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FINAL CA
MAY '19
REVISION NOTES
Financial Reporting

Part - V - Questions

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Ind AS 7/AS 3 - STATEMENT OF CASH FLOWS

Q.1. A bank, received gross ₹ 3,000 crores demand deposits from customers and customers withdrew Rs.2,800 crores of demand deposit during the Financial Year 2017-2018. How will you classify such receipts and payments in cash flow statement of that bank?

Ind AS 10/AS 4 - EVENTS AFTER THE REPORTING PERIOD

Q.1. Explain as to how you would treat the following events occurring after the balance sheet date in the financial statements.

a) A major fire has damaged the assets in the factory on April 2, two days after the closure of accounts. The loss is estimated at ₹ 20 crores out of which ₹ 12 crores would be recoverable from the insurers.

b) The directors have agreed to increase the retirement benefits and this may involve a future annual increase of provision by ₹ 2 lacs.

c) The dispute for bonus to employees was before the arbitrator and he gave the award in favour of workmen for ₹ 3 lacs.

d) A contract for civil construction was performed during the accounting year. The client has gone on appeal for damages for low quality works and was awarded an amount of ₹ 1.5 lacs.

Ind AS 2/ AS 2 – INVENTORIES

Q. 1. Induga Ltd. manufactures computers, during the year ended 31st March, 2018 the company manufactured 550 computers, it has the policy of valuing finished stock of goods at a standard cost of v 1.8 lakhs per computer. The details of the cost are as under :

	(₹ in Lakhs)
Raw material consumed	400
Direct Labour	250
Variable production overheads	150
Fixed production overheads (Including interest of ₹ 100)	290

Compute the value of cost per computer for the purpose of closing stock.

Q. 2. A Ltd. incurs a fixed production overhead of ₹ 10,00,000 every year. Its normal capacity of production is 1,00,000 units. In the year 2017, 80,000 units were produced and in 2018, 1,20,000 units were produced. Calculate the production fixed overhead allocated to each unit in each of these years.

Q. 3. From the information given below you are required to estimate the cost of inventory of Ram Dayal as on 31st March, 2018.

Beginning inventory	400 items at ₹ 19.5 cost ;	Retail price ₹ 30
Purchases for the year	1,200 items at ₹ 25 cost;	Retail price ₹ 35
Net sales for the year	₹ 45,000	

Q. 4. Can materials issued on loan to other companies / contractors be classified along with inventories? Or would the head 'loans and advances' be appropriate?

Ind AS 17/ AS 19 - LEASES

Q.1. Amro Ltd. is considering the replacement of its outdated mainframe computer on 1st October 2018. The replacement computer has a cost of ₹ 21 lakhs and its useful economic life is estimated to be seven years. After negotiations the directors of Amro Ltd. decide to enter into a four-year lease with Scottish Ltd. for total lease payments of ₹ 20 lakhs payable in four equal instalments - the first instalment being due on day one of the leasing period.

Under this arrangement, Scottish Ltd. would have responsibility for up keep and maintenance, and has negotiated a guaranteed repurchase by the manufacturer at the end of the lease term. The interest rate implicit in the lease is 10%. Analyse whether this transaction should be treated as a Finance Lease I Operating Lease in the books of Amro Ltd.

Ans. A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

The following provisions will be considered in determining whether the lease is a finance or operating lease.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are :

(a) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(b) the lease transfers ownership of the asset to the lessee by the end of the lease term;

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

Various aspects of the agreement are to be examined in order to determine whether any of the provisions and indications above are being satisfied.

i. We shall first calculate the present value of the minimum lease payments as under

Year 0 (day 1)	Year 1	Year 2	Year 3	Total
5,00,000	5,00,000	5,00,000	5,00,000	20,00,000
* 1	* 0.909	*0.826	*0.751	
5,00,000	4,54,500	4,13,000	3,75,500	= 17,43,000
				(r / off to 000)

Going by the fair value of computer at ₹ 21.00 lacs, the present value of minimum lease payments is about 83%. This is indicative of the arrangement being an operating lease. However, other factors ought to be considered.

ii Scottish Ltd. the lessor is vested with the responsibility of upkeep and maintenance and thus the risks of ownership continues to remain with the lessor. This is also indicative of the arrangement being an operating lease.

iii As regards residual value, manufacturer has himself agreed to a guaranteed repurchase, and the asset will no longer be with Amro Ltd. at the end of lease term.

iv The computer has a life of seven years. But the lease term is restricted to only four years. Thus the lease term does not cover the entire economic life of the asset.

