PAPER – 1 : FINANCIAL REPORTING

*Question No.**1** is compulsory.*

*Candidates are also required to answer any **five** questions from the remaining **six** questions.*

Working notes should form part of the respective answers.

Wherever necessary, candidates are permitted to make suitable assumptions which should be disclosed by way of a note.

Question 1

(a) *From the following information, you are required to compute the basic and adjusted earnings per share:*

Net profit for 2013-14	*₹ 11 lakhs*
Net profit for 2014-15	*₹ 15 lakhs*
Number of shares issued before rights issue	*5 lakhs*
Right issue	*One for every 5 held*
Right issue price	*₹ 15 per share*
Last date of exercising right option	*01-06-2014*
Fair value of shares before right issue	*₹ 21 per share*

(b) *Fine Ltd. acquired a machine on 1st April, 2009 for ₹ 14 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 2013, the carrying value of the machine was reassessed at ₹ 10.20 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended 31st March, 2015, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only ₹ 140 lakhs.*

You are requested to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of Fine Ltd.

Fine Ltd. had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

(c) *Sagar Future is a non-banking finance company. It makes available to you the costs and market price of various investments held by it as on 31-03-2015 as under:*

Scripts:		*(Figures ₹ in lakhs)*	
		Cost	*Market Price*
A.	*Equity Shares-*		
	A	*60.00*	*61.20*
	B	*31.50*	*24.00*

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	C	*60.00*	*36.00*
	D	*60.00*	*120.00*
	E	*90.00*	*105.00*
	F	*75.00*	*90.00*
	G	*30.00*	*6.00*
B.	*Mutual Funds-*		
	MF-1	*39.00*	*24.00*
	MF-2	*30.00*	*21.00*
	MF-3	*6.00*	*9.00*
C.	*Government Securities-*		
	GV-1	*60.00*	*66.00*
	GV-2	*75.00*	*72.00*

(i) Can the company adjust depreciation of a particular item of investment within a category?

(ii) What should be the value of investments as on 31-03-2015?

(iii) Is it possible to off-set depreciation in investment in mutual fund against appreciation of the value of investment in equity shares and government securities?

(d) As on 1st April, 2014, the fair value of planned assets was ₹ 1,00,000 in respect of a pension of Zeleous Ltd. On 30th September, 2014, the plan paid out benefits of ₹ 19,000 and received inward contribution of ₹ 49,000. On 31st March, 2015, the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 2014-15 were ₹ 600.

On 1st April, 2014, the company made the following estimates, based on its market studies, understanding and prevailing prices:

	%
Interest & dividend income, after tax payable by the fund	*9.25*
Realised and unrealized gains on plan assets (after tax)	*2.00*
Fund administrative costs	*(1.00)*
Expected rate of return	*10.25*

You are required to find the expected and actual returns on plan assets.

(4 x 5 = 20 Marks)

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Answer

(a) Computation of theoretical ex-rights fair value per share

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

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

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor

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

Computation of earnings per share

	Year 2013-14	*Year 2014-15*
EPS for the year 2013-14 as originally reported: (₹ 11,00,000/5,00,000 shares)	₹ 2.20	
EPS for the year 2013-14 restated for rights issue: [₹ 11,00,000/ (5,00,000 shares x 1.05)]	₹ 2.10	
EPS for the year 2014-15 including effects of rights issue $\frac{₹\ 15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)}$		₹ 2.55

(b) Statement showing Impairment Loss

	(₹ in crores)
Cost of the machine as on 1st April 2009	14.00
Depreciation for 4 years i.e. 2009-10 to 2012-13 = $\frac{₹\ 14 \text{ crores}}{7 \text{ years}} \times 4 \text{ years}$	(8.00)
Carrying amount as on 31.03.2013	6.00
Add: Upward Revaluation (credited to Revaluation Reserve account)	4.20
Carrying amount of the machine as on 1st April 2013 (revalued)	10.20
Less: Depreciation for 2 years i.e. 2013-14 & 2014-15 $\left[\frac{10.20 \text{ crores}}{3 \text{ years}} \times 2 \text{ years}\right]$	(6.80)
Carrying amount as on 31.03.2015	3.40

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Less: Recoverable amount		(1.40)
Impairment loss		2.00
Less: Balance in revaluation reserve as on 31.03.2015:		
Balance in revaluation reserve as on 31.03.2013	4.20	
Less: Enhanced depreciation met from revaluation reserve		
2013-14 & 2014-15 = [(3.40 – 2.00) x 2 years]	(2.80)	
Impairment loss set off against revaluation reserve balance as per AS 28 "Impairment of Assets"		(1.40)
Impairment Loss to be debited to Profit and Loss account		0.60

(c) **Assumption:** It is assumed that investment in equity shares and mutual funds have been done with an intention not to hold it for more than one year i.e. the date of making an investment in equity shares and mutual fund is during the year. For Government securities it is assumed that the intention of the entity is to hold it for more than a year.

(i) Quoted current investments for each category shall be valued at cost or market value, whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise. Sometimes, the concern of the entity may be with the value of a category of related current investments and not with each individual investment and accordingly, the investments may be carried at the lower of cost and fair (market) value computed category-wise. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. Therefore, depreciation of a particular item of investments can be adjusted within the same category of investments.

