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REVISION NOTES
Financial Reporting

Part - XI

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VALUATION OF GOODWILL & SHARES

Q.1. Negotiation is going on for transfer of X Ltd. on the basis of the Balance Sheet and the additional information as given below :

Balance sheet of X Ltd. as on 31st March, 2012.

	₹		₹
Share Capital			
(₹ 10 fully paid up share)	10,00,000	Goodwill	1,00,000
Reserve and Surplus	4,00,000	Land & Building	3,00,000
Sundry Creditors	3,00,000	Plant and Machinery	8,00,000
		Stock	1,00,000
		Investment	2,00,000
		Debtors	1,50,000
		Cash and Bank	50,000
	17,00,000		**17,00,000**

Profit before tax for 2011-2012 amounted to ₹ 6,00,000 including ₹ 10,000 as interest on investment. However, an additional amount of ₹ 50,000 p.a. shall be required to be spent for smooth running of the business.

Market values of Land and Buildings and Plant and Machinery are estimated at ₹ 9,00,000, and ₹ 10,00,000 respectively. In order to match the above figures further depreciation to the extent of ₹ 40,000 should be taken into consideration. Income tax rate may be taken at 50%. Return on capital at the rate of 20% before tax may be considered normal for this business at the present stage.

For the purpose of determining the rate of return, profit for this year after the aforesaid adjustments may be taken as the expected average profit. Similarly, average trading capital employed is also to be considered on the basis of the position in this year.

It has been agreed that 4 years purchase of super profit shall be taken as the value of goodwill for the purpose of the deal.

You are requested to calculate the value of goodwill of the company.

Q.2. The following is the Balance Sheet of Alpha Limited as on 31st March, 2012 :

Liabilities	₹	₹	**Assets**	₹
Share Capital :			Land & Building	4,00,000
Equity Shares of			Machinery	4,50,000
₹ 100 each	10,00,000		Motorcar	25,000
Less Calls in			Furniture	25,000
Arrears (₹ 20	1,00,000	9,00,000	Investments (face value)	50,000
for final call)			Current Assets :	
Reserve and Surplus :			Sundry Debtors	7,25,000
General Reserve	3,50,000		Cash at Bank	2,00,000
Profit & Loss Account	2,50,000	6,00,000	Miscellaneous	1,05,000
Current Liabilities :			Expenditure	
Sundry Creditors		5,00,000	Preliminary Expenses	20,000
		20,00,000		**20,00,000**

Additional information is as under :

(1) Fixed Assets are worth -

Building ₹ 6,00,000

Machinery ₹ 5,20,000

(2) All investments are non-trading investments and are to be valued at 20% above cost. Dividend at uniform rate of 20% is earned on all investments.

(3) For the purpose of valuation of shares, goodwill is to be valued on the basis of 3 years purchase of super profits based on average profit (after tax) of the last three years.

(4) Depreciation on appreciated value of Land and Building and Machinery is not to be considered for valuation of goodwill.

31st March	₹
2010	3,80,000
2011	4,20,000
2012	5,00,000

Rate of income tax 50%

In similar business, return on capital employed is 20% (after tax).

(6) In 2009 – 2010 machinery (Book value ₹ 20,000) was sold for ₹ 20,000 but the proceeds were wrongly credited to profit and loss account. The mistake has not yet been rectified.

Depreciation has been charged on machinery @ 10% per annum on reducing balance method.

Find out the value of each fully paid and partly paid equity share on net assets basis.

Note : Trend in profit is to be ignored for the purpose of calculation of average profit.

Q.3. The following is the Balance Sheet of Ravi Ltd. as on 31st March, 2012 :

Liabilities	₹	Assets	₹
Share Capital :		Fixed Assets :	
1,00,000 Equity Shares of	10,00,000	Machinery	8,00,000
₹ 10 each		Factory Shed	3,00,000
Less: Calls in Arrears	50,000	Vehicles	2,00,000
(₹ 2 for Final Call)	9,50,000	Furniture	50,000
		Current Assets :	
Reserve and Surplus :		Stock	4,00,000
General Reserve	4,00,000	Debtors	7,50,000
Profit & Loss Account	2,30,000	Bank Balance	60,000
Current Liabilities :		Miscellaneous Expenditure :	
Bank Overdraft	5,00,000	(to the extent not written off)	
Creditors	5,00,000	Preliminary Expenses	20,000
	25,80,000		**25,80,000**

The following additional information is furnished :

(i) Machinery and Factory Shed are worth 30% above their book value.