Viewed in totality, this is an operating lease.

Q. 2. Catterpillar Ltd. procured an asset under lease, and no legal title was available to the company. However, it enjoyed all the economic benefits of the use of the asset. The present value of lease charges paid by the company to the lessor closely approximated the fair value of the asset.

The manager argues that since there exists no legal title, classification as a finance lease is not correct. Is he justified?

Ans. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

In the given case, the lessee enjoys all economic benefits of the use of the asset and the lease charges paid by the lessee closely approximate the fair value of the asset. Therefore mere absence of a legal title will not debar the lease from being classified as a finance one.

Q. 3. Can a single lease agreement be classified differently by the lessor and lessee?

Ans. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

Let us consider the following example:

A Ltd. has taken as asset on lease from B Ltd on the following terms :

Date of Lease Agreement	01/01/2018
Cost of the asset as on 01/01/2018	₹ 16,00,000
Lease Term	2 years
Lease Rentals	₹ 5,00,000
RV guaranteed by A Ltd.	NIL
C Ltd agrees to purchase the asset at the end of two years for	₹ 10,40,000
Interest rate implicit in the lease is	14.97%

Classify the lease from the standpoint of A Ltd. and B Ltd.

Ans. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset"

Classification from the standpoint of A Ltd.

MLP from the standpoint of A Ltd. = Lease Rentals + GRV by or on behalf of the lessee = ₹ 10,00,000

PV of the MLPs = ₹ 8,13,500.

Since the present value of the MLP does not substantially cover the fair value of the asset which is the cost of the asset, the lease will be classified as an operating lease.

Note : Other provisions will also need to be considered. The objective of this example is to show how lease can be classified differently by the lessor and the lessee.

Classification of the lease from the standpoint of the lessor:

MLP form the standpoint of the lessor = Lease Rentals + GRV by or on behalf of the lessee or GRV by an independent third party, whichever is higher

= ₹ 20,40,000

PV of the MLPs is approx ₹ 16,00,000.

The present value of the MLPs substantially covers the fair value of the asset. Therefore the lease will be classified as a finance lease from the standpoint of B Ltd.

Q. 4. Classify the following, into either operating or finance leases.

a) Ownership of an asset gets vested in the lessee at the end of lease term

b) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.

c) Economic life of the asset 5 Years, lease term 41/2 years, but asset is not acquired at the end of lease term.

d) PV of MLP = ”X”, Fair value of the asset is Y.

e) Economic life = 5 Years, lease term 2 years, but the asset is of a special nature, and has been procured only for use of lessee.

Ans. a) Finance Lease

b) If it becomes certain, at the inception of lease itself, that the option will be exercised by the lessee, it is a Finance Lease.

c) It will still be classified as a finance lease, since a substantial portion of the life of the asset is covered by lease - term.

d) Where X = Y, or where X substantially equals Y, it is a finance lease.

e) Since the asset is procured only for the use of lessee, it is a finance lease.

Q. 5. Softpro Ltd. has entered into a lease agreement with IBM for the use of AS 400 server. The issue is regarding classification of lease as operating or finance lease. Details of the lease are as follows:

Cost of the asset	₹ 17,50,000
Annual lease obligation payable in advance	₹ 5,00,000
Total lease obligation	₹ 20,00,000
Lease period (equivalent to the economic useful life of the asset)	4 years

The lessee has the option to renew the lease for further period of 2 years with annual lease payment of ` 10,000.

Interest rate implicit in the lease is 10%.