(ii) **Value of Investments as on 31.3.2015:**

When considered category-wise:

Type of Investment	*Valuation Principle*	*Value ₹ in lakhs*
Equity Shares (Aggregated)	Lower of cost or market value	406.50
Mutual Funds	NAV (Market value assumed to be NAV)	54.00
Government Securities	Cost	135.00
		595.50

When considered scrip-wise

Type of Investment	*Valuation Principle*	*Value ₹ in lakhs*
Equity Shares (Aggregated)	Lower of cost or market value	351.00

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Mutual Funds	NAV (Market value assumed to be NAV)	51.00
Government Securities	Cost	135.00
		537.00

(iii) Valuation of current investments on overall basis is not considered appropriate. Inter-category adjustments of appreciation and depreciation in values of investments cannot be done. Therefore, it is not possible to offset depreciation in investment in mutual funds against appreciation of the value of investments in equity shares and Government securities.

Note : It may alternatively be assumed that investment in equity shares and mutual funds have been done with an intention to hold them for more than a year and the fall in the market value is temporary and accordingly value the investment at cost. In such a case the value of investment in point (ii) will be as follows:

Type of Investment	*Valuation Principle*	*Value ₹ in lakhs*
Equity Shares (Aggregated)	Cost	406.50
Mutual Funds	Cost	75.00
Government Securities	Cost	135.00
		616.50

(d) **Assumption:** Expected rate of return given in the question is assumed to be the compunded rate of return and accordingly the question has been solved.

Calculation of expected return on plan assets: *(Amount in ₹)*

Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
*Add:*Return on ₹ (49,000-19,000) 30,000 held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets for 2014-15	11,750

Note: Computation of return on net receipts can alternatively be made on simple interest basis on ₹ 30,000 i.e @ 10.25/2 = 5.125%. In such a case the expected return on plan assets for 2014-15 will be ₹ 11,787.50 instead of ₹ 11,750.

Calculation of actual return on plan assets: (Amount in ₹)

Fair value of plan assets at 31st March, 2015	1,50,000
Less: Fair value of plan assets at 1st April, 2014	(1,00,000)
Less: Contributions received	(49,000)
Add: Benefits paid	19,000
Actual return on plan assets	20,000

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Question 2

White Ltd. has 2 divisions, E and N, and their respective shares of various assets and liabilities in the company's balance sheet as on 31st March, 2015 are given below:

			₹ in lakhs
	E Division	N Division	Total
Fixed Assets			
Cost	975	510	
Less: Depreciation	(340)	(240)	
Written Down Value	635	270	905
Investments			175
Current Assets	525	645	
Less: Current Liabilities	(275)	(305)	
Net Current Assets	250	340	590
Total			1670
Financed By			
Loan Funds		20	530
Own Funds			
Equity Share Capital:			420
Share of ₹ 10 each			
Reserves & Surplus			720
Total			1670

Loan funds included, inter-alia, bank loans of ₹ 20 lakhs specifically taken for N Division and debentures of the paid-up value of ₹ 200 lakhs redeemable at any time between 1st December, 2014 and 30th Sept., 2015.

Division N has been invariably suffering losses. The company sold this division N along with its assets and liabilities to a newly formed company Bright Ltd., which was incorporated with an authorized capital of ₹ 1,200 lakhs, divided into shares of ₹ 10 each.

Bright Ltd., allotted to White Ltd.'s shareholders its two fully paid equity shares of ₹ 10 each at par for every fully paid equity shares of ₹ 10 each held in White Ltd., as discharge of consideration for the division taken-over.

Bright Ltd. recorded in its books the fixed assets at ₹ 400 lakhs, current assets at ₹ 450 lakhs and liabilities at the same value at which they appeared in the books of White Ltd.

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On 1st April, 2015, White Ltd., sold all its investments for ₹ 200 lakhs and redeemed debentures liability at 10% discount, which was included in loan funds. The cash transaction being recorded in the bank account pertaining to E Division.

You are required to:

(i) Show the journal entries in the books of White Ltd.

(ii) Prepare White Ltd.'s balance sheet immediately after the demerger and the initial balance sheet of Bright Ltd.

(iii) Calculate the intrinsic value of the share of White Ltd., immediately before the demerger and after the demerger, and

(iv) Comment on the impact of demerger on "Shareholders' wealth". (16 Marks)

Answer

(i) Journal Entries in White Ltd.'s books *(₹ in lakhs)*

		Dr. Amount	Cr. Amount
Bank Account (Current Assets)	Dr.	200	
To Investments			175
To Profit and Loss Account (Reserves and Surplus)			25
(Sale of investments at a profit of ₹ 25 lakhs)			
Debentures (Loan Funds)	Dr.	200	
To Bank Account (Current Assets)			180
To Profit and Loss Account (Reserve & Surplus)			20
(Redemption of debentures at 10 % discount)			
Current Liabilities	Dr.	305	
Bank Loan (Loan Funds)	Dr.	20	
Provision for Depreciation	Dr.	240	
Reserves and Surplus (Loss on Demerger)	Dr.	590	
To Fixed Assets			510
To Current Assets			645
(Assets and liabilities pertaining to N Division taken out of the books on transfer of the division to Bright Ltd.)			

Note :

(i) The date of de-merger is assumed as 1st April 2015.

(ii) Any other alternative set of entries, with same net effect on various accounts may also be given.