Depreciation on appreciated value of Machinery and Factory Shed is not to be considered for valuation of goodwill and shares.

(ii) For the purposes of valuation of shares, goodwill is to be considered on the basis of 4 years purchase of super profits based on average profit (after tax) of the last 3 years. Profits of the last 3 years (after tax) are as follows :

For the year ended 31.3.2010 ₹ 2,60,000

For the year ended 31.3.2011 ₹ 3,50,000

For the year ended 31.3.2012 ₹ 2,90,000

(iii) In the year ended 31.3.2010, new addition to Factory Shed costing ` 20,000 was charged to Profit and Loss Account. Depreciation charged on Factory Shed is @ 10% on reducing Balance method.

(iv) In a similar business, return on capital employed is 15% (after tax).

(v) Income Tax @ 46%.

Find out the value of each fully paid and partly equity share on Net Assets basis.

Show your working to the nearest rupee. Your working will form part of the answer.

Q.4. A Ltd. and its subsidiary B Ltd. get their supply of some essential raw-materials from C Ltd. To co-ordinate their production on a more profitable basis, A Ltd. and C. Ltd. agree between themselves each to acquire a quarter of shares in the other's authorised Capital by means of exchange of shares. The terms are as follows :

(i) A Ltd.s' shares are quoted at ₹ 14 but for the purpose of exchange the value is to be taken at the higher of the two values .e.g. (a) quoted & (b) on the basis of the Balance Sheet Valuation.

(ii) C. Ltd's Shares which are unquoted are to be taken at the higher of the values as on (a) yield basis & (b) the Balance Sheet basis. The future profits are estimated at ₹ 1,05,000 subject to one-third to be retained for development purposes. Shares of similar companies yield 8%.

(iii) Freehold properties of C. Ltd. are to be taken at ₹ 4,30,000.

(iv) No cash is to pass and the balance due on settlement is to be treated as loan between the two companies.

The summarised balance sheets of the companies at the relevant date stood as follows.

	A Ltd.	B Ltd.	C Ltd.
	₹	₹	₹
Authorised Share Capital	12,00,000	5,00,000	10,00,000
Equity Shares of ₹ 10 each			
Issued and Fully paid	8,00,000	5,00,000	7,50,000
Share Premium	80,000		
7% Debentures	3,00,000		
Profit & Loss A/c	2,30,000	2,10,000	2,00,000
Current Liabilities	2,80,000	1,80,000	2,10,000
Proposed Dividend	1,00,000	50,000	
	17,90,000	**9,40,000**	**11,60,000**
Freehold properties	6,60,000	2,90,000	3,30,000
Plant & Machinery etc.	4,50,000	4,10,000	4,40,000
<u>Investments :</u>			
40,000 shares in B. Ltd.	4,70,000	----	----
Current Assets	2,10,000	2,40,000	3,90,000
	17,90,000	**9,40,000**	**11,60,000**

You are required to compute the value of the Shares according to the terms of the agreement and to present the final settlement, showing all the necessary workings.

Q.5. From the following information, determine the possible value of brand as per potential earning model:

		₹ in lakhs
(i)	Profit After Tax (PAT)	₹ 2,500
(ii)	Tangible fixed assets	₹ 10,000
(iii)	Identifiable intangible other than brand	₹ 1,500
(iv)	Weighted average cost of capital (%)	14%
(v)	Expected normal return on tangible assets Weighted average cost (14%) + normal spread 4%	 18%
(vi)	Appropriate capitalization factor for intangibles	25%

Q.6. The following is the extract from the Balance Sheets of Popular Ltd.

Liability	As at 31.3.2004	As at 31.3.2005	Assets	As at 31.3.2004	As at 31.3.2005
Share Capital	500	500	Fixed Assets	550	650
General Reserve	400	425	10% investment	250	250
Profit & Loss Account	60	90	Stock	260	300
18% term loan	180	160	Debtors	170	110
Sundry Creditors	35	45	Cash at bank	46	45
Provisions for tax	11	13	Fictitious assets	10	8
Proposed dividend	100	125			
	1,286	**1,363**		**1,286**	**1,363**

Additional information :

(i) Replacement values of Fixed assets were ₹ 1,100 lakhs on 31.3.04 and ₹ 1,250 lakhs on 31.3.2005 respectively.

