PAPER – 1: FINANCIAL REPORTING

*Answer **all** questions.*

Working notes should form part of the answer.

Wherever necessary, suitable assumptions may be made by the candidates.

Question 1

(a) *Mr. A bought a forward contract for three months of US \$ 1,00,000 on 1st December at 1 US \$ = Rs.47.10 when exchange rate was US \$ 1 = Rs.47.02. On 31st December when he closed his books, exchange rate was US \$ 1 = Rs.47.15. On 31st January, he decided to sell the contract at Rs.47.18 per dollar. Show how the profits from contract will be recognised in the books.*

(b) *Sun Ltd. has entered into a sale contract of Rs.5 crores with X Ltd. during 2009-10 financial year. The profit on this transaction is Rs.1 crore. The delivery of goods to take place during the first month of 2010-11 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of Rs.1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2009-10 financial year. As on balance sheet date (31.3.2010), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.*

   (i) *Should Sun Ltd. provide for contingency as per AS 29?*

   (ii) *Should provision be measured as the excess of compensation to be paid over the profit?*

(c) *Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.2009 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. The weighted average cost of capital is 13% p.a. The accountant of Rainbow Ltd., capitalised interest of Rs.19.50 crores for the accounting period ending on 31.3.2010. Due to surplus fund out of Rs.150 crores, an income of Rs.3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.*

(d) *Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference resulting in a tax liability in year 1 and 2 is Rs.200 lakhs and Rs.400 lakhs respectively. From the third year it is expected that the timing difference would reverse each year by Rs.10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.* *(4 × 5 = 20 Marks)*

Answer

(a) It is apparent from the facts given in the question that Mr. A entered into forward exchange contract for speculation purpose*. According to paragraphs 38 and 39 of AS

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* The forward contract is sold before its due date, hence considered as speculative.

11(Revised) 'The Effects of Changes in Foreign Exchange Rates', gain or loss on forward exchange contracts intended for trading or speculation purpose should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period and the premium or discount on the forward exchange contract is ignored and not recognised separately. In recording such contract, at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Thus, the premium on contract i.e., the difference between the contract rate and the spot rate amounting Rs. 8,000 [US$ 1,00,000 x (Rs.47.10 – Rs.47.02)] will be ignored and not be recorded in the books. However, the profit on contract i.e. the difference between the sale rate and contract rate amounting Rs. 8,000 [US$ 1,00,000 x 0.08* (Rs.47.18 – Rs.47.10)] will be recognized in the books of Mr. A on 31st January.

Note: The answer has been given on the basis that Mr. A is a small and medium-sized entity and AS 30 "Financial Instruments: Recognition and Measurement" is not applicable to him.

(b) (i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting Rs. 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2010 and no profit had accrued for the financial year 2009-2010. Therefore, provision should be made for the full amount of compensation amounting Rs.1.50 crores.

(c) Para 10 of the AS 16 'Borrowing Cost' states, "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings". The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding

* The current market value of the forward contract on 31st December has not been given in the question. Therefore, no gain or loss can be recognised in the books on 31st December. The profit amounting Rs. 8,000 will be recognised in the year of sale only.

during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. In the given case, the amount of Rs. 150 crores was specifically borrowed for construction of boiler plant. Therefore, treatment of accountant of Rainbow Ltd. is not correct and the amount of borrowing costs to be capitalised for the financial year 2009-10 should be calculated as follows:

	Rs. (in crores)
Interest paid for 2009-10 (11% on Rs.150 crores)	16.50
Less: Income on temporary investment from specific borrowings	3.50
Borrowing costs to be capitalised during 2009-10	13.00

(d) As per Accounting Standards Interpretation (ASI) 5* "Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income-tax Act, 1961 Accounting Standard (AS) 22, Accounting for Taxes on Income", deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of Rs. 200 lakhs depreciation timing difference, amount of Rs. 80 lakhs (Rs. 10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for Rs. 120 lakhs (Rs. 200 lakhs – Rs. 80 lakhs), deferred tax liability will be recognised for Rs. 48 lakhs (40% of Rs. 120 lakhs) in first year. In the second year, the entire amount of timing difference of Rs. 400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting Rs. 160 lakhs (40% of Rs. 400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be Rs. 208 lakhs (48 lakhs + 160 lakhs).

Question 2

(a) While closing its books of account as on 31.12.2009 a non-banking finance company (NBFC) has its advances classified as under:

	Rs. in lakhs
Standard assets	*10,000*
Sub-standard assets	*1,000*
Secured portion of doubtful debts	

* This ASI has been incorporated as an explanation to para 13 of the notified AS 22.

