VALUATION OF INVENTORIES (AS-2) :

CA PREMAL GANDHI

Objective :

1. Formulate the **method of computation** of cost of inventories(R.M, W.I.P & F.G.)

2. **Determine** the **value** of closing stock/ inventory for recognition in the Financial Statements as of any cut-off date/year end.

Scope of the Standard :

This standard deals with **all** inventories **except** the following :

1. Work-in-progress arising under construction contract including directly related to service contract. (**AS-7** Construction contracts).

2. Work-in-progress arising in ordinary course of business for **service** providers (Incomplete consultancy services, incomplete merchant bank activities, medical services in progress)

3. **Financial Instrument** held as stock-in-trade (Shares, Debentures, Bonds etc.)

4. **Producers' inventories** like livestock, agricultural and forest products, mineral oils, ores and gases. Such inventories are valued at net realisable value.

Definition of Inventories :

Inventories are defined as **assets** –

1. Held for sale in the ordinary course of business (finished goods)
2. In the process of production of such sale (raw material and work-in-progress)
3. In the form of materials or supplies to be consumed in production process or in the rendering of services (stores, spares, raw material, consumables).
4. Inventories do not include machinery.

Example :

1. Maple Ltd deals in manufacturing and selling of mobile phones, their closing stock consists of Mobile phones, camera, speaker, microphone, circuit board and battery. It also needs certain spares which will used in the manufacturing of these phones. How will it value it Inventories as on 31st March 2020?

1. *The mobile phones that are readily available for sale will be considered as inventories.*
2. *The mobile phones in the assembly line at year end and the raw material (camera, speaker, microphone etc.) are to be considered as a part of inventory.*
3. *As per Para 4 of the standard "Inventories also encompasses...........consumables and loose tools awaiting use in the production process. Inventories do not include machinery spare which can be used in connection with an item of of fixed asset and whose use is expected to be irregular: such machinery spares are accounted for in accordance with AS-10.*

Measurement of inventories :

Inventories should be valued at the **lower** of **cost** and **net realisable value**

Why lower and not higher ?

Definition of Cost ?

Definition of Net realisable value ?

This is at par with the accounting concept of **conservatism** (The doctrine of prudence)

Cost of inventories :

Cost of Inventories includes :

- Cost of Purchase
  - Purchase Price
    +
    Non-Recoverable Taxes
- Cost of Conversion
  - Cost of conversion RM in FG
    Ex. Labour, Production overhead
    +
    Fixed and Variable overheads
- Other costs incurred in bringing the inventories to their present location/condition
  - Cost of bringing inventory to their present location/condition

Cost of Purchase :

Cost of Purchase consists of -
Purchase price including duties and taxes , freight inwards and other expenditure directly attributable to the purchase,
Trade discounts, rebates, duty drawbacks and other similar items are **deducted** in determining the costs of purchase.

Example :
Krishna ltd. purchased raw material- “R”
Cost price including excise duty is Rs.1,000.
Government has also given a duty drawback of 10% on cost for procuring this good from Balrampur (backward region), Furthermore it is entitled to an incentive on export of goods of Rs 20 under the MEIS scheme. The other cost are as follows:
Freight Rs.50
Excise duty Rs. 100
Unloading charges Rs.20
Trade discount Rs. 15
Determine the cost of Purchase?

Particulars	Rs
Cost Price	1000
Less : Excise Duty	(100)
Less : Duty Drawback	(90)
Add : Freight	50
Add : Unloading charges	20
Less : Trade discount	(15)
Total cost of Purchase	**865**

Cost of Conversion :

Cost of conversion of inventories comprises of costs that are directly associated with converting raw materials into finished goods like Direct labour. It also includes systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

Fixed Production overhead means Indirect cost of production which remains constant irrespective of volume of production. Allocation of fixed production overhead is done on normal capacity. For eg: Salaries of Factory Staff & Administrative Overheads.

Variable Production overhead means indirect cost of production which changes directly or proportionately directly with the volume of production. Allocation of variable production overhead is done on actual production. eg; wages to contract staff for handling material on the shop- floor.

Joint-products, when the cost of conversion of each product is not identifiable separately, total cost of conversion is allocated between the products on the rational and consistent basis.

By-products, scrap or waste materials are not of material value, they are measured at net realisable value, then the net realisable value is deducted from cost of conversion. Net cost of conversion is distributed among the main products.

