is convertible into 10 equity shares*

    *Tax Rate 30%*

    *Compute Diluted Earnings per Share.*

    *Working notes should form part of the answer.*

*13.* Following information is supplied by K Ltd.:

Number of shares outstanding prior to right issue - 2,50,000 shares.

Right issue - two new share for each 5 outstanding shares (i.e. 1,00,000 new shares)

Right issue price - ₹ 98

Last date of exercising rights - 30-06-20X2.

Fair value of one equity share immediately prior to exercise of right on 30-06-20X2 is ₹ 102.

Net Profit to equity shareholders:

20X1-20X2 - ₹ 50,00,000

20X2-20X3 -₹ 75,00,000

You are required to calculate the basic earnings per share as per AS-20 Earnings per Share.

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **1.** | (c) | **2.** | (a) | **3.** | (b) | **4.** | (b) | **5.** | (c) | | |

## Answers to the Theoretical Questions

**6.** The following dates should be considered for consideration of weights for the purpose of calculation of weighted average number of shares in the given cases:

(i) Date of Cash receivable

(ii) Date of conversion

(iii) Date on which settlement becomes effective

(iv) When the services are rendered

(v) Date when interest ceases to accrue

(vi) Date on which the acquisition is recognised.

A Potential Equity Share is a financial instrument or other contract that entitles or may entitle its holder to equity shares.

**7.** As per AS 20 "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares".

Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

The current method of calculating Diluted EPS adopted by AB limited is not in accordance with AS 20. The calculation of Diluted EPS should include all potential equity shares, i.e., all the stock options granted at the balance sheet date, which are dilutive in nature, irrespective of the vesting pattern. The options that have lapsed during the year should be included for the portion of the period the same were outstanding, pursuant to the requirement of the standard.

**8.** In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. Since the bonus issue is an issue without consideration, *the issue is treated as if it had occurred prior to the beginning of the earliest period reported.*

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

## Answers to the Scenario based Question

**9. (i) Computation of Basic Earnings per share for the year ended 31st March, 20X2:**

**(including the comparative figure)**

**Working Note – I:**

**Earnings for the year ended 31st March, 20X1:**

= EPS x Number of shares outstanding during 20X0-20X1

= ₹ 62.30 x 10,00,000 equity shares

= ₹ 6,23,00,000

**Adjusted/Restated Earnings per share for the year ended 31st March 20X1:**

**(after taking into consideration bonus issue)**

**Adjusted/Restated Basic EPS:**

= Earnings for the year 20X0-20X1 / (Total outstanding shares +Bonus issue)

= ₹ 6,23,00,000 / (10,00,000+ 5,00,000)

= ₹ 6,23,00,000 / 15,00,000

= ₹ 41.53 per share

**Computation of Basic EPS for the year 20X1-20X2:**

Basic EPS = (Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 20X2)

= (₹ 90,00,000 – ₹ (1,00,00,000 x 8%)) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= ₹ 82,00,000 / 15,50,000 shares

= ₹ 5.29 per share

(ii) In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources.

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

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

**10. Computation of Basic Earnings Per Share**

**(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)**

| | Year 20X1<br>₹ | Year 20X2<br>₹ |
|---|---|---|
| *EPS for the year 20X1 as originally reported*<br>$\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ | | |
| = (₹ 20,00,000 / 10,00,000 shares) | 2.00 | |
| *EPS for the year 20X1 restated for rights issue* | | |
| = [₹ 20,00,000 / (10,00,000 shares × 1.04*)] | 1.91<br>(approx.) | |
| *EPS for the year 20X2 including effects of rights issue* | | |
| $\frac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$ | | |
| $\frac{₹\ 30,00,000}{11,97,500 \text{ shares}}$ | | 2.51<br>(approx.) |

* Refer working note 2.