(ii) Rate of depreciation adopted on Fixed assets was 5% p.a.

(iii) 50% of the stock is to be valued at 120% of its book value.

(iv) 50% of investments were trade investments.

v) Debtors on 31st March, 2005 included foreign debtors of $ 35,000 recorded in the books at ₹ 35 per U.S. dollar. The closing exchange rate was $ 1 = ₹ 39.

(vi) Creditors on 31st March, 2005 included foreign creditors of $ 60,000 recorded in the books at $ 1 = ₹ 33. The closing exchange rate was $ 1 = ₹ 39.

(vii) Profits for the year 2004-05 included `60 lakhs of government subsidy which was not likely to recur.

(viii) ₹ 125 lakhs of Research and Development expenditure was written off to the Profit & Loss Account in the current year. This expenditure was not likely to recur.

(ix) Future maintainable profits (pre-tax) are likely to be higher by 10%.

(x) Tax rate during 2004-2005 was 50%, effective future tax rate will be 40%.

(xi) Normal rate of return expected is 15%.

One of the directors of company Arvind, fears that the company does not enjoy a goodwill in the prevalent market circumstances.

Critically examine this & establish whether Popular Co. has or has not any goodwill.

If your answers were positive on the existence of goodwill, show the leverage effect it has on the company's result.

Industry average return was 12% on long-term funds and 15% on equity funds.

AS – 22 : Accounting For Taxes on Income

1) Until recently the amount of tax provision was determined on the Profit or Loss calculated on per Income Tax laws. As per Accounting Standard - 22 tax should be accounted by following the principle of Matching Concept. i.e. tax should be accounted in the period in which the corresponding revenue and expenses are accounted.

2) **Accounting Standard -** 22 covers domestic and foreign taxes based on taxable income. The standard does not deal with corporate dividend tax or wealth tax.

3) There is a difference between accounting profit (i.e. Profit calculated on the basis of accounting policies) and taxable profit (i.e. profit calculated as per Income Tax laws). There are two main reasons for this difference.
   a) Timing difference: these differences originate in one period and are capable of reversal in one or more subsequent periods. e.g.
      ❖ Difference in rate of depreciation
      ❖ Difference in method of depreciation
      ❖ Section 43B items of the Income Tax Act (Outstanding Interest, Bonus, etc).
      ❖ Provision for doubtful debts
      ❖ Provision for warranties
      ❖ Provision for decrease in value of assets
      ❖ Provision for impairment of assets, etc.
   b) Permanent Difference: These differences originate in one period and do not reverse subsequently e.g., expenses charged to profit & Loss but not allowed for tax purpose at all in any year or incomes credited to Profit & Loss but are exempt from tax.

4) Timing differences will lead to either Deferred Tax Asset or Deferred Tax Liability. When accounting profit is more than taxable profit, a deferred tax liability is created. However when accounting profit is less than taxable profit, a Deferred Tax Asset is created e.g.
   ❖ Accelerated depreciation allowed by Income Tax Act leads to creation of Deferred Tax Liability.
   ❖ Provision for doubtful debts will lead to creation of Deferred Tax Asset.

5) Permanent differences are differences that always remain and are of permanent nature.
   ∴ Permanent differences do not create Deferred Tax Asset / Deferred Tax Liability.
   ∴ These are excluded for determining of tax expense.

6) The difference between tax expenses and current tax (i.e. Tax payable as per Income Tax Laws) arises only on account of timing difference which creates Deferred Tax Asset or Deferred Tax Liability
   ∴ **Tax expense = Current Tax + Deferred Tax**
   Current tax is calculated using tax rates and tax laws applicable for the relevant accounting year. Deferred Tax Assets or Deferred Tax Liabiliy is determined using tax rate and tax laws that have been enacted or substantially enacted at the Balance Sheet date. Further deferred tax is not discounted to its P.V.