Example :

Morpat Ltd produced 1,10,000 units of its famous calculators "OR-6" during F.Y. 2019-20.Its cost sheet is as follows:

Particulars	Per unit cost
Direct Material	50
Direct Labour	30
Direct Expenses	5
	Rs 85

The Production Overhead is Rs.2,00,000 out of the same 30% is Fixed Overheads, whereas the balance are Variable Overheads. The installed capacity of the plant is 1,20,000 calculators per year and the same is running at 100% capacity. The sales of Morpat ltd is 85,000 units during the year.

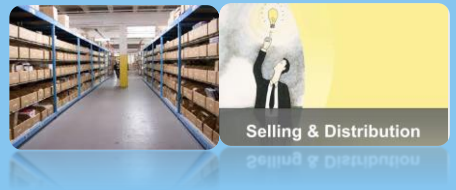
Determine the value of closing stock?

Particulars	Amount	Per unit cost (Rs)
Direct Material		50
Direct Labour		30
Direct Expenses		5
Fixed Overhead	(2,00,000*30/100)/1,20,000	0.50
Variable Overhead	(2,00,000*70/100)/1,10,000	1.27
Total		**86.77**

The value of 25,000 units of finished goods to be recognized is as

= 25,000 units*Rs 86.77 i.e **Rs 21,69,250**.

Here, it must be noted that the allocation of fixed overhead up to the extent of admin and office expense will remain as per normal capacity and the shortfall in recovery of the fixed overhead due to reduction in production due to Covid 19, cannot be adjusted and will have to be charged to the Profit & Loss Account even though the plant is Idle.



Other Costs :

Other costs also forms a part of inventory costs to the extent that they contribute in bringing the inventories to their present location and condition. However, it is to be noted that **Interest costs and other borrowing costs** are **not** considered as contributing in bring the inventory to its present state, hence the same is excluded.
Other cost will include the cost of specific design or customization done for a customer and therefore included in the value of the Inventory.

Specific Exclusions from Cost of Inventories :

1. Storage cost (unless such inventory is stored for further production process).
2. Selling and distribution cost.
3. Administrative overheads.
4. Abnormal loss.(abnormal waste of materials, labor and other overheads).

Example :

Queenfisher Ltd is in the line of production and selling of alcoholic beverages. It has a normal wastage of 5% of the total production (Total production = 1000 barrels) . During the year 2019-20, there was a surprise inspection by the authorities due to which production was halted for 15 days. This delay of 15 days resulted beverages being rejected by the quality department and which resulted into an abnormal wastage of 25 barrels.

In this scenario, the normal wastage/loss of 50 barrels will form a part of cost of inventory at the year end, whereas the abnormal wastage/loss of 25 barrels will be charged to Profit and Loss statement.

Method of Determination of Cost :

1. **Specific Identification Method**
2. **First In First Out (FIFO) Method**
3. **Weighted Average Cost (WAC)Method**

If in any case, specific identification method is not applicable the cost of inventories is valued by FIFO or WAC method.

In the cases where it is not practical to calculate cost, the following methods shall be considered :

1. **Standard Cost**
2. **Retail Cost**

Net Realisable Value :

1. Net realisable value means the estimated selling price in ordinary course of business, less estimated cost of completion and estimated cost necessary to make the sale.
2. It is estimated based on most reliable evidence at the time of valuation.
3. The estimation of net realisable value also considers the purpose for which the inventory is held.
4. The estimation is made as at each balance sheet date.

Estimation of Net Realisable Value in certain cases :

1. If the finished product is **sold at cost or above cost** in the market as of a cut off date. Then inventories will be valued at **cost**.
2. If the finished product is **sold below cost**. Then the inventory will be valued at its **selling price** or **replacement price.**

Examples :

- MUL Ltd deals into range of dairy products like milk, cream ,butter, yogurt etc. Due to covid 19, they had to sell these products in April 20 at a discount of 40% on the MRP which is lower than its cost. Therefore the Company will value the inventory on 31st March 2020 at the reduced price.
- Faggi Ltd manufactures Atta noodles sells its noodles at Rs.50 per packet. However, due to certain speculations , the FSSAI banned the sale of these noodles in January 2020 till the investigation was completed. The Net realisable value of these inventories become zero and hence the entire cost is to be written off in the books.