**Working Notes:**

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

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

$$= \frac{(₹\ 25 \times 10{,}00{,}000 \text{ shares}) + (₹\ 20 \times 2{,}50{,}000 \text{ shares})}{10{,}00{,}000 \text{ shares} + 2{,}50{,}000 \text{ shares}}$$

$$= \frac{₹\ 3{,}00{,}00{,}000}{12{,}50{,}000 \text{ shares}} = ₹\ 24$$

2. Computation of adjustment factor

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

$$= \frac{₹\ 25}{₹\ 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

**11.** Basic Earnings per share (EPS) =

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

$$= \frac{21{,}96{,}000}{4{,}57{,}500 \text{ Shares (as per working note)}} = ₹\ 4.80 \text{ per share}$$

**Working Note:**

Calculation of weighted average number of equity shares

As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

| Date | No. of equity shares | Amount paid per share | Weighted average no. of equity shares |
|---|---|---|---|
| | ₹ | ₹ | ₹ |
| 1.4.20X1 | 6,00,000 | 5 | 6,00,000 x 5/10 x 5/12 = 1,25,000 |
| 1.9.20X1 | 5,40,000 | 10 | 5,40,000 x 7/12 = 3,15,000 |
| 1.9.20X1 | 60,000 | 5 | 60,000 x 5/10 x 7/12 = 17,500 |
| Total weighted average equity shares | | | 4,57,500 |

**12. Earnings for the year:**

= No. of Shares x Basic EPS

= 30,00,000 shares x ₹ 5 per share = ₹ 1,50,00,000

**Computation of Adjusted Net Profit:**

= Earnings for the year + Interest on debentures net of tax

= 1,50,00,000 + (6,00,000 - 1,80,000) = ₹ 1,54,20,000

**Computation of Adjusted Denominator:**

No. of equity shares resulting from conversion of debentures:

= 50,000 x 10 shares = 5,00,000 shares

No. of equity shares for diluted EPS = 30,00,000 + 5,00,000

= 35,00,000 shares

**Computation of Diluted EPS:**

= ₹ 1,54,20,000/35,00,000 shares = ₹ 4.4 per share.

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

$$\frac{102 \text{ x } 2{,}50{,}000 \text{ Shares} + ₹\ 98 \text{ x } 1{,}00{,}000 \text{ shares}}{3{,}50{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ 100.86

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = 102/100.86 = 1.01$$

**Computation of earnings per share:**

EPS for the year 20X1-X2 as originally reported: ₹ 50,00,000/2,50,000 shares = ₹ 20

EPS for the year 20X1-X2 restated for rights issue: =₹ 50,00,000/ (2,50,000 shares x 1.01)

= ₹ 19.80

EPS for the year 20X2-X3 including effects of rights issue:

EPS = 75,00,000/3,25,625* = ₹ 23.03

** [(2,50,000 x 1.01 x 3/12) + (3,50,000 x 9/12)] =63,125 + 2,62,500 = 3,25,625 shares*

**Note**: Financial year (ended 31st March) is considered as accounting year while giving the above answer.

# UNIT 6: ACCOUNTING STANDARD 24 DISCONTINUING OPERATIONS

## LEARNING OUTCOMES

**After studying this unit, you will be able to comprehend the following:**

- Meaning of Discontinuing Operation;
- Definition of Initial Disclosure Event;
- Recognition and Measurement principles;
- Presentation and Disclosures as required under the standard.

## 6.1 INTRODUCTION

Imagine that a large company selling several products in the market decides to discontinue the sale of one of its key product as it plans to sell that portion of its business to another entity.

Ideally, this information should be disclosed to primary stakeholders as they would take economic decisions based on the performance of the remaining portion of the business that is expected to be continued by the company in future. Therefore, the presentation requirements of such discontinuing operations becomes relevant and the aspects of AS 24 need to be understood. AS 24 is applicable to all discontinuing operations.

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

## 6.2 DISCONTINUING OPERATION

A discontinuing operation is a component of an enterprise:

(a) That the enterprise, pursuant to a single plan, is:

- (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or
- (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
- (iii) Terminating through abandonment; and

(b) That represents a separate major line of business or geographical area of operations.

(c) That can be distinguished operationally and for financial reporting purposes.

**Example 1**

Co XY runs a famous chain of restaurants. It decides to sell its stake in one of the restaurant. This restaurant contributes around 5% of total revenue to the entire business. XY does not intend to sell any other restaurant as part of its strategy.

In the above case, the sale of one restaurant out of the chain does not constitute disposal of business under a single plan, or a portion that represents a major line of business or geographical area of operations._Thus, it cannot be regarded as a discontinuing operation.