7) Deferred Tax Liability must be provided for, but prudence would require that Deferred Tax Assets should be recognised and carried forward only to the extent that there is reasonable certainty that sufficient future taxable income will be available against which such Deferred Tax Asset can be realised. However in case of unabsorbed depreciation and carry forward losses under Income Tax laws, Deferred Tax Asset should be

recognised only to the extent there is virtual certainty that sufficient future taxable income will be available against which such Deferred Tax Asset can be realised.

8) **Review of deferred tax asset:** The carrying amount of deferred tax asset should be reviewed at each balance sheet date, if it is evident that any portion of the deferred tax asset is not recoverable because of uncertainty of future income, the deferred tax asset should be written down. Any such written down amount may be reversed in subsequent period to the extent that it becomes reasonably certain that sufficient future taxable income will be available.

9) **Re -** assessment of unrecognized deferred tax Asset: Previously unrecognized deferred tax asset is re-assessed at every balance sheet date. If it becomes reasonably certain that such unrecognized deferred tax asset will be realised, then unrecognized deferred tax asset is recognised now.

10) Any adjustment arising out of such review / reassessment is charged / credited to Profit & loss account of the year. (i.e. year of review / reassessment) It is not prior period item but a change in accounting estimate. However if the amount is material proper disclosure should be made because this item would be an item of exceptional nature.

11) For determining taxes during an interim period, the integral approach is followed. (see Accounting Standard - 25).

12) **Transitional Provision :** When this accounting standard of taxes on income is first time applied, the amount of deferred tax asset / liability should be treated in the same way had this accounting standard been in effect from the beginning. The corresponding debit / credit to the revenue reserves is subject to the consideration of prudence in case of deferred tax assets.

13) **Disclosure:**
- ❖ The break - up of deferred tax asset / liability should be disclosed.
- ❖ In case of deferred tax asset arising out of unabsorbed depreciation or loss, evidence-supporting recognition should be disclosed.
- ❖ Deferred tax asset / liability should be disclosed separately from current asset / liabilities. They should also be distinguished from advance tax / tax provision / tax refund due.
- ❖ Deferred tax asset and liability should be set off if permissible under the tax laws but to be shown separately if not permissible.

AS – 22 : Accounting For Taxes on Income

Q.1. ABC Ltd. has provided depreciation as per accounting records ₹ 8,00,000 and as per tax records ₹ 14,00,000. Unamortised preliminary expenses, as per tax record is ₹ 10,000. There is adequate evidence of future profit sufficiency. How much deferred tax asset / liability should be recognized as transition adjustment. Tax rate is 30%.

Q.2. From the following details of XYZ Ltd. for the year ended 31.03.2009, calculate the deferred tax asset / liability as per Accounting Standard - 22.

Accounting Profit	5,00,000
Book profit as per MAT	4,50,000
Profit as per Income-tax Act	50,000
Tax rate	30%
MAT rate	7.50%

Q.3. 1. Cost of asset purchased in year 1 = 200 lakhs
2. Depreciation
   a) Book at 20%
   b) Income tax 100%
3. PBDT = 200 lakhs each for years 1 to 5
4. Rate of tax = 50%

Calculate deferred tax and show journal entries.

Q.4. 1 . Profit before tax for year 1 and year 2 = ₹ 200 lacs each
2. Provision for interest on loan from Financial Institutions in year 1 = ₹ 20 lacs paid in year 2
   Rates of tax = 50%

Calculate deferred tax and show journal entries.

Q.5. Krishna Ltd. started business on 1st April 2005. The following details are available from the books of account and other records of Krishna Ltd.

Profit before depreciation and taxes

	₹
2005 - 2006	15,00,000
2006 - 2007	18,00,000
2007 - 2008	25,00,000
2008 - 2009	30,00,000

The company purchased the following machines :

Date of purchase	Amount (₹)
1. 4. 2005	4,00,000
1. 4. 2006	3,00,000
1. 4. 2007	4,00,000

The company charges depreciation on machines @ 15% p. a., whereas the rate of depreciation for tax purpose is 25% p. a. The company has no other fixed assets. Tax rates for the five relevant years were 50%, 45%, 40%, 35% and 35% respectively.
You are required to prepare the profit and loss statement showing the provision for taxes under the following methods (a) Tax Payable method, and (b) As per Accounting Standard – 22.