Example :

1. Bose Ltd sells product Notebook and Pens, the raw materials used in manufacturing of notebook is wood and in incase of pens is plastic respectively. The cost of wood and plastic is Rs 10 and Rs 50 respectively. The realizable value of wood and plastic is Rs. 8 and Rs.35 respectively.

However it is expected that the Notebook will be realized at 15% of gross profit, whereas Pen is expected to be making a loss of 10% of the total cost. What will be the value at which wood and plastic will be recognised in the books?

- *As per AS-2, materials and supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost.*
- In case of **wood**, cost is Rs.10 and net realizable value is Rs. 8. Since the price of finished goods is expected to be above the cost even though NRV is less, the Company will value the wood at Rs. 10 **(Cost)**

- *However, when there has been a decline in the price of materials and it is estimated that the cost of the finished goods will exceed the net realizable value, the materials are to be written down to its net realizable value. In these circumstances, replacement cost may be the best available measure of their net realizable value.*
- Hence in case of **plastic**, the cost is Rs.50 and net realizable value is Rs.35, since final product Pen is expected to be sold at a value less than its cost, the Company will value the plastic to its estimated realizable value (**Replacement Cost**) of Rs. 35 at the year end.

Disclosures :

1. Accounting policy adopted in measuring inventories. (Cost or Net realizable value)
2. Cost formula used.
3. Total carrying amount of inventories together.
4. Classifications of inventories are:

(i) Raw materials and components
(ii) Work-in-progress
(iii) Finished goods
(iv) Stock-in-trade (in respect of goods acquired for trading)
(v) Stores and spares
(vi) Loose tools
(vii) Others (specify nature)

ACCOUNTING FOR INVESTMENTS (AS-13) :

CA PREMAL GANDHI

Objective :

- The objective of this Standard is to set out how investments shall be recognised, measured, recorded and presented in financial statements.

Scope of the Standard :

Accounting for Investments **doesn't deal** with the following:

- The base for recognizing dividends, interest, and rentals which are earned on the investments that are covered by **AS-9**
- Finance or operating leases which are covered by **AS-19**
- Investments in retirement benefit plans and life insurance enterprises which is covered by **AS-15**
- The following Companies which are formed under the Central or the State Government Act or declared under Companies Act, 2013 :

1. Mutual Funds.
2. Venture Capital Funds and related Asset Management Companies.
3. Banks as well as Public Financial Institutions.

<u>What is Investment :</u>

- An investment is essentially an asset that is created with the intention of allowing money to grow. The wealth created can be used for a variety of objectives such as meeting shortages in income, saving up for retirement, or fulfilling certain specific obligations such as repayment of loans, payment of tuition fees, or purchase of other assets.

- *Assets held for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to investment enterprise. Assets held as stock-in-trade are not investments.*

- ## <u>Concept of Fair Value and Market Value for long Term Investment:</u>

- **<u>Fair value:</u>** is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under normal circumstances, market value or net realizable value can be recognized as fair value.
- **<u>Market value</u>:** is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Cost of Investment - Recognition :

1. Investment Acquired :

- The total cost of an investment consists of the charges incurred to acquire such an investment. These may include any brokerage, fees and duties

Example :

Bincon Ltd took a substantial stake in Vincon Ltd. For 10,00,000 shares at a face value of Rs.10. To facilitate the acquisition, Bincon Ltd paid professional and consulting fees to merchant bankers and lawyers of Rs.5,00,000.

The total cost of investment acquisition will include the purchase cost of Rs.1,00,00,000 as well the fees paid to professionals i.e. Rs.5,00,000 .

2. Investment Acquired by Issue of Shares :

- There are scenarios where an investment is acquired wholly or partly by issuing shares or other securities. The acquisition costs of investments in such a case is the fair value of the securities issued.
- This fair value of shares issued can be determined by considering the issue price of such securities estimated by the statutory authorities. Furthermore, such a fair value may not be equal to the nominal or par value of securities issued

Examples :

- *Melican Ltd. took over Bayway Ltd by issuing 8,00,000 shares of fair value Rs.100 and balance by cash. The total consideration was Rs. 10 crores. Here, the cost of acquisition will include both shares (Rs 8 Crores) as well as the cash consideration (2 Crores).*

- *Melican Ltd. took over Hayway Ltd by issuing 8,00,000 shares of fair value Rs.100 at Rs.20 premium and balance by cash. The total consideration was Rs. 10 crores. In this case, cost of acquisition will be Rs. 9.6 Crores and Rs. 0.40 Crores by cash.*

3. Investment Acquired in Exchange of Another Asset :

- Some enterprises may acquire an investment by wholly or partly exchanging another asset. Thus, the acquisition cost of such an investment is the fair value of the asset exchanged.
- However, it would be appropriate for an enterprise to determine the fair value of the investment acquired if such a value can be determined readily.