**Example 2**

Group MN operates in various industries including Hotels, Airlines and Software through its subsidiaries. It has decided to sell its Airline business to be able to concentrate on other verticals. As a result, it has started to sell its aircrafts and paying off the associated liabilities. During the year, it has sold off 5 aircrafts out of the fleet of 50 aircrafts so far as part of the sale. The Airline business constitutes 25% of total group revenue.

In the above case, Airline business may be considered as **discontinuing operation**. This is due to the fact that the assets are sold off as part of a single plan, and that the business represents a separate major line of business, and can be distinguished both operationally and for financial reporting purposes.

**Separate major line of business or geographical area of operations**:

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

### Example 3

Entity RT operates in a single state and is trading in 3 products – X, Y and Z. Details with respect to the performance of each of the products are as under:

| Particulars | X | Y | Z | Total |
|---|---|---|---|---|
| Sales | 1,00,000 | 14,00,000 | 20,00,000 | 35,00,000 |
| Cost of Goods Sold | (80,000) | (10,80,000) | (14,40,000) | (26,00,000) |
| Gross Margin | 20,000 | 3,20,000 | 5,60,000 | 9,00,000 |
| Operational Expenses | (15,000) | (1,70,000) | (3,60,000) | (5,45,000) |
| Profit before Tax | 5,000 | 1,50,000 | 2,00,000 | 3,55,000 |

RT has decided to sell the business relating to Product Y to another entity. Since Product Y constitutes a major product, it may be considered as a discontinuing operations.

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

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

**Example 4**

GH, a large car manufacturing company, decides to discontinue its manufacturing operations relating to the diesel cars production. It plans to restructure the business by revamping its existing operations, and starting new manufacturing process for manufacture and sale of electric vehicles.

In the above example, it needs to be evaluated whether the restructuring is a result of continuing operations, or termination of existing operations, and accordingly it can be concluded whether it is a case of discontinuing operations or not.

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

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

(b) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

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

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

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

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

(a) The operating assets and liabilities of the component can be directly attributed to it.

(b) Its revenue can be directly attributed to it.

(c) At least a majority of its operating expenses can be directly attributed to it.

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

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

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

## 6.3 INITIAL DISCLOSURE EVENT

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

(a) The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(b) The enterprise's board of directors or similar governing body has both

  (i) approved a detailed, formal plan for the discontinuance and

  (ii) made an announcement of the plan.

A detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;

- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

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

## 6.4 RECOGNITION AND MEASUREMENT

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

## 6.5 PRESENTATION AND DISCLOSURE

### 6.5.1 Initial Disclosure

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

(a) A description of the discontinuing operation(s);

(b) The business or geographical segment(s) in which it is reported as per AS 17;

(c) The date and nature of the initial disclosure event;

(d) The date or period in which the discontinuance is expected to be completed if known or determinable;

(e) The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

(f) The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;

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

(h) The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period;

### 6.5.2 Disclosures Other Than Initial Disclosures Note

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

### 6.5.3 Other disclosures

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

(a) For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and

(b) The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

## 6.6 UPDATING THE DISCLOSURES

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

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

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

## 6.7 SEPARATE DISCLOSURE FOR EACH DISCONTINUING OPERATION

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

## 6.8 PRESENTATION OF THE REQUIRED DISCLOSURES

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

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

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

## 6.9 RESTATEMENT OF PRIOR PERIODS

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

## 6.10 DISCLOSURE IN INTERIM FINANCIAL REPORTS

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

(a) Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and

(b) Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

## TEST YOUR KNOWLEDGE

### Multiple Choice Questions

1. *AB decided to dispose of its Clothing division as part of its long-term strategy.*

   *(a) Date of Board approval - 1st March 20X1;*

   *(b) Date of formal announcement made to affected parties - 15th March 20X1.*

   *(c) Date of Binding Sale agreement – 1st July 20X1;*

   *(d) Reporting date – 31st March 20X1*

   *The date of initial disclosure event would be:*

   *(a) 1st March 20X1*

   *(b) 15th March 20X1*

(c) *31st March 20X1*

(d) *31st July 20X1*

2. *To qualify as a component that can be distinguished operationally and for financial reporting purposes, the condition(s) to be met is (are):*