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Q.6. A company ABC Ltd. prepares its accounts annually on 31st March. The company has incurred a loss of ₹ 1,00,000 in the year 20x1 and made profits of ₹ 50,000 and 60,000 in year 20x4 and year 20x5 respectively. It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 20x3, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. It is also assumed that there is not difference between taxable income and accounting income except that set-off of loss is allowed in years 20x4 and 20x5 for tax purposes.

Q.7. **1.** **OTD in year - 1 = 100 lakhs**

2. **RTD**

(a) Year - 2 = 40 lakhs

(b) Year - 3 = 30 lakhs

(c) Year - 4 = 30 lakhs

3. **Rates of tax**

(a) Year - 1 = 50%

(b) Year - 2 = 50%

(c) Year - 3 = 40% [known in Year - 2]

(d) Year - 4 = 30% [known in Year - 3]

Q.8. Rama Ltd. a listed company started business on 1st April, 2001. The following details are available from the books of account and other records of Rama Ltd.

Profit before depreciation and taxes.

	₹
2001 - 2002	14,45,500
2002 - 2003	18,20,200
2003 - 2004	24,56,560
2004 - 2005	30,22,280

The Company purchased the following machines :

Date of Purchase	**Amount (₹)**
1.3.2001	3,45,000
1.4.2002	2,75,000
1.4.2004	3,62,000

The Company charges depreciation on machines @ 15% p.a. (WDV) whereas the rate of depreciation for tax purpose is 25% p.a. The Company has no other fixed assets. Tax rates for the five relevant accounting years were 50%, 45%, 40%, 35% and 35% respectively.

You are required to prepare the profit and loss statement showing the provision for taxes.

Q.9. Income before depreciation and tax of the enterprise is ₹ 200 lacs p.a. It is eligible for 100% tax holiday for first 10 years under section 80 - IA of Income - tax Act. Tax rate is 35%. At the beginning of year 1 the enterprise purchased a machine costing ₹ 300 lacs. The enterprise follows straight line depreciation method for accounting purposes, scrap value is nil and useful life is 15 years. For the purpose of taxation it has to follow WDV method of depreciation applying 25% rate. In this case timing difference will arise because of difference in tax depreciation and accounting depreciation.

Show the deferred tax effect for year 1 - 15.

Q.10. Your client is a full tax free enterprise for the first 10 years and is in the second year of operations. Depreciation timing difference resulting in a deferred tax liability in Year 1 and 2 is ₹ 100 million and ₹ 200 million respectively. From the 3rd year and onwards it is expected that the timing difference would reverse each year by ₹ 5 million. Determine deferred tax liability at the end of 2nd year and the charge to the Profit and Loss Account if any. Assume tax rate @ 35%.

Q.11. The following details are available in the books of ABC Ltd.

Particulars	**₹ in Lakhs**
Provision for tax :	
For 2005 - 2006	200
For 2006 - 2007	300
For 2007 - 2008	250
Advance tax paid :	
For 2005 - 2006	175
For 2006 - 2007	350
For 2007 - 2008	270

ABC Ltd. estimates its Deferred Tax Liabilities to be ₹100 lakhs and its Deferred Tax Assets to be ₹ 20 lakhs. How will the above be disclosed?

Q.12. Dilemma Ltd. has operating profit before taxes and depreciation of ₹500 Lacs in each of the 3 years. The company purchased a microcomputer for ₹ 240 Lacs in the beginning of Year 1. The expenditure was fully allowed as a deduction U/s 35 of the Income - tax Act.

However the company has decided to amortise the expense over its useful life of 3 years in its books.

The tax rates in the 3 years are :

Year 1	**40%**
Year 1	**38%**
Year 3	**35%**

(a) If it is assumed that future tax rates are known only one year ahead, pass journal entries for all the three years.

(b) If it is assumed that future tax rates are known two years ahead, pass journal entries for all the three years.

Q.13. Omega Limited is working on different projects those are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statement during 2006, 2007 and 2008 for ₹ 11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income - tax purpose, it has adopted the completed contract method under which it has recognised revenue of ₹ 7,00,000, ₹ 18,00,000 and ₹ 23,00,000 for the years 2006, 2007 and 2008 respectively. Income - tax rate is 35%. Compute the amount of deferred tax asset / liability for the years 2006, 2007 and 2008.