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(ii) (a) **White Ltd.'s Balance Sheet after demerger**

Particulars	*Note No.*	*(₹ in lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		420
(b) Reserve and Surplus	1	175
(2) Non-current Liabilities		
Long-term borrowings	2	310
(3) Current Liabilities		275
Total		1180
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets		635
(2) Current assets	3	545
Total		1180

Notes to Accounts:

			(₹ in lakhs)
1.	Reserves and Surplus		
	Balance as on 31st March, 2015		720
	Add: Profit on sale of investments		25
	Add: Profit on redemption of debentures at discount		20
			765
	Less: Loss on demerger		(590)
	Balance shown in balance sheet after demerger		175
2.	Loan Funds		
	Balance as on 31st March, 2015		530
	Less: Bank Loan transferred to Bright Ltd.	20	
	Debentures redeemed	200	(220)
	Balance shown in balance sheet after demerger		310
3.	Current Assets		
	Balance as on 31st March, 2015		525

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Add: Cash received from sale of investments	200
	725
Less: Cash paid to redeem debentures	(180)
Balance in balance sheet after demerger	545

(b) **Initial Balance Sheet of Bright Ltd.**

Particulars	*Note No.*	*(₹ in lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital	1	840
(2) Non-current Liabilities		
Long-term borrowings	3	20
(3) Current Liabilities		305
Total		1165
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible		400
Intangible	2	315
(2) Current assets		450
Total		1165

Notes to Accounts:

1. **Share Capital**

	(₹ in lakhs)
Authorised capital	
120 lakhs Equity shares of ₹ 10 each	1200
Issued and subscribed capital	
84 lakhs Equity shares of ₹ 10 each	840
(issued for consideration other than cash)	

2. **Intangible Assets (Goodwill)**

	(₹ in lakhs)
Purchase consideration	840

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Less: Assets transferred* (400+450)	850	
Less : Loan funds transferred	(20)	
Current Liabilities	(305)	(525)
Goodwill		315

3. **Long-term borrowings** *(₹ in lakhs)*

Bank Loan	20

(iii) Calculation of intrinsic value of a share of White Ltd. *(₹ in lakhs)*

Particulars	*Before demerger (Division E and N)*	*After demerger (Division E only)*
Fixed Assets	905	635
Net Current Assets	(590+ 200-180)610	(525+20-275) 270
Total Assets	1,515	905
Less: Loan Funds	(530 -200) (330)	(530-200-20) (310)
Net Asset Value	1185	595
No. of share	42 lakhs	42 lakhs
Intrinsic Value per Share	₹ 28.21 per share	₹ 14.17 per share

Intrinsic Value of Bright Ltd.'s share = ₹ $\frac{(1165-20-305)\text{ lakhs}}{84\text{ lakhs}}$ = ₹ 10 per share

(iv) Gain per share to shareholders:

After demerger, for every share in White Ltd. the shareholder holds 2 shares in Bright Ltd.

	₹
Value of one share in White Ltd. after demerger	14.17
Value of two shares in Bright Ltd. (₹ 10 × 2)	20.00
	34.17
Less: Value of one share before demerger	(28.21)
Gain per share	5.96

Wealth of shareholders of White Ltd. has been increased by ₹ 5.96 per share. Earlier intrinsic value of Division N was only ₹ 14.07 per share. But after merger, the intrinsic value of Bright Ltd. on taking up Division N has become ₹ 10 per share and two such shares were given to the shareholders of White Ltd. which means that shares of value ₹ 20 has been received. This has contributed to gain per share by ₹ 5.96 to White Ltd. on demerger. This gain is on account of overpricing of Division N by ₹ 315 lakhs. There

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would be change in yield valuation because of separate focusing on two distinct business whereby profitability is likely to improve on account of demerger.

Question 3

X Ltd. acquired 100% (2,00,000) shares in Y Ltd. for ₹ 200 lakhs on April 1st, 2011 when Y Ltd. was formed with share capital of ₹ 200 lakhs.

X Ltd. acquired 80% (1,60,000) shares in Z Ltd. for ₹ 400 lakhs on April 1st, 2011 when Z Ltd. had share capital of ₹ 200 lakhs and Reserves and Surplus of ₹ 200 lakhs.

The company amortizes goodwill on consolidation on a SLM basis over a period of 5 years. A full year's amortization is provided if the goodwill exists for more than 6 months.

On 1st April 2014, X Ltd. sold 80,000 shares of Z Ltd. for cash consideration of ₹ 300 lakhs.

The net assets of Z Ltd. on 31st March, 2014 was ₹ 600 lakhs. The amount of reserves and surplus was ₹ 800 lakhs, ₹ 600 lakhs and ₹ 400 lakhs respectively in X Ltd., Y Ltd. and Z Ltd., on 31st March 2014.

The Balance Sheet of the companies as on 31st March 2015 were as follows:

	₹ in lakhs		
	X Ltd.	Y Ltd.	Z Ltd.
Share capital (₹ 100 per share)	800	200	200
Reserve and Surplus	1100	840	560
Current Liabilities	500	560	640
Total	2400	1600	1400
Investment at cost			
2,00,000 Shares in Y Ltd.	200		
80,000 Shares in Z Ltd.	200		
Current Assets	2000	1600	1400
Total	2400	1600	1400

Prepare for X Ltd., Group Balance Sheet as on 31st March, 2015 alongwith notes to accounts. Give workings wherever necessary. *(16 Marks)*

Answer

Consolidated Balance Sheet of X Ltd. and its subsidiary Y Ltd. and associate Z Ltd. as on 31.3.2015

Particulars	Note No.	(₹ in lakhs)
I. Equity and Liabilities		
(1) Shareholder's Funds		

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	Note	
(a) Share Capital	1	800
(b) Reserves and Surplus	2	2,052
(2) Current Liabilities	3	1,060
Total		3,912
II. Assets		
(1) Non-current assets		
Non-current investment in Associate	4	312
(2) Current assets	5	3,600
Total		3,912