   (a) *The operating assets and liabilities of the component can be directly attributed to it.*

   (b) *Its revenue can be directly attributed to it.*

   (c) *At least a majority of its operating expenses can be directly attributed to it.*

   (d) *All of the above*

3. *Identify which of the following statements is incorrect?*

   (a) *A discontinuing operation is a component of an enterprise that represents a separate major line of business or geographical area of operations.*

   (b) *A discontinuing operation is a component of an enterprise that can be distinguished operationally and for financial reporting purposes.*

   (c) *A discontinuing operation is a component of an enterprise that may or may not be distinguished operationally and for financial reporting purposes.*

   (d) *A discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.*

4. *Identify the incorrect statement.*

   (a) *Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.*

   (b) *The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 would always raise a question regarding the enterprise's ability to continue as a going concern.*

   (c) *For recognising and measuring the effect of discontinuing operations, AS 24 does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.*

(d) *An enterprise shall include a description of the discontinuing operation, in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs.*

## Theoretical Questions

5. (i) *What are the disclosure and presentation requirements of AS 24 for discontinuing operations?*

   (ii) *Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.*

6. *What are the initial disclosure requirements of AS 24 for discontinuing operations?*

## Scenario based Question

7. *Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner.*

   *You are required to comment:*

   (i) *If mere gradual phasing out in itself can be considered as a 'discontinuing operation' within the meaning of AS-24.*

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

   (iii) *Would your answer to (ii) above be different if the Company resolves to sell the assets of the passenger car division in a phased but time bound manner?*

*8.* A consumer goods producer has changed the product line as follows:

| | ***Dish washing Bar (Per month)*** | ***Clothes washing Bar (Per month)*** |
|---|---|---|
| *January 2021 - September 2021* | *2,00,000* | *2,00,000* |
| *October 2021 - December 2021* | *1,00,000* | *3,00,000* |
| *January 2022 - March 2022* | *Nil* | *4,00,000* |

*The company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors has passed a resolution in March 2021 to this effect. The company follows calendar year as its accounting year.*

*You required to advise the company whether it should be treated as discontinuing operation or not as per AS 24?*

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **1.** | (b) | **2.** | (d) | **3.** | (c) | **4.** | (b) |

## Answers to the Theoretical Questions

**5.** (i) An enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15 of AS 24) occurs. For details, please refer Section 6.5 of this Chapter above.

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

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

(b) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

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

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

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

(a) A description of the discontinuing operation(s)

(b) The business or geographical segment(s) in which it is reported as per AS 17.

(c) The date and nature of the initial disclosure event.

(d) The date or period in which the discontinuance is expected to be completed if known or determinable

(e) The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

(f) The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.

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

(h) The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

## Answer to the Scenario based Question

**7.** **(i)** A discontinuing operation is a component of an enterprise:

(a) that the enterprise, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment; and

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes.

Mere gradual phasing out is not considered as discontinuing operation as defined under AS 24, 'Discontinuing Operations'.

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

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

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

(iii) Closing of a facility to achieve productivity improvements or other cost savings. In this case, it cannot be considered as Discontinuing Operation as per AS-24 as the companies' strategic plan has no final approval from the board through a resolution and there is no specific time bound activities like shifting of assets and employees. Moreover, the new segment i.e. commercial vehicle production line in a new factory has not started.

**(ii)** No, the resolution is silent about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposal were passed through a resolution to the new factory, but the closure road map and new segment starting roadmap are missing.

Hence AS 24 will not be applicable and it cannot be considered as Discontinuing operations.

**(iii)** Yes, phased and time bound program resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and will constitute a clear roadmap.

Hence this action will attract compliance of AS 24 and it will be considered as Discontinuing Operations as per AS-24.

**8.** As per AS 24 'Discontinuing Operations', a discontinuing operation is a component of an enterprise:

(i) that the enterprise, pursuant to a **single plan**, is:

(1) disposing of substantially in its entirety,

(2) disposing of piecemeal, or

(3) terminating through abandonment; and

(ii) that represents a separate **major line** of business or geographical area of operations; and

(iii) that can be distinguished operationally and for financial reporting purposes.