Other relevant terms in lease agreement are as below :

1. Once the term of the lease has begun, lessee’s commitments become irrevocable and independent of acceptance of the equipment. Lessees obligation to pay all rent and other amounts under this agreement is absolute and unconditional and shall not be affected by any right of set off or defence of any kind including failure of the equipment to perform or any representations by the supplier.
2. The agreement states that the lessee shall not make any alternations or modification to the equipment, without the permission of the lessor.
3. The asset will be insured by the lessee, and in the event of any damage to the equipment, which is not insured, the liability will be borne by the lessee.
4. The lessor shall provide the following free of cost:
   i) AMC for all parts and peripherals

ii) Warranty for a period of 4 years, including one person from IBM deputed on site for a period of 4 years during normal business hours.

Softpro Ltd. wishes to classify the lease as operating lease on the following grounds:

i) The company has not undertaken any risk with regard to the equipment as it has received a free AMC for all parts and peripherals and a warranty for a period of 4 years.

ii) It does not have any ownership rights, as it cannot make any alternations or modifications to the asset without the permission of the lessor.

iii) The company does not receive the title for the asset, as the said asset will be returned back to IBM upon completion of the lease period.

Advise on classification of lease.

Ans. As per the provisions of Ind AS 17

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset.

An operating lease is a lease other than a finance lease.

The classification of leases is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value."

As per the information given the lessee does not bear any loss relating to damage in the parts and peripherals of the asset since the lessor provides free of cost AMC for all parts and peripherals and a warranty for a period of 4 years.

Further the case provides that "Once the term of the lease has begun, lessee's commitments become irrevocable and independent of acceptance of the equipment. Lessees obligation to pay all rent and other amounts under this agreement is absolute and unconditional and shall not be affected by any right of set off or defence of any kind including failure of the equipment to perform or any representations by the supplier."

Further the case also provides that "The asset will be insured by the lessee, and in the event of any damage to the equipment, which is not insured, the liability will be borne by the lessee."

This indicates that all the risks ,except the loss relating to damage of faulty parts and peripherals of the asset, lie with the lessee.

Let us now consider the provisions contained in Ind AS 17 :

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are :

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

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

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

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

The lease term is equal to the economic life of the asset which is 4 years. Besides the present value of MLPs discounted at 10% is ₹ 17,43,000. This amount substantially covers the fair value which is the cost of the asset in the present case and is equal to ` 17,50,000.

Thus the provisions of Ind AS 17 are satisfied.

Further "Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge."

Taking all the above provisions into consideration the lease will be classified as a finance lease.

Ind AS 37/ AS 29 – PROVISIONS

Question : What Action an enterprise is to take in the following situations :

Q. 1. Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Ans. Present obligation as a result of a past obligating event - The obligations event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole.

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date.

Q. 2. Contaminated Land Legislation Virtually Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean - up of land already contaminated will be enacted shortly after the year end.

Ans. Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion – a provision is recognised for the best estimate of the costs of the clean - up.

Q. 3. Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Ans. Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig on PV basis. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Q. 4. Refund Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Ans. Present obligation as a result of past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund .

Conclusion - A provision is recognised for the best estimate of the costs of refunds.

Q.5. Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September, 2017. The enterprise has not fitted the smoke filters. What should the enterprise do :

(a) At the balance sheet date of 31 March 2017.

(b) At the balance sheet date of 31 March 2018.

Ans. (a) At the balance sheet date of 31 March 2017.

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters.

(b) At the balance sheet date of 31 March, 2018

Present obligation as result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non - compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

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Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

Q. 6. Staff Retraining as a Result of Changes in the Income - Tax System.

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales work force in order to ensure continued compliance with financial services regulation. At the balance sheet date, not retraining of staff has taken place.

Ans. Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised.

Q. 7. A Single Guarantee

During 2016-17, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2017-18, the financial condition of Enterprise B deteriorates and at 30 September, 2017 Enterprise B goes into liquidation.

Ans. (a) At 31 March, 2017

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2017.

Conclusion - No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2018

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March, 2018 it is possible that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation.

Note : This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable. Where an enterprise gives guarantees in exchange for a fee, revenue should be recognised.