Notes to Accounts

		₹ *in lakhs*	
1.	Share Capital		
	8 lakhs shares of ₹ 100 each		800
2.	Consolidated Reserves and Surplus		
	Balance of reserves and surplus of X Ltd. as on 31.3.2015	1100	
	Add: Post-acquisition reserves and surplus of Y Ltd.	840	
	Profit accumulated over the years on investment in Z Ltd. (256 - 200)	56	
	Post-acquisition reserves and surplus of Z Ltd. (560-400) x 40%	64	
	Less: Goodwill amortised for the period	(8)	2052
3.	Current liabilities		
	X Ltd.	500	
	Y Ltd.	560	1060
4.	Non-current investment		
	Carrying amount of Investment in Associate – Z Ltd.	256	
	(Identified goodwill included in the above ₹ 16 lakhs)		
	Add: Increase in reserves and surplus during the year (560-400) x 40%	64	
	Less: Goodwill written off in the fourth year ₹ 16 lakhs x ½	(8)	312
5.	Current Assets		
	X Ltd.	2,000	
	Y Ltd.	1,600	3600

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Working Notes:

1. **Analysis of profits of Z Ltd. as on 31.3.2014**

	Z Ltd.	
	Pre-acquisition	*Post-acquisition*
	₹ in lakhs	*₹ in lakhs*
Reserves and Surplus	200	200
X Ltd. (80%)	160	160
Minority Interest (20%)	40	40

2. **Minority Interest**

	Z Ltd.
	₹ in lakhs
Share Capital (20%)	40
Share in Reserves and Surplus	
Pre-acquisition	40
Post-acquisition	40
	120

3. **Cost of Control**

	Z Ltd.
	₹ in lakhs
Investment by X Ltd.	400
Less: Share capital (80%)	(160)
Capital profit (pre-acquisition) (W.N.1)	(160)
Goodwill	80
Less: Amortization for 3 years [(80/5) x3]	(48)
Carrying value of goodwill after 3 years	32

4. **Associate valuation for Consolidated Balance Sheet as on 31.3.2015**

Z Ltd. became a subsidiary of X Ltd. on 1st April 2011 when 80% thereof was acquired. The holding –subsidiary relationship continued till 31st March, 2014 and from 1st April, 2014 the relationship between the two companies changed to Associate. As per AS 21, "Consolidated Financial Statements", the carrying value of the investment at the date it ceases to be subsidiary is regarded as cost thereafter.

Accordingly, if the nature of the investee changes to that of an associate, the carrying amount of the investment in Consolidated Financial Statements of the investor, as on

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date it ceases to be a subsidiary, would be considered as cost of investment in the associate. Goodwill or capital reserve arising on account of the change in the nature of the investment will be computed as on the date of such change.

(a) Ascertainment of carrying value of investment in Z Ltd. (disposed off and retained)

	₹ in lakhs
Net Assets of Z Ltd. on the date of disposal	600
Less: Minority's interest in Z Ltd. on the date of disposal (20%)	(120)
Share of X Ltd. in Net Assets	480
Add: Carrying value of Goodwill	32
Total value of investment in consolidated financial statements of X Ltd.	512
Less: Carrying Value of investment disposed off (₹ 512 lakhs x 80,000/1,60,000)	(256)
Carrying Value of investment retained	256

(b) Goodwill arising on the carrying value of unsold portion of the investment

	₹ in lakhs
Carrying value of retained 40% holdings in Z Ltd. as on 1st April, 2014	256
Less: Share in value of equity (net worth) of Z Ltd., as at date of investment when its subsidiary relationship is transformed toan associate (600 x 40%)	(240)
Goodwill arising on such investment under Equity method as per AS 23	16

Note: As sale of part investment in Z Ltd. took place on 1st April, 2014; therefore, it is not accounted again in the consolidated balance sheet assuming that the profit of X Ltd. includes the profit on sale of such investments.

Question 4

(a) A company announced a Stock Appreciation Right (SAR) on 01/04/2011 for each of its 600 employees. The scheme gives the employees the right to claim cash payment equivalent to excess on market price of company's shares, on exercise date, over the exercise price ₹ 130 per share in respect of 100 shares, subject to the condition of continuous employment of 3 years. The SAR is exercisable after 31/03/14 but before 30/06/14.

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Particulars	*2011-12*	*2012-13*	*2013-14*
Fair value of SAR	*25*	*28*	*32*
Actual number of employees left	*25*	*15*	*10*
Company estimation for left employee	*3%*	*5%*	*-*

On 30/06/2014 when SAR was exercised, the intrinsic value per share was ₹ 35 per share.

Show Provision for SAR account by fair value method. *(8 Marks)*

(b) You are required to:

(i) Identify Equity and Liability Components.

(ii) Compute bond liability at the end of each year, and

(iii) Pass necessary journal entries from the following information:

Number of convertible bonds	*:*	*5000 bonds issued at the end beginning of year 1*
Value of Books	*:*	*₹ 500 per bond.*
Period of Bonds	*:*	*3 years validity*
Interest Rate on the bond	*:*	*9% p.a. payable annually*
Proceeds Received	*:*	*₹ 25 lacs*
Conversion	*:*	*At the bond holders' discretion conversion into 125 ordinary shares for each bond of ₹ 500.*
Prevailing Market Rate	*:*	*11% p.a., for bonds issued without conversion option.*
Present Value factor for 11%	*:*	*0.900, 0.812, 0.731 (for one year, two years and three years, respectively)* *(8 Marks)*

Answer

(a) Note: The solution given below is by rounding off the number of employees and then the number of SARs has been calculated.