As per provisions of the standard, business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations, they can occur in connection with a discontinuing operation. Examples of activities that do not necessarily satisfy criterion of discontinuing operation are gradual or evolutionary phasing out of a product line or class of service, discontinuing, even if relatively abruptly, several products within an ongoing line of business;

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(i) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(ii) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.

# UNIT 7: ACCOUNTING STANDARD 25 INTERIM FINANCIAL REPORTING

## LEARNING OUTCOMES

**After studying this unit, you will be able to comprehend the following:**

- Objective and scope of AS 25
- Content of an Interim Financial Report
- Minimum Components of an Interim Financial Report
- Form and Content of Interim Financial Statements
- Selected Explanatory Notes
- Periods for which Interim Financial Statements are required to be presented
- Disclosure in Annual Financial Statements
- Recognition and Measurement principles as per the Standard.

## 7.1 INTRODUCTION

AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, lenders and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

A statute governing an enterprise or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

## 7.2 DEFINITIONS OF THE TERMS USED UNDER THE ACCOUNTING STANDARD

**Interim period** is a financial reporting period shorter than a full financial year.

**Interim financial report** means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

## 7.3 CONTENT OF AN INTERIM FINANCIAL REPORT

A complete set of financial statements normally includes Balance sheet, Statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Standard requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported. AS 25 does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Standard as well as those required by other Accounting Standards. Minimum components of an Interim Financial Report includes condensed Financial Statement.

**Note**: Interim financial report may contain a complete set of financial statements or condensed financial statements. If the entity opted for a complete set of financial statements, it will be like annual set of financial statements. The condensed financial statements would include the limited information as required by this standard.

## 7.4 FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement.

Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20 then it has to present basic and diluted earnings per share as per AS 20 on the face of Statement of Profit and Loss complete or condenses for an interim period also.

## 7.5 SELECTED EXPLANATORY NOTES

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

(a) A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.

(b) Explanatory comments about the seasonality of interim operations.

(c) The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that is unusual because of their nature, size, or incidence as per AS 5.

(d) The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.

(e) Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares.

(f) Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares.

(g) Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements).

(h) The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and

(i) Material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

## 7.6 PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED

Interim reports should include interim financial statements (whether condensed or complete) for the periods listed in the following table:

| Statement | Current period | Comparative period |
|---|---|---|
| Balance sheet | End of current interim period | End of immediately preceding financial year |
| Statement of profit and loss | Current interim period and cumulatively for the year-to-date | Comparable interim period and year-to-date of immediately preceding financial year |
| Cash flow statement | Cumulatively for the current financial year-to-date | Comparable year-to-date of immediately preceding financial year |

## 7.7 MATERIALITY

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data.

In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data.

Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.

The Preface to the Statements of Accounting Standards states that "The Accounting Standards are intended to apply only to items which are material". The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, states that *"information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information"*.

## Illustration 1

*Sincere Corporation is dealing in seasonal product. Sales pattern of the product quarter-wise is as follows:*

| | |
|---|---|
| *1st quarter 30th June* | *10%* |
| *2nd quarter 30th September* | *10%* |
| *3rd quarter 31st December* | *60%* |
| *4th quarter 31st March* | *20%* |

*Information regarding the 1st quarter ended on 30th June, 20X1 is as follows:*

| | |
|---|---|
| *Sales* | *80 crores* |
| *Salary and other expenses* | *60 crores* |
| *Advertisement expenses (routine)* | *4 crores* |
| *Administrative and selling expenses* | *8 crores* |

*While preparing interim financial report for first quarter Sincere Corporation wants to defer ₹ 10 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, the third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view.*

## Solution

| **Particulars** | **(₹ In crores)** | |
|---|---|---|
| Result of first quarter ended 30th June, *20X1* | | |
| Turnover | 80 | |
| Other Income | Nil | |
| Total (a) | | 80 |

| | | |
|---|---|---|
| *Less*: Changes in inventories | | Nil |
| Salaries and other cost | | 60 |
| Administrative and selling Expenses (4+8) | | 12 |
| Total (b) | | 72 |
| Profit (a)-(b) | | 8 |

According to AS 25, the Income and Expense should be recognized when they are earned and incurred respectively. Therefore, seasonal incomes will be recognized when they occur. Thus, the company's view is not as per AS 25.