-Upto one year	*160*
-One year to three year	*70*
-More than three years	*20*
Unsecured portion of doubtful debts	*90*
Loss assets	*30*

Calculate the provision to be made against advances by NBFC as per prudential norms.

(b) Comforts Ltd. granted Rs.10,00,000 loan to its employees on January 1, 2009 at a concessional interest rate of 4% per annum. Loan is to be repaid in five equal annual instalments along with interest. Market rate of interest for such loan is 10% per annum. Following the principles of recognition and measurement as laid down in AS 30 'Financial Instruments : Recognition and Measurement', record the entries for the year ended 31st December, 2009 for the loan transaction, and also calculate the value of loan initially to be recognised and amortised cost for all the subsequent years. The present value of Re.1 receivable at the end of each year based on discount factor of 10% can be taken as:

Year end	*1*	*0.9090*
	2	*0.8263*
	3	*0.7512*
	4	*0.6829*
	5	*0.6208*

(4 + 12 = 16 Marks)

Answer

(a) Calculation of provision on advances as on 31.12.2009

	Amount	*Provision*	
	Rs. in lakhs	*%*	*Rs. in lakhs*
Standard assets	10,000	Zero	Nil
Sub standard assets	1,000	10%	100
Secured portion of doubtful debts			
Upto one year	160	20%	32
One year to three years	70	30%	21
More than three years	20	50%	10
Unsecured portion of doubtful debts	90	100%	90
Loss assets	30	100%	30
Total provision			283

(b) (i) Journal Entries in the books of Comfort Ltd.

for the year ended 31st December, 2009 (regarding loan to employees)

		Dr. Amount (Rs.)	Cr. Amount (Rs.)
Staff loan A/c	Dr.	10,00,000	
To Bank A/c			10,00,000
(Being the disbursement of loans to staff)			
Staff cost A/c (10,00,000 – 8,54,763) [Refer part (ii)]	Dr.	1,45,237	
To Staff loan A/c			1,45,237
(Being the write off of excess of loan balance over present value thereof, in order to reflect the loan at its present value of Rs. 8,54,763)			
Staff loan A/c	Dr.	85,476	
To Interest on staff loan A/c			85,476
(Being the charge of interest @ market rate of 10% to the loan)			
Bank A/c	Dr.	2,40,000	
To Staff loan A/c			2,40,000
(Being the repayment of first instalment with interest for the year)			
Interest on staff loan A/c	Dr.	85,476	
To Profit and loss A/c			85,476
(Being transfer of balance in staff loan Interest account to profit and loss account)			
Profit and loss A/c	Dr.	1,45,237	
To Staff cost A/c			1,45,237
(Being transfer of balance in staff cost account to profit and loss account)			

(ii) **Calculation of initial recognition amount of loan to employees**

Year end	*Cash Inflow*		*Total*	*P.V. factor*	*Present value*
	Principal	Interest @ 4%			
	Rs.	*Rs.*	*Rs.*		*Rs.*
2009	2,00,000	40,000	2,40,000	0.9090	2,18,160
2010	2,00,000	32,000	2,32,000	0.8263	1,91,702
2011	2,00,000	24,000	2,24,000	0.7512	1,68,269
2012	2,00,000	16,000	2,16,000	0.6829	1,47,506
2013	2,00,000	8,000	2,08,000	0.6208	1,29,126
Present value or Fair value					8,54,763

(iii) **Calculation of amortised cost of loan to employees**

Year	Amortised cost (Opening balance) [1]	Interest to be recognised@10% [2]	Repayment (including interest) [3]	Amortised Cost (Closing balance) [4]=[1]+ [2] – [3]
	Rs.	*Rs.*	*Rs.*	*Rs.*
2009	8,54,763	85,476	2,40,000	7,00,239
2010	7,00,239	70,024	2,32,000	5,38,263
2011	5,38,263	53,826	2,24,000	3,68,089
2012	3,68,089	36,809	2,16,000	1,88,898
2013	1,88,898	19,102 (Bal. fig.)*	2,08,000	Nil

Question 3

The draft Balance Sheet of three companies, W, H, O, as at 31.3.2010 is as under:

			Rs. in thousands
Assets	*W*	*H*	*O*
Fixed assets	*697*	*648*	*349*
Investments			
1,60,000 shares in H	*562*	---	---

* The difference of Rs. 212 (Rs. 19,102 - Rs. 18,890) is due to approximation in computations.