Provision of SARs A/c (For 2011-12)

	₹		₹
To Balance c/d	4,50,833	By Employee Compensation Expense	4,50,833
	4,50,833		4,50,833

Provision of SARs A/c (For 2012-13)

	₹		₹
To Balance c/d	9,93,067	By Balance b/d	4,50,833
		By Employee Compensation Expenses	5,42,234
	9,93,067		9,93,067

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Provision of SARs A/c (For 2013-14)			
To Balance c/d	17,60,000	By Balance b/d	9,93,067
		By Employee Compensation Expenses	7,66,933
	17,60,000		17,60,000

Provision of SARs A/c (For 2014-15)			
To Bank (55000 x 35)	19,25,000	By Balance b/d	17,60,000
		By Employee Compensation Expenses	1,65,000
	19,25,000		19,25,000

Working Notes:

Year 2011-12

Number of employees to whom SARs were announced = 600 employees

Total number of employees after three years, on the basis of the estimation in 2011-12

= [(600 -25) x .97 x .97] = 541 employees (approx.)

Total estimated SARs, to be vested at the end of the vesting period

= 541 employees x 100 SARs = 54,100 SARs

Fair value of SARs = 54,100 SARs × ₹ 25 = ₹ 13,52,500

Vesting period = 3 years

Value of SARs to be recognized as an expense in 2011–12 = ₹ 13,52,500/3 years

= ₹ 4,50,833

Year 2012-13

Total number of employees after three years, on the basis of the estimation in 2012-13

= [(600 – 25 - 15) x 0.95] = 532 employees

Total estimated SARs, to be vested at the end of the vesting period

= 532 employees x 100 SARs = 53,200 SARs

Fair value of SARs = 53,200 SARs × ₹ 28 = ₹ 14,89,600

Vesting period = 3 years and No. of years expired = 2 years

Cumulative value of SARs to recognize as expense = 14,89,600/3 × 2 = ₹ 9,93,067

Value of SARs to be recognized as an expense in 2012–13 = ₹ 9,93,067– ₹ 4,50,833

= ₹ 5,42,234

Year 2013-14

Fair value of SARs = ₹ 32

SARs actually vested = (600-25-15-10) employees x 100 SARs

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= 550 employees × 100 = 55,000 SARs

Fair value = 55,000 SARs × ₹ 32 = ₹ 17,60,000

Cumulative value to be recognized = ₹ 17,60,000

Value of SARs to be recognized as an expense = ₹ 17,60,000 – ₹ 9,93,067= ₹ 7,66,933

Year 2014–15

Cash payment of SARs = 55,000 SARs × ₹ 35 = ₹ 19,25,000

Value of SARs to be recognized as an expense in 2014–15 = ₹ 19,25,000 – ₹ 17,60,000

= ₹ 1,65,000

(b) (i) **Classification into Equity and Liability Component**

(a) **Ascertainment of Liability Component**

Had the bonds been issued at 11% p.a. the present value would emerge as below:

	₹
Present value of ₹ 25 lacs repayable after 3rd year (25 lacs x 0.731)	18,27,500
Present value of interest payable @ 9% and discounted @ 11% at the end of	
Year 1 – (2,25,000 x 0.900)	2,02,500
Year 2 – (2,25,000 x 0.812)	1,82,700
Year 3 – (2,25,000 x 0.731)	1,64,475
Liability component (Total of present value)	23,77,175

(b) **Ascertainment of Equity Component**

	₹
Value of Instrument	25,00,000
Less: Fair Value of liability component	(23,77,175)
Equity component	1,22,825

(ii) **Table showing bond liability at the end of each year**

	Year 1	*Year 2*	*Year 3*
	₹	₹	₹
Beginning	23,77,175	24,13,664	24,54,167
Add: Interest @ 11%	2,61,489	2,65,503	2,69,958

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	26,38,664	26,79,167	27,24,125
Rounding off adjustment	-	-	875*
Less: Interest @ 9%	(2,25,000)	(2,25,000)	(2,25,000)
Carrying amount	24,13,664	24,54,167	25,00,000

(iii) **Journal Entries**

		Debit ₹	*Credit* ₹
Initial recognition at the inception			
Cash/Bank A/c	Dr.	25,00,000	
To Bond A/c			23,77,175
To Equity A/c			1,22,825
(Being proceeds received from Bond recognized)			
End of Year 1			
Finance Charges A/c	Dr.	2,61,489	
To Bonds A/c			36,489
To Cash or Bank A/c			2,25,000
(Being finance charges debited @ 11% and difference credited to Bond Account)			
End of Year 2			
Finance Charges A/c	Dr.	2,65,503	
To Bonds A/c			40,503
To Cash or Bank A/c			2,25,000
(Being finance charges debited @ 11% and difference credited to Bond Account)			
End of Year 3			
Finance Charges A/c	Dr.	2,70,833*	
To Bonds A/c			45,833
To Cash or Bank A/c			2,25,000
(Being finance charges debited @ 11% and difference credited to Bond Account)			

* Rounding off is due to approximation of discounting factor @ 11%.

*₹2,69,958 + ₹875 = ₹ 2,70,833

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Question 5

(a) *Railway Products Private Ltd. (RPPL) is engaged in the business of design and manufacture of Railways products that are supplied to Railway Department. The core component of such product is outsourced by RPPL from Allied Component Ltd. (ACL), the sole manufacturer of such components.*

RPPL wants to gain leadership in this industry and seeks to take over ACL, RPPL estimates that its goodwill will increase on the acquisition. Minimum increased value of goodwill will be ₹ 200 lakhs.