## Illustration 2

*The accounting year of X Ltd. ends on 30th September, 20X1 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year from 1-10-20X0 to 30-9-20X1, the quarterly income is as under:*

| | |
|---|---|
| *1st quarter ending on 31st December, 20X0* | *₹ 200 crores* |
| *2nd quarter ending on 31st March, 20X1* | *₹ 200 crores* |
| *3rd quarter ending on 30th June, 20X1* | *₹ 200 crores* |
| *4th quarter ending on 30th September, 20X1* | *₹ 200 crores* |
| *Total* | *₹ 800 crores* |

*Average actual tax rate for the financial year ending on 31st March, 20X1 is 20% and for financial year ending 31st March, 20X2 is 30%. Calculate tax expense for each quarter.*

## Solution

**Calculation of tax expense**

| | | |
|---|---|---|
| 1st quarter ending on 31st December, 20X0 | 200 ×20% | ₹ 40 lakhs |
| 2nd quarter ending on 31st March, 20X1 | 200 ×20% | ₹ 40 lakhs |
| 3rd quarter ending on 30th June, 20X1 | 200 ×30% | ₹ 60 lakhs |
| 4th quarter ending on 30th September, 20X1 | 200 ×30% | ₹ 60 lakhs |

## 7.8 DISCLOSURE IN ANNUAL FINANCIAL STATEMENTS

AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

## 7.9 ACCOUNTING POLICIES

Same Accounting Policies as annual financial statements

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

**To illustrate:**

(a) The principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

(b) A cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

(c) Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual effective income tax rate changes.

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. 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. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. However, the nature and amount of any significant changes in estimates be disclosed.

### Changes in Accounting Policies

Preparers of interim reports in compliance with AS 25 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes.

If there has been any change in accounting policy since the most recent annual financial statements, the interim report is required to include a description of the nature and effect of the change.

## 7.10 REVENUE RECEIVED SEASONALLY OR OCCASIONALLY

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

For example: Dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.

## 7.11 COST INCURRED UNEVENLY DURING THE FINANCIAL YEAR

Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

A cost that does not meet the definition of an asset at the end of an interim period is not deferred in the interim balance sheet either to await future information as to whether it has met the definition of an asset, or to smooth earnings over interim periods within a financial year. Thus, when preparing interim financial statements, the enterprise's usual recognition and measurement practices are followed. The only costs that are capitalized are those incurred after the specific point in time at which the criteria for recognition of the particular class of asset are met.

Deferral of costs as assets in an interim balance sheet in the hope that the criteria will be met before the year-end is prohibited.

## 7.12 USE OF ESTIMATES

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed.

## 7.13 RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS

One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

## 7.14 TRANSITIONAL PROVISION

On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year:

(a) Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

(b) Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

## 7.15 APPLICABILITY OF AS 25 TO INTERIM FINANCIAL RESULTS

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise.

For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

### Illustration 3

*Accountants of Poornima Ltd. showed a net profit of ₹ 7,20,000 for the third quarter of 20X1 after incorporating the following:*

*(i) Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.*

*(ii) Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.*

*(iii) Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.*

*Ascertain the correct quarterly income.*

### Solution

In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000 – ₹ 20,000).

### Illustration 4

*Intelligent Corporation (I–Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:*

| *Quarter I* | *II* | *III* | *IV* |
|---|---|---|---|
| *Ending 30th June* | *30th September* | *31st December* | *31st March* |
| *15%* | *15%* | *50%* | *25%* |

*For the First quarter ending 30th June, 20X1, I–Corp. gives you the following information:*

| | *₹ crores* |
|---|---|
| *Sales* | *50* |
| *Salary and other expenses* | *30* |
| *Advertisement expenses (routine)* | *02* |
| *Administrative and selling expenses* | *08* |

*While preparing interim financial report for the first quarter, 'I –Corp.' wants to defer ₹ 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, third quarter should be debited by higher expenditure, considering the seasonal nature of business and that the expenditures are uniform throughout all quarters.*