Q.8. A Court Case

After a wedding in 2016-17, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2017, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2018, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

Ans. (a) At 31 March 2017

Present obligation as a result of past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2018

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation.

Q.9. Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Ans. Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised.

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replacing the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Q.10. Refurbishment Costs -Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

Ans. Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the linings not recognised as a provision above example. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Q.11. The sales tax authority ordered an additional demand on the company for under payment of sales tax on the basis of under-invoicing of goods. The company contested the case. The lawyer advised the company as on 31-3-2017 that there would be no liability. As on 31-3-2018, the lawyer advised the company that on the basis of latest development in the case, a liability would arise. Advice disclosure?

Q.12. AFC Company is engaged in the business of financial services and is undergoing tight liquidity position, since most of the assets of the company are tied to various claims / petitions in a Special Court. AFC had accepted Inter-Corporate Deposits (ICDs) and, it is makings 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 from the due date to the date of repayment was effected 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 contract, the company considers that these claims are in the nature of "claims against the company not acknowledged as debt", and the same has been disclosed by way of a note in the accounts instead of making a provision in the profit and loss accounts.

Comment on accounting treatment of overdue interest.

Q.13. The ship building yards usually demand a "Letter of Commitment" (LOC) from the buyer's bank undertaking irrevocably to issue a deferred payment guarantee (DPG) when the delivery of the vessel is made by the yard, before they start building the vessel. Whether the LOC issued by the buyer's bank undertaking irrevocably to issue a DPG at a later date constitutes a contingent liability for the bank?

Q.14. Justifiables Limited Company has at its financial year ended 31st March 2018 fifteen law suits outstanding, none of which has been settled by the time the accounts are approved by the directors. The directors have estimated that the possible outcomes are as below:

Result	Probability	Amount of loss per case
For first ten cases:		
Win	0.6	--
Lose-low damages	0.3	90,000
Lose-high damages	0.1	1,60,000
Result	**Probability**	**Amount of loss per case**
For remaining	0.5	60,000
Win	0.3	95,000
Lose-low damages	0.2	--
Lose-high damages		

The directors believe that the outcome of each case is independent of the outcome of all of the others. Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

Ind AS 38/ AS 26 – INTANGIBLE ASSETS

Q.1. AB Ltd is developing a new distribution system of its material, following are the costs incurred at different stages on research and development of the system.

Year	Phase / Expenses	Amount (₹ in Crores)
2016-17	Research	16
2017-18	Research	20
2018-19	Development	60
2019-20	Development	72
2020-21	Development	80

On 31-3-2021 the AB Ltd identified the level of cost savings at ₹ 32 crores p.a. expected to be achieved by the new system over a period of 5 years, in addition to this system developed can be marketed by way of consultancy, which will earn cash flow of ₹ 20 crores per annum. AB Ltd. demonstrated that new system meet the criteria of asset recognition on 01-04-2018.

Determine the amount/cost which will be expensed and to be capitalized as intangible assets, presuming that no active market exist to determine the selling price product i.e. system developed. System shall be available for use from 2021 - 22. DF is 10%.

Q.2. An enterprise acquired a patent right for Rs.200 lacs. The product life cycle has been initially estimated to be 5 years. The estimated cash flow over the useful life of the patent are (₹ in lacs) Year 1 : 300; Year-2 : 300, Year – 3 : 300, Year - 4 : 200, Year - 5 : 200. Initially a five-year amortization period has been decided and amortization was decided in the ratio of estimated further cash flow.

After third year, it was ascertained that the patent will continue to maintain the market share' for another six years but the estimated cash flow after fifth year is expected to be ₹ 150 lacs. What would be the change in amortization?

Q.3. During 2017-18, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows :

	Amounts / ₹
Completion of detailed programme and design	75,000
Coding and testing	60,000
Development coding costs	1,26,000
Testing costs	36,000
Product masters for training materials	39,000
Duplication of computer software and training materials, from product masters (6,000 units)	1,20,000
Packing the product (3,000 units)	33,000

a) What should be capitalised as software costs in the books of the company, on Balance Sheet date?

b) Should there be a stock of inventory, what is its valuation?