RPPL has made the following calculation of the economic benefits presently available and that are foreseen as a result of the acquisition:

(i) *Projected cash flows for the next 5 years:*

	Cash Flow forecasts (₹ in lakhs)				
Year	*1*	*2*	*3*	*4*	*5*
RPPL	*2000*	*2500*	*3000*	*3500*	*4000*
ACL	*600*	*600*	*800*	*800*	*1000*

(ii) *The net worth of ACL is as follows:*

		₹ in lakhs
Fixed Assets		
Tangible assets		*3000*
Investments (Non-Trade)		*1500*
Current Assets		
Inventories	*1000*	
Receivables	*500*	*1500*
Total		*6000*
Less : Current Liabilities		
Trade Payables	*800*	
Bank Loan	*700*	*(1500)*
Net worth (Represented by 300 lakhs shares of ₹ 10 each and reserves and surplus ₹ 1500 lakhs)		*4500*

(iii) *Other information:*

a. *20% of the fixed assets of ACL will not be required on acquisition and the same has ready buyers for ₹ 300 lakhs.*

b. *Investments have a ready market for ₹ 2,000 lakhs.*

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c. Currents assets include surplus inventory of ₹ 50 lakhs that can realize ₹ 80 lakhs.

d. The current liabilities are to be paid off immediately. A sum of ₹ 820 lakhs are payable on account of a compensation claim awarded against ACL, which has been treated as a contingent liability in the accounts, on which 20% was provided for.

(iv) RPPL has estimated the combined cash flows post merger as follows:

Year	*1*	*2*	*3*	*4*	*5*
Cash Flow (₹ in lakhs)	*2800*	*3200*	*3700*	*4300*	*5000*

You are required to advice RPPL the maximum value it can pay for take-over of ACL and also show current valuation of ACL as a "stand alone" equity. The discount rate of 15% is advised appropriate.

P.V. of discounting factor of 15% are as follows:

Year	*1*	*2*	*3*	*4*	*5*
Discounting factor (15%)	*0.870*	*0.756*	*0.658*	*0.572*	*0.497*

(10 Marks)

(b) Find out leverage effect on Goodwill from the following information:

(i)	*Average capital employed (Equity Approach)*	*₹ 11,50,000*
(ii)	*Future Maintainable Profit on equity fund (After Tax)*	*₹ 1,80,000*
(iii)	*10% Long-term Loan*	*₹ 4,50,000*
(iv)	*Tax rate*	*40%*
(v)	*Normal rate of return:*	
	On equity capital employed	*15%*
	On long-term capital employed	*12%*

(6 Marks)

Answer

(a) (1) Calculation of operational synergy expected to arise out of merger

(₹ in lakhs)

Year	1	2	3	4	5
Projected cash flows of RPPL after merger with ACL	2,800	3,200	3,700	4,300	5,000
Less: Projected cash flows of					

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RPPL Ltd. without merger	(2,000) 800	(2,500) 700	(3,000) 700	(3,500) 800	(4,000) 1,000

(2) Valuation of ACL in case of merger

Year	*Cash Flows from operations (₹ in lakhs)*	*Discount Factor*	*Discounted Cash Flow (₹ in lakhs)*
1	*800*	*0.870*	*696.00*
2	*700*	*0.756*	*529.20*
3	*700*	*0.658*	*460.60*
4	*800*	*0.572*	*457.60*
5	*1000*	*0.497*	*497.00*
			2,640.40

(3) Maximum value to be quoted

	₹ in lakhs	*₹ in lakhs*
Value as per discounted cash flows from operations		2640.40
Add: Increase in goodwill of RPPL on acquisition of ACL		200
		2,840.40
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	300	
Investments	2,000	
Inventory	80	2,380.00
		5,220.4
Less: Cash to be paid immediately for		
Current liabilities (1500 – 164*)	1336	
Compensations claim	820	(2,156.00)
		3,064.40

So, RPPL can quote as high as ₹ 3,064.40 lakhs for taking over the business of ACL.

*i.e. 820 x 20% = 164

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(4) Valuation of ACL ignoring merger (as a 'Stand Alone' entity)

Year	*Cash Flows*	*Discount Factor*	*Discounted Cash Flow*
	(₹ in lakhs)		*(₹ in lakhs)*
1	600	0.870	522.00
2	600	0.756	453.6
3	800	0.658	526.40
4	800	0.572	457.60
5	1,000	0.497	497.00
			2,456.60

(b) Determination of leverage effect on goodwill

			₹
a	Profit available for equity fund after tax		1,80,000
b	Profit (as per Long-term fund approach)		
	Profit for equity fund	1,80,000	
	Add: Interest on Long-term loan (net of tax) 4,50,000 x [10%x(1-0.4)]	27,000	2,07,000
c	Capital employed (by Equity approach)		11,50,000
d	Capital employed as per Long-term fund approach		
	Capital employed (by Equity approach)	11,50,000	
	Add: 10% Long term loan	4,50,000	16,00,000
e	Value of Goodwill		
	(A) By Equity Approach		
	Capitalised value of Profit as per equity approach (1,80,000/15 x 100)		12,00,000
	Less: Capital employed as per equity approach		(11,50,000)
	Value of Goodwill		50,000
	(B) By Long-Term Fund Approach		
	Capitalized value of Profit as per Long-term fund approach (2,07,000/12 x 100)		17,25,000
	Less: Capital employed as per Long-term fundapproach		(16,00,000)
	Value of Goodwill		1,25,000

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Leverage effect on Goodwill:

Adverse leverage effect on goodwill is ₹ 75,000 (i.e. ₹ 1,25,000 – ₹ 50,000)

In other words, leverage ratio is low for which its goodwill value has been reduced when calculated with reference to equity fund as compared to value arrived at with reference to long term fund.