*Calculate the result of first quarter as per AS 25 and comment on the company's view.*

## Solution

**Result of the first quarter ended 30th June, 20X1**

| | | (₹ in crores) |
|---|---|---|
| Turnover | | 50 |
| Add: Other Income | | Nil |
| Total | | 50 |
| Less: Change in inventories | Nil | |
| Salaries and other cost | 30 | |
| Administrative and selling expenses (8 + 2) | 10 | 40 |
| Profit | | 10 |

As per AS 25 on Interim Financial Reporting, the income and expense should be recognized when they are earned and incurred respectively. As per AS 25, the costs should be anticipated or deferred only when

(i) it is appropriate to anticipate that type of cost at the end of the financial year, and

(ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

# TEST YOUR KNOWLEDGE

## Multiple Choice Questions

1. *AS 25 mandates the following in relation to interim financial reports.*

   *(a) which entities should publish interim financial reports.*

   *(b) how frequently it should publish interim financial reports.*

   *(c) how soon it should publish after the end of interim period.*

   *(d) none of the above.*

2. *The standard defines Interim financial Report as a financial report for an interim period that contains a set of .......... financial statements.*

   *(a) Complete*

   *(b) Condensed*

   *(c) Financial statement similar to annual*

   *(d) Either complete or condensed*

3. *ABC Limited has reported ₹ 85,000 as per tax profit in first quarter and expects a loss of ₹ 25,000 each in subsequent quarters. It has corporate tax rate slab of 20% on the first ₹ 20,000 earnings and 40% on all additional earnings. Calculate tax expenses that should report in first quarter interim financial report.*

   *(a) ₹ 17,000*

   *(b) ₹ 30,000*

   *(c) ₹ 2,000*

   *(d) AS 25 does not mandate to report tax expenses*

4. *An entity prepares quarterly interim financial reports in accordance with AS 25. The entity is engaged in sale of mobile phones and normally 5% of customers claim on their warranty. The provision in the first quarter was calculated as 5% of sales to date, which was ₹10 million. However, in the second quarter, a fault was found and warranty claims were expected to be 10% for the whole of the year. Sales in*

*the second quarter were ₹ 15 million. What would be the provision charged in the second quarter's interim financial statements?*

*(a) ₹ 1 million*

*(b) ₹ 2 million*

*(c) ₹ 1.25 million*

*(d) ₹ 1.5 million*

## Theoretical Questions

5. *What are the periods for which Interim financial Statements are required to be presented? You are required to answer your question in light of preparation of financial statements for the period ended and as at 31st December, 20X1. The Financial Year is FY 20X1-X2.*

6. *Whether quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises meet the definition of 'interim financial report' as per AS 25 and the provisions of AS 25 should be applied on the same?*

7. *Whether the impairment loss recognized on property, plant and equipment in first quarter of the financial year can be reversed in the second quarter in that financial year?*

## Scenario based Question

8. *In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?*

9. *On 30th June, 20X1, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal of a business segment. Also, on 31st July, 20X1, the company paid ₹ 60,000 for property taxes assessed for the calendar year 20X1. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30th September, 20X1.*

10. *An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%.*

*The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000.*

*Calculate the tax expense to be recognized in each quarter.*

11. *Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 4 lakhs for the third quarter ending 30-09-20X1. On enquiry you observe the following. Give the treatment required under AS 25:*

(i) *Dividend income of ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.*

(ii) *80% of sales promotion expenses ₹ 15 lakhs incurred in the third quarter has been deferred to the fourth quarter as the sales in the last quarter is high.*

(iii) *In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of ₹ 12 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only ₹ 3 lakhs.*

(iv) *₹ 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.*

(v) *Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of ₹ 3 lakhs. Out of this loss ₹ 1 lakh relates to previous quarters.*

(vi) *Sale of investment in the first quarter resulted in a gain of ₹ 20 lakhs. The company had apportioned this equally to the four quarters.*

*Prepare the adjusted profit before tax for the third quarter.*

# ANSWERS/HINTS

## Answers to the Multiple Choice Questions

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **1.** | (d) | **2.** | (d) | **3.** | (a) | **4.** | (b) |