80,000 shares in O		*184*	*---*	*---*
Cash at bank		*101*	*95*	*80*
Trade receivables		*386*	*321*	*251*
Inventory		*495*	*389*	*287*
	Total	*2,425*	*1,453*	*967*
Liabilities				
Share capital (Nominal value Re.1 per share)		*600*	*200*	*200*
Reserves		*1,050*	*850*	*478*
Trade payables		*375*	*253*	*189*
Debentures		*400*	*150*	*100*
	Total	*2,425*	*1,453*	*967*

You are given the following information:

(a) W purchased the shares in H on 13.10.2005 when the balance in reserves was Rs.500 thousands.

(b) The shares in O were purchased on 11.5.2005 when the balance in reserves was Rs.242 thousands.

(c) The following dividend have been declared but not accounted for before the accounting year end.

W	-	*Rs.65 thousands*
H	-	*Rs.30 thousands*
O	-	*Rs.15 thousands*

(d) Included in inventory figure of O is inventory valued at Rs.20 thousands which had been purchased from W at cost plus 25%.

(e) Goodwill in respect of the acquisition of H has been fully written off.

(f) On 31.3.2010 H made bonus issue of one share for every share held. This had not been accounted in the balance sheet as on 31.3.2010.

(g) Included in trade payables of W is Rs.18 thousands to O, which is included in trade receivables of O.

Prepare Consolidated Balance Sheet of W as at 31.3.2010. *(16 Marks)*

Answer

Consolidated Balance Sheet of W and its subsidiary H

As at 31st March, 2010

		(Rs. in thousands)
Assets		
Fixed assets (697+ 648)		1,345.00
Investment in Associate (W.N.5)	184.00	
(including goodwill Rs.7.20 thousand)		
Add: Accumulated reserves	86.80	270.80
Cash at bank (101+ 95)		196.00
Trade receivables (386+ 321)		707.00
Inventory (495+ 389)		884.00
Dividend receivable from O		6.00
	Total	3,408.80
Liabilities		
Share capital (Nominal value Re.1 per share)		600.00
Minority Interest (W.N.3)		204.00
Reserves (W.N.4)		1,355.80
Trade payables (375+ 253)		628.00
Debentures (400+ 150)		550.00
Proposed Dividend (W.N.6)		71.00
	Total	3,408.80

Working Notes:

1. Analysis of profits of H

		(Rs. in thousands)
	Pre acquisition profits	*Post acquisition profits*
Reserves on the date of acquisition	500	350
Less: Bonus issue*	200	
	300	350

* It is assumed that bonus issue had been made out of pre-acquisition reserves.

Less: Dividend declared on 31.3.2010	____	30
	300	320
Minority interest (20%)	60	64
W's share (80%)	240	256

2. **Cost of control/Goodwill**

		Rs. in thousands
Amount paid for investment		562
Less: Paid up value of shares including bonus (80% of 400)	320	
Share in pre-acquisition profits of H	240	560
Goodwill		2

3. **Minority Interest**

	Rs. in thousands
Paid up value of share including bonus issue (400 × 20%)	80
Share in pre acquisition profits of H	60
Share in post acquisition profits of H	64
	204

4. **Consolidated Reserves**

		Rs. in thousands	*Rs. in thousands*
Balance as per W's Balance Sheet			1,050.00
Add:	Share in post acquisition profits of H		256.00
	Dividend from H		24.00
	Share of profit from Associate O	86.80	
	Add: Dividend from O	6.00	92.80
			1,422.80
Less:	Dividend payable	65.00	
	Goodwill written off	2.00	67.00
			1,355.80

5. **Investment in Associate O as on 31.03.2010 (As per AS 23)**

			Rs. in thousands
Amount paid for investment			184.00
Less:	Paid up value of shares	80.00	
	Share in pre acquisition reserves (40% of 242)	96.8	176.80
Goodwill (Identified at the time of purchase)			7.20

Initial cost		184.00
Add: Increase in equity reserves [40% of (478 – 15 – 242)]	88.40	
Less: Unrealised profit ($20\times\frac{25}{125})\times 40\%$)	(1.60)	86.80
Investment in Associate O as on 31.03.10		270.80
Share of profit from Associate O (270.80 – 184 + 6)		92.80

6. **Proposed Dividend**

	Rs. in thousands
W	65
Minority Interest (30 – 24)	6
	71

Question 4

The following are the Balance Sheets of Cat Ltd. and Bat Ltd. as on 31.3.2010:

(Rs. in thousands)

Liabilities	*Cat Ltd.*	*Bat Ltd.*
Share capital:		
Equity shares of 100 each fully paid up	*2,000*	*1,000*
Reserves	*800*	*---*
10% Debentures	*500*	*---*
Loans from Banks	*250*	*450*
Bank overdrafts	*---*	*50*
Sundry creditors	*300*	*300*
Proposed dividend	*200*	*---*
Total	*4,050*	*1,800*
Assets		
Tangible assets/fixed assets	*2,700*	*850*
Investments (including investments in Bat Ltd.)	*700*	*---*
Sundry debtors	*400*	*150*
Cash at bank	*250*	*---*
Accumulated loss	*---*	*800*
Total	*4,050*	*1,800*

Bat Ltd. has acquired the business of Cat Ltd. The following scheme of merger was approved:

(i) Banks agreed to waive off the loan of Rs.60 thousands of Bat Ltd.

(ii) Bat Ltd. will reduce its shares to Rs.10 per share and then consolidate 10 such shares into one share of Rs.100 each (new share).

(iii) Shareholders of Cat Ltd. will be given one share (new) of Bat Ltd. in exchange of every share held in Cat Ltd.

(iv) Proposed dividend of Cat Ltd. will be paid after merger to shareholders of Cat Ltd.

(v) Sundry creditors of Bat Ltd. includes Rs.100 thousands payable to Cat Ltd.

(vi) Cat Ltd. will cancel 20% holding in Bat Ltd. as investment, which was held at a cost of Rs.250 thousands.

Pass necessary entries in the books of Bat Ltd. and prepare Balance Sheet after merger.

(16 Marks)

Answer

Calculation of purchase consideration

One share of Bat Ltd. will be issued in exchange of every share of Cat Ltd. (i.e. 20,000 equity shares of Bat Ltd will be issued against 20,000 equity shares of Cat Ltd.)		20,000 shares
Less:	Shares already held (20% of 10,000) 2,000 shares converted in new equity shares	200 shares
Number of shares to be issued by Bat Ltd to shareholders of Cat Ltd.		19,800 shares

Journal Entries in the books of Bat Ltd.

Date			*(Rs. in thousands)*	
2010			Dr.	Cr.
March, 31	Loan from bank A/c	Dr.	60	
	To Reconstruction A/c			60
	(Being loan from bank waived off to the extent of Rs. 60 thousand)			
	Equity share capital A/c (Rs.100)	Dr.	1,000	
	To Equity share capital A/c (Rs.10)			100
	To Reconstruction A/c			900
	(Being Equity share of Rs. 100 each reduced to Rs.10 each)			

	Equity share capital A/c (Rs.10)	Dr.	100	
	To Equity share capital A/c (Rs.100 each)			100
	(Being 10 Equity shares of Rs. 10 each consolidated to one share of Rs.100 each)			
	Reconstruction A/c	Dr.	960	
	To Profit and loss A/c			800
	To Capital reserve A/c			160
	(Being accumulated losses set off against reconstruction A/c and balance transferred to capital reserve account)			
	Business purchase A/c	Dr.	1,980	
	To Liquidator of Cat Ltd.			1,980
	(Being purchase of business of Cat Ltd.)			
	Fixed asset A/c	Dr.	2,700	
	Investment A/c (700 – 250)	Dr.	450	
	Sundry debtors A/c	Dr.	400	
	Cash at bank A/c	Dr.	250	
	To Sundry creditors A/c			300
	To Proposed dividend A/c			200
	To Loans from bank A/c			250
	To 10% Debenture A/c			500
	To Business purchase A/c			1,980
	To Reserves A/c (800 – 230)			570
	(Being assets, liabilities and reserves taken over under pooling of interest method)			
	Liquidator of Cat Ltd. A/c	Dr.	1,980	
	To Equity share capital A/c			1,980
	(Being payment made to liquidators of Cat Ltd. by allotment of 19,800 new equity shares))			
	Sundry creditors A/c	Dr.	100	
	To Sundry debtors A/c			100
	(Being mutual owing cancelled)			
	Proposed dividend A/c	Dr.	200	
	To Bank A/c			200
	(Being dividend paid off)			