Question 6

(a) *Vijay Ltd. furnishes the following information from which you are required to calculate the Economic Value Added (EVA) of the company and also explain the reason for the difference, if any, between the EVA as calculated by you and the MVA (Market Value Added) of Vijay Ltd. amounting to ₹ 7010 crores.*

Common share of ₹ 10 face value	*79,10,000 Shares*
10% Debentures of ₹ 100 face value	*2,50,000 Debentures*
Tax rate	*30%*
Financial Leverage	*1.1 Times*
Capital Reserves (₹ in lakhs)	*54*
Free Reserves(₹ in lakhs)	*75*
Securities Premium (₹ in lakhs)	*80*

It is common practice for companies in the industry to which Vijay Ltd. belongs to pay atleast a dividend of 12% p.a. to its common shareholders. *(8 Marks)*

(b) *During the financial year 2014-15, Power Ltd. had the following transactions:*

(i) *On 01.04.2014, Power Ltd. purchased a new asset of Dark Ltd. for ₹ 11,40,000. The fair value of Dark Ltd.'s identifiable net assets was ₹ 8,50,000. Power Ltd. is of the view that due to popularity of Dark Ltd.'s product, the life of goodwill is 10 years.*

(ii) *On 01.05.2014, Power Ltd. purchased a franchise to operate transport service from the Government for ₹ 12,00,000 and at a annual fee of 4% of transport revenues. The franchise expires after 5 years. Transport Revenue were ₹ 1,20,000 for Financial Year 2014-15. Power Ltd. projects future revenue of ₹ 2,40,000 in 2015-16 and ₹ 3,50,000 p.a. for 3 years thereafter.*

(iii) *On 05.07.2014, Power Ltd. was granted a patent that had been applied for by Dark Ltd. During 2014-15, Power Ltd. incurred legal cost of ₹ 1,10,000 to register the patent and an additional ₹ 3,00,000 to successfully prosecute a patent infringement suit against a competitor. Power Ltd. expects the patent's economic life to be 10 years. Power Ltd. follows an accounting policy to amortise all intangibles on SLM basis over a maximum period permitted by Accounting Standard taking a full year amortization in the year of acquisition.*

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Prepare:

a. *A Schedule showing the intangible section in Power Ltd. balance sheet at 31st March, 2015.*

b. *A Schedule showing the related expenses that would appear in the Statement of Profit and Loss of Power Ltd. for 2014-15.* *(8 Marks)*

Answer

(a) Computation of Economic Value Added

	₹ in lakhs
NOPAT	192.50
Less: Cost of Capital	(137.50)
Economic Value Added	55.00

MVA of Vijay Ltd. is ₹ 7,010 crore.

The MVA of ₹ 7,010 crore is the difference between the current market value of Vijay Ltd. and the capital contributed by the fund providers. While EVA measures current earning efficiency of the company, MVA takes into consideration the EVA from not only the assets in place but also from the future projects/activities of the company. The difference between MVA over EVA thus represents the value attributed to the future potential of the company & may change from time to time based on market sentiments. In short, the MVA is the net present value of all future EVA's.

Working Notes:

1. **Calculation of Net Profit before interest and tax**

Interest on Debentures = 2,50,000 units x 100 x 10% = ₹ 25,00,000

Therefore, Financial Leverage = $\frac{\text{Profit before Interest \& taxes (PBIT)}}{\text{PBIT less Interest}}$

$$1.10 = \frac{\text{PBIT}}{\text{PBIT - ₹ 25,00,000}}$$

1.10 (PBIT – ₹ 25,00,000) = PBIT

1.10 PBIT – ₹ 27,50,000 = PBIT

1.10 PBIT – PBIT = ₹ 27,50,000

0.10 PBIT = ₹ 27,50,000

PBIT = ₹ 2,75,00,000

2. **Calculation of NOPAT**

NOPAT = PBIT – Interest –Tax + Interest (net of tax)

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or

NOPAT = PBIT – Tax

NOPAT = ₹ 2,75,00,000x (1-0.3)= ₹ 1,92,50,000.

3. **Calculation of Weighted Average Cost of Capital (WACC)**

	₹ in lakhs	*₹ in lakhs (1)*	*Weight (2)*	*Cost% (3)*	*WACC% (4)=2x3*
Equity Shareholders' fund					
Common Shares	791				
Securities Premium	80				
Free Reserves	75				
Capital Reserves	54				
		1,000	0.80	12	9.6
Debenture holders' fund		250	0.20	7*	1.4
		1,250	1.00		11.00

Cost of Capital = Capital Employed x WACC%

= ₹ 1,250 lakhs x 11%

= ₹ 137.50 lakhs

* Rate of interest on debentures is taken net of tax of 30%.

(b) Power Ltd.

(i) Balance Sheet (Extract relating to Intangible Asset) as on 31st March 2015

	Note No.	*₹*
Assets		
(1) Non- current asset		
Intangible assets	1	15,90,000

(ii) Statement of Profit and Loss (Extract) for the year ended 31st March 2015

	Note No.	*₹*
Revenue from Operations		1,20,000
Total Revenue		xxx
Expenses:		
Amortization	2	3,10,000

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Other expenses	3	4,800
Total Expenses		xxx

Notes to Accounts

		₹	₹
1.	Intangible assets		
	Goodwill (W.N. 1)	2,61,000	
	Franchise (W.N. 2)	9,60,000	
	Patents (W.N. 3)	3,69,000	15,90,000
2.	Amortization expenses		
	Goodwill	29,000	
	Franchise	2,40,000	
	Patent	41,000	3,10,000
3.	Other expenses		
	Annual fee paid to Govt. on Franchise revenue @ 4% (1,20,000 x 4%)		4,800