## Answers to the Theoretical Questions

**5.** As per Accounting Standard 25, Interim reports should include interim financial statements (condensed or complete) for periods as given below.

| *Statement* | *Current period* | *Comparative period* |
|---|---|---|
| Balance sheet | End of current interim period | End of immediately preceding financial year |
| Statement of profit and loss | Current interim period and cumulatively for the year-to-date | Comparable interim period and year-to-date of immediately preceding financial year |
| Cash flow statement | Cumulatively for the current financial year-to-date | Comparable year-to-date of immediately preceding financial year |

In light of the above, following periods needs to be covered in interim financial statements for the period ended and as at 31st December, *20X1:*

| | |
|---|---|
| **Balance Sheet** | as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year (As at 31 December 20X1 and 31 March 20X1). |
| **Statements of Profit and Loss** | for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. (for 3 months and 9 months i.e., year to date ended 31 December 20X1 and same for 31 December 20X0 being comparative period). |
| **Cash Flow Statement** | cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year. (year to date i.e., 1 April 20X1 to 31 December 20X1 and 1 April 20X0 to 31 December 20X0). |

**6.** The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise.

The quarterly financial results presented under Clause 41 of the Listing Agreement do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

**7.** As per AS 25, the principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount. In light of the same, the impairment loss recognized in one quarter can be reversed in the another quarter of the financial year, if favourable indicator exists as per AS 28 and the recoverable amount increased in comparison to earlier period.

## Answers to the Scenario based Question

**8.** Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

**9.** According to Para 10 of AS 25 “Interim Financial Reporting”, if an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As at 30th September, 20X1, Asmitha Ltd would report the entire amount of ₹ 2,00,000 as loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to interim periods on accrual basis. Since ₹ 60,000 Property tax payment relates to entire calendar year 20X1, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 20X1 while out of the remaining ₹ 30,000, ₹ 15,000 for January, 20X1 to March, 20X1 should be shown as payment of the outstanding amount of previous year and another ₹ 15,000 related to quarter October, 20X1 to December, 20X1 would be reported as prepaid expenses.

**10.** As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

| | | ₹ |
|---|---|---|
| Estimated Annual Income | (A) | 10,00,000 |
| Tax expense: | | |
| 30% on ₹ 5,00,000 | | 1,50,000 |
| 40% on remaining ₹ 5,00,000 | | 2,00,000 |
| | (B) | 3,50,000 |

Weighted average annual income tax rate = $\frac{B}{A} = \frac{3,50,000}{10,00,000}$ = 35%

| *Tax expense to be recognized in each of the quarterly reports* | ₹ |
|---|---|
| Quarter I - ₹ 75,000 x 35% | 26,250 |
| Quarter II - ₹ 2,50,000 x 35% | 87,500 |
| Quarter III - ₹ 3,75,000 x 35% | 1,31,250 |
| Quarter IV - ₹ 3,00,000 x 35% | 1,05,000 |
| ₹ 10,00,000 | 3,50,000 |

**11.** As per para 36 of AS 25 "Interim Financial Reporting", seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date until it is appropriate to defer at the end of the enterprise's financial year. Therefore, dividend income, extra-ordinary gain, and gain on sale of investment received during 3rd quarter should be recognised in the 3rd quarter only. Similarly, sales promotion expenses incurred in the 3rd quarter should also be charged in the 3rd quarter only.

Further, as per AS 10, Property, Plant and Equipment, if there is change in the depreciation method, such a change should be accounted for as a change in accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, and applied prospectively. Therefore, no adjustment would be required due to change in the method of depreciation.

Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

**Statement showing Adjusted Profit Before Tax for the third quarter**

| | (₹ in lakhs) |
|---|---|
| Profit before tax (as reported) | 4 |
| Add: Dividend income ₹ (4-1) lakhs | 3 |
| Excess depreciation charged in the 3rd quarter, due to change in the method | - |
| Extra ordinary gain ₹ (2-1) lakhs | 1 |
| Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (3-2) lakhs | 1 |
| | 9 |
| Less: Sales promotion expenses (80% of ₹ 15 lakhs) | (12) |
| Gain on sale of investment (occasional gain should not be deferred) | (5) |
| Adjusted Profit before tax for the third quarter | (8) |