Balance Sheet of Bat Ltd. after merger as on 31.3.2010

Liabilities	*Rs. in thousands*	*Assets*	*Rs. in thousands*
Share capital		Fixed assets (2,700 + 850)	3,550
Equity shares of 100 each fully paid	2,080	Investments	450
(Out of the above, 19,800 shares have been issued for consideration other than cash)		Sundry debtors (400+150-100)	450
Capital reserve	160	Cash at bank (250 – 200)	50
General reserve	570		
10% Debentures	500		
Loan from bank (250 +450 -60)	640		
Bank overdraft	50		
Sundry creditors (300+300-100)	500		
	4,500		4,500

Question 5

The Balance Sheet of D Ltd. on 31st March, 2009 is as under:

Liabilities	*Rs.*	*Assets*	*Rs.*
1,25,000 shares of Rs.100 each fully paid up	*1,25,00,000*	*Goodwill*	*10,00,000*
		Building	*80,00,000*
Bank overdraft	*46,50,000*	*Machinery*	*70,00,000*
Creditors	*52,75,000*	*Stock*	*80,00,000*
Provision for taxation	*12,75,000*	*Debtors (all considered good)*	*50,00,000*
Profit and loss account	*53,00,000*		
Total	*2,90,00,000*		*2,90,00,000*

In 1989, when the company started its activities the paid up capital was the same. The Profit/Loss for the last five years is as follows:

2004-2005: Loss (13,75,000), 2005-2006: Profit Rs.24,55,000, 2006-2007: Profit Rs.29,25,000, 2007-2008: Profit Rs.36,25,000, 2008-2009: Profit Rs.42,50,000.

Income-tax rate so far has been 40% and the above profits have been arrived at on the basis of such tax rate. From 2008-2009, the rate of income-tax should be taken at 45%. 10% dividend in 2005-2006, 2006-2007 and 15% dividend in 2007-2008 and 2008-2009 has been paid. Market price of this share on 31st March, 2009 is Rs.125. With effect from 1st April, 2009, the Managing Directors remuneration will be Rs.20,00,000 instead of Rs.15,00,000.

The company has secured a contract from which it can earn an additional Rs.10,00,000 per annum for the next five years.

Calculate the value of goodwill at 3 years purchase of super profit. (For calculation of future maintainable profits weighted average is to be taken). *(16 Marks)*

Answer

(i) **Future Maintainable Profit**

Year	Profit (P) Rs.	Weight (W)	Products (PW) Rs.
2005-2006	24,55,000	1	24,55,000
2006-2007	29,25,000	2	58,50,000
2007-2008	36,25,000	3	1,08,75,000
2008-2009	42,50,000	4	1,70,00,000
		10	3,61,80,000

Weighted average annual profit (after tax)* = $\frac{3,61,80,000}{10}$ = Rs. 36,18,000

		Rs.
Weighted average annual profit before tax is 36,18,000 $\times \frac{100}{60}$		60,30,000
Less:	Increase in Managing Director's remuneration	5,00,000
		55,30,000
Add:	Contract advantage	10,00,000
		65,30,000
Less:	Tax @ 45%	29,38,500
Future maintainable profit		35,91,500

(ii) **Average Capital Employed**

Assets	*Rs.*
Building	80,00,000
Machinery	70,00,000
Stock	80,00,000
Debtors	50,00,000
	2,80,00,000

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* Loss amounting Rs.13,75,000 for the year 2004-2005 has not been considered in calculation of weighted average profit assuming that the loss was due to abnormal conditions.

Liabilities		
Bank Overdraft	46,50,000	
Creditors	52,75,000	
Provision for taxation	12,75,000	
Additional provision for taxation•	3,54,167	1,15,54,167
Capital employed at the end of the year		1,64,45,833
Add: Dividend 15% during the year		18,75,000
		1,83,20,833
Less: ½ profit after tax for the year [(42,50,000-3,54,167)/2]		19,47,917
Average capital employed		1,63,72,916

(iii) **Normal Profit**

Average dividend for the last four years

$$\frac{10+10+15+15}{4} = 12.5$$

Market Price of share =Rs.125

Normal rate of return* $= \frac{12.5}{125} \times 100 = 10\%$

Normal profit 10% of Rs.1,63,72,916 — Rs. 16,37,292

(iv) **Valuation of Goodwill**

	Rs.
Future maintainable profit	35,91,500
Less: Normal profit	16,37,292
Super Profit	19,54,208
Goodwill at 3 years' purchase of super profits (Rs. 19,54,208 x 3)	58,62,624

• Additional provision for taxation [5% of Rs. 70,83,333 (Rs. 42,50,000/60%) has also been created assuming that the necessary rectification is being done in the financial statements for the year 2008-2009.