Working Notes:

		₹
(1)	Cash paid for assets	11,40,000
	Less: Fair value of identifiable net assets	(8,50,000)
	Goodwill	2,90,000
	Less: Amortisation (over 10 years as per SLM)	(29,000)
	Balance to be shown in the balance sheet	2,61,000
(2)	Franchise	12,00,000
	Less: Amortisation (over five years)	(2,40,000)
	Balance to be shown in the balance sheet	9,60,000
(3)	Patent (1,10,000 + 3,00,000)	4,10,000
	Less: Amortisation (over ten years as per SLM)	(41,000)
	Balance to be shown in the balance sheet	3,69,000

Question 7

*Answer any **four** of the questions:*

(a) *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 locked in various*

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claims/petition 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 accepted 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 the 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 Account. State whether the treatment done by company is correct or not.

(b) *Company owns an office building. Company enters into a put option with an investor that permits the company to put the building to the investor for ₹ 150 million. The current value of the building is ₹ 175 million. The option expires in 5 years. The option, if exercised, may be settled through physical delivery or net cash, at company's option. How do the Company and the investor account for the option?*

(c) *Aakash Limited is the owner of a CGU (Cash Generating Unit) block of assets whose current carrying cost is ₹ 1000 lakhs. Current carrying cost of the CGU block of assets as per Accounting and Tax records are after charging depreciation of the current year. The company, after a detailed study by its technical team, has assessed the present value recoverable amount of this CGU block of assets at ₹ 550 lakhs. The value of the block of assets as per the Income Tax records is ₹ 800 lakhs. The Approving Authority of the company have issued a signed statement confirming that the impairment in the value of CGU is only a temporary phenomenon which is reversible in subsequent periods and also assuring virtual certainty of taxable incomes in the foreseeable future. You are required to show Deferred Tax workings as per Accounting Standards in force, given the tax rate of 30% plus 10% surcharge thereon. The depreciation rate for tax purposes is 15% and that as per books is 13.91%.*

(d) *A Company enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits the company to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative? Explain.*

(e) *Due to immense loss to Nepal in the recent earthquake, one FMCG Company undertakes various commercial activities with considerable discounts and concessions at the related affected areas of Nepal for a continuous period of 3 months after earthquake. In the Financial Statements for the year 2014-15, the Management has shown the expenditure incurred on such activity as expenditure incurred to discharge Corporate Social Responsibility. State whether the intention* of management is correct. Explain with reasons.*

****PS:** Read the 'intention of management' given in the last sentence of the question as 'treatment done by the management'.* *(4 x 4 = 16 Marks)*

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Answer

(a) 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.

AS 29 'Provisions, Contingent Liabilities and Contingent Assets' states that provision should be recognised when there is a present obligation as a result of a past event and an outflow of resources embodying economic benefits will be required to settle the obligation and lastly a reliable estimate can be made of the amount of the obligation. In the given question, amount has not been paid on due date so present obligation arises on non-payment of principal amount which is to be settled by paying later. Also the question states that the interest has been paid till due date. It implies that interest on overdue amount can also be calculated by applying that rate. Therefore, reliable estimate can be made for the amount of provision. Since all the three conditions stated in AS 29 for recognition of provision is satisfied, the company shall provide for the interest on the overdue amount.

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 placed in a disadvantageous position for non-receipt of interest in respect of overdue amount.

From the aforesaid, it is apparent that the company has an obligation on account ofthe interest on the overdue amount to be paid after due date. The company should provide for the liability (since it is not waived off by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case.

However, in respect of the interest, for which the payment of principal amount has been later on made, 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 for the interest amount from due date to the date of repayment of principal is not correct.

(b) As per AS 30 "Financial Instruments: Recognition and Measurement", company's accounting depends on the intention of the company and past practice followed by it for settlement. Although the contract meets the definition of a derivative, the company will not account for it as a derivative if it intends to settle the contract by delivering the building and there is no past practice of settling net in cash.

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery. In addition, the option may be settled net in cash.

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Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention is immaterial whether settlement is to be made by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from AS 30 because the option writer does not have the choice or ability to require delivery.

(c) **Statement showing Deferred Tax workings for the current year**

	₹ in lakhs
Depreciation as per Accounting Books for the current year $\frac{1,000}{(1-.1391)} \times .1391$	161.58
Depreciation as per Income Tax Records for the current year $\frac{800}{(1-.15)} \times .15$	(141.18)
Timing difference	20.40
Tax effect of the above timing difference at 33%* (deferred tax asset) (A)	6.73
Impairment Loss recognised in the profit and loss account (1,000- 550)	450.00
Impairment Loss allowed for tax purposes	Nil
Timing difference	450.00
Tax effect of the above timing difference at 33% (deferred tax asset) (B)	148.50
Total deferred tax asset (A+B)	155.23

(d) As per AS 30 "Financial Instruments: Recognition and Measurement", while such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if the company intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under AS 30. Instead, it is accounted for as an executory contract.

(e) The Companies Act, 2013 mandated the corporate entities that the expenditure incurred for Corporate Social Responsibility (CSR) should not be the expenditure incurred for the

*Tax rate = 30%x 110%= 33%.

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activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

The statutory guidelines relating to CSR also require the deployment of funds for the benefit of the local area of the Company. Since Nepal is another country the expenditure done there i.e. in Nepal shall not qualify to be accounted as CSR expenditure.

Further, it is presumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the company. Therefore, the treatment done by the Management by showing the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

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