Example :

X Ltd. sells a part of its land to Y Ltd, a newly-formed unlisted company, in exchange for 50,000 shares of Y Ltd (face value of Rs 10 each). There are frequent transactions of purchase and sale of land in the area in which the aforesaid piece of land is situated. The market value of land is estimated at Rs 10 Crores. What would be the acquisition cost of shares?

The acquisition cost of 50,000 shares for Y Ltd would be the market value of land given up, i.e. Rs 10 Crores.

4. Investment Acquired From Pre-Acquisition Benefits :

- Typically, interest, dividends or rentals earned through an investment are regarded as income. However, in some cases such inflows are not considered as income. Rather, they represent recovery of cost. Eg An Enterprise is investing in an interest-bearing instrument. Such an interest is not regarded as an income, rather it is included in the price paid for the investment as the interest would be received after a specified period.
- Thus, when such an enterprise receives interest subsequently, it is allocated between pre-acquisition and post-acquisition periods. The pre-acquisition portion of the interest received is deducted from the cost of such an investment. Likewise, an Enterprise may treat the dividends on equity shares declared from pre-acquisition profits in a similar way.

Example :

On 01/04/2019, Raruti Ltd acquired 10% Government bonds of face value 10 Lakhs for Rs 11 lakhs, half yearly interest is payable on 1st January & 1st July every year.
Hence on 1st July, Raruti Ltd will receive interest for six months i.e. Rs. 50,000 and while the company has received the interest for the entire period however the period pre acquisition will have to be reduced from the cost of the investment and therefore the investment will have to be recorded at Rs 10,75,000 and the balance Rs 25,000 will be recorded in the Profit & Loss Account.

5. Investment Acquired Through Rights Shares :

- An Enterprise often offers rights shares to its existing shareholders. In such cases, if the existing shareholders subscribe to the rights shares, the cost of such shares is added to their existing holding in the Enterprise. However, if rights shares are not subscribed by the existing shareholders, then such entitlements are sold in the market and the proceeds received are recorded in the Profit and Loss.
- Furthermore, there can be cases where investments are acquired on **cum right basis**. But when such investment become **ex-right**, their market value turns out to be lower than the cost at which such an investment was acquired. Thus, the sale proceeds would be utilized to reduce the carrying amount of these investments to the market value.

Example:

X acquires 100 shares of feeliance ltd on cum-rights basis for Rs 35,000. He sells the rights in the market for Rs 8,000. The market value of X's holding immediately after the record date falls to Rs 30,000. In this case Rs 5,000 will be applied to reduce carrying amount of original holding and the balance Rs 3,000 (Rs 8,000- Rs 5,000)would then be recognised in the profit and loss account.

Classification of Investments:

- **Current Investments** – Current Investments are investments which by their nature are **readily realizable** and are intended to be held for **less than a year** from the date when such investment is done.
- **Long-Term Investments** – Long-term investments are investments other than the current investments, even though they might be freely marketable.
- **Investment Properties** are real estate property purchased with the intention of earning a return on the investment either through rental income, the future resale of the property, or both.

Reclassification of Investments :

RECLASSIFICATION

- Where a *long-term investment* is reclassified as a *current investment*, the transfer is made at carrying amount and lower of cost at the date of such transfer.
- Where an investment is reclassified from *current investment* to *long-term investment*, the transfer is made at the lower of its cost and the fair value of such investment at the date of such transfer.
- Any **gain/loss** in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

Carrying Amount

Carrying Amount of Investments :

Current investments must be carried in financial statements at **lower of cost and fair value** which is determined either by category of investment or on an individual investment basis.

Long-term investments must **always** be carried in financial statements at their **cost**. But, when there's a decline, apart from temporary, in value the long-term investment, carrying amount is reduced for recognizing such decline. Also, Long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an **individual investment basis**.

Example:

1. Ghotilal Financial Services Ltd is having current investment in mutual funds, the NAV of all mutual funds have been reduced by 25% as on 31st March 2020? How does it recognize these investments in its Financial Statements?
2. Furthermore, it has recognized certain investment of certain shares as Long-term Investments. The market value of such shares is also lower by 40% as on year end.

Investment

Current Investment

They are recorded at lower cost or NRV

If the reduction in value of assets. It is charged to P&L a/c as NRV is less than cost.

If there is increase in value of assets, it should be shown at cost

Asset value if decreases first and then increases, the loss already booked can be reversed

Long Term Investment

They are valued at cost only.
However there is permanent decline, loss is charged to P&L a/c.
Asset value if initially declined and now increase

Increase is temporary

Loss is not reversed

Increase is permanent

Loss is reversed

Disposal of Investments :

- When **an asset** is disposed of, the **difference** between proceeds received from disposal and the carrying amount of investment is **recognized** in the **Profit & Loss**. Any expenses incurred with respect to disposal of such investments should be adjusted from the sale proceeds.

- However, there are cases where only a part of an **individual investment** is disposed of. In such a case, the carrying amount of a portion of such investment is determined based on the **average carrying amount** of the total investment.

Example :

Bincon Ltd. decided to dispose his stake in Vincon Ltd for Rs.90,00,000. The company incurred professional fees of Rs. 2,00,000 and Rs.3,00,000 with respect to lawyers and merchant bankers.

Here, the net selling price will be derived after deducting the legal and professional expenses borne by the company.

Disclosures in the Financial Statements:

(a) accounting policies employed for determining carrying amount of investment

(b) the amounts which are included in the profit and loss statement for:

(i) Dividends, Interest, and Rentals on the Investments presenting the income from such Long-term and Current Investments separately. Gross income from investments must be stated in the Profit and Loss Statement, amount of Tax Deducted at Source(TDS) included under the Advance Taxes Paid.

(ii) Profits and Losses on the disposal of current investment and the changes in carrying the amount of the investment.

(iii) Profits and Losses on the disposal of long-term investment and the changes in carrying the amount of the investment.

(c) Substantial limitations on the right of ownership, realizability of the investments or remittance of income and proceeds of disposal.

Disclosure(Contd.)

(d) Classification of Investment into Current & Long Term as they must be presented in this order:

1) Government or Trust Securities,

2) Shares, Debentures or Bonds,

3) Investment properties

4) Others – Specifying Nature.

(e) the total amount of both the quoted and unquoted investments, providing the total market value of the quoted investments.

(f) other disclosures as explicitly as required by the relevant statute governing the company.

Question 1:

A partnership firm received equity shares from the relative of partner as gift and the shares is shown in the inventory, as on the year end the Market value of such share is decreased what treatment is required to be given in the financials?

Ans:

Since the cost of acquisition is NIL in case of gift and the same is show as inventory , therefore the same will have carrying at Cost only.

Question 2:

The entity holds a long-term investment. On 10th March, it enters into a binding agreement to sell the investment subject to receipt of statutory approvals. The approvals were received on 29th March and the actual sale transaction took place on 2nd April. At which point should the gain be recognized?

Ans:

The sale would have to be recognized in the financial statements as on 29^{th} March as all the necessary approvals were received on that date furthermore as per AS- 4, Events occurring after Balance Sheet Date, since transaction which meets the definition of "Adjusting Events" as on 31^{st} March, therefore the same will have to be recorded in the Financial Statements on 29^{th} March only and not on 2^{nd} April.

Question 3:

ABC Ltd. having Building which they used for their Administrative purpose. Now they shifted their entire administrative activity at plant. Management wants to let this property and earn rental till the time the alternative usage of the building is not decided. Can they classify this building from PPE to Investment Property? If yes how long? Subsequently if they have alternate usage can it again be classified as PPE?

Ans:

The PPE can be classified as investment property till ABC Ltd decides to let out the property and earn rental from the same. Furthermore it can be reclassified back to PPE at lower of its cost and the fair value of such property at the date of such transfer.

CASH FLOW STATEMENTS(AS-3) :

CA PREMAL GANDHI

Objective and Scope of AS-3 :

- Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

- The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

- This accounting standard accounts for information about **changes in cash and cash equivalents** of an entity during a period.

- Users of an enterprise's financial statements are interested in knowing how the enterprise generates and uses cash and cash equivalents.

Definitions :

- **Cash** comprises cash on hand and demand deposits with banks.

- **Cash equivalents** are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

- **Cash flows** are inflows and outflows of cash and cash equivalents.

- **Operating activities** are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

- **Investing activities** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

- **Financing activities** are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