* Normal rate of return has been computed by dividend yield method.

Question 6

(a) From the following information, determine the possible value of brand as per potential earning model:

		Rs. in lakhs
(i)	*Profit After Tax (PAT)*	*Rs.2,500*
(ii)	*Tangible fixed assets*	*Rs.10,000*
(iii)	*Identifiable intangilble other than brand*	*Rs.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 capitalisation factor for intangibles*	*25%*

(b) Hero Ltd. was registered on 1st April, 2008. It raised its capital as under:

(i)	*Issued 2,00,000 equity shares at Rs.10 each*	*Rs.20,00,000*
(ii)	*12.5% debentures of Rs.100 each*	*Rs.2,00,000*

This money was invested as under:

Equipments	*Rs.16,00,000*
(useful life 10 years with nil scrap value)	
Goods purchased for resale at Rs.200 per unit	*Rs.6,00,000*

Goods purchased were entirely sold upto 31st January, 2009, for Rs.10,00,000. All the sale proceeds were collected except Rs.60,000 as on 31st March, 2009. Goods sold were replaced at a cost of Rs.7,20,000 at the rate of Rs.240 per unit. Creditors outstanding as on 31.3.2009 was Rs.40,000.

The replaced goods remained entirely in stock on 31.3.09. The replacement cost as at 31.3.09 was considered to be Rs.280 per unit. Replacement cost of equipment was Rs.20,00,000 as at 31.3.09, considering depreciation on straight line basis.

Prepare Profit and Loss account and Balance Sheet on replacement cost (entry value) basis. *(4+12= 16 Marks)*

Answer

(a) Calculation of Possible Value of Brand

	Rs. in lakhs
Profit after Tax	2,500
Less: Profit allocated to tangible assets [18% of Rs.10,000]	1,800
Profit allocated to intangible assets including brand	700

Capitalisation factor 25%	
Capitalised value of intangibles including brand [$\frac{700}{25} \times 100$]	2,800
Less: Identifiable intangibles other than brand	1,500
Brand value	1,300

(b) Profit and Loss Account for the year ended 31.03.2009 on replacement cost basis

	Rs.
Sales	10,00,000
Less: Cost of sales (Rs.240 × 3000)	7,20,000
Gross profit	2,80,000
Depreciation (Refer Working Note 1)	1,80,000
Profit before interest and taxes (PBIT)	1,00,000
Debenture interest (12.5% of Rs. 2,00,000)	25,000
Profit before taxes (PBT)	75,000

Balance Sheet of Hero Ltd. as on 31.3.09 on replacement cost basis

Liabilities	*Rs.*	*Assets*	*Rs.*
Equity share capital (2,00,000 shares of Rs. 10 each)	20,00,000	Equipments (20,00,000- 2,00,000)	18,00,000
Profit and loss account	75,000	Stock (3,000 × Rs.280)	8,40,000
		Debtors	60,000
Replacement reserve (W.N.3)	6,20,000	Cash at bank (W.N. 2)	2,35,000
12.5% Debentures	2,00,000		
Creditors	40,000		
	29,35,000		29,35,000

Working Notes:

1. **Depreciation under replacement cost basis**

   Under replacement cost basis, depreciation is calculated (on the basis of average of historical cost and replacement cost) which can be shown as follows:

   10% of [$\frac{16,00,000+20,00,000}{2}$] = 10% of Rs. 18,00,000 Rs. 1,80,000

2. **Cash at Bank on 31st March, 2009**

	Rs.
Sale proceeds (Rs.10,00,000 – Rs.60,000)	9,40,000
*Less :*Payment to creditors (Rs. 7,20,000 – Rs. 40,000)	6,80,000
	2,60,000
Less: Debenture interest paid	25,000
Balance as on 31st March, 2009	2,35,000

3. **Replacement Reserve**

	Realised Gain	*Unrealised Gain*
	Rs.	*Rs.*
Sold goods (Rs. 7,20,000 – Rs. 6,00,000)	1,20,000	
Unsold goods [3,000 x (Rs. 280 – Rs. 240)]		1,20,000
Depreciation on equipments (Rs. 1,80,000 – Rs.1,60,000)	20,000	
Book value of equipments		
[(Rs.20,00,000- Rs.2,00,000) – (Rs.16,00,000-Rs.1,60,000)]		3,60,000
	1,40,000	4,80,000

Replacement Reserve = Rs. 1,40,000 +Rs. 4,80,000 = Rs. 6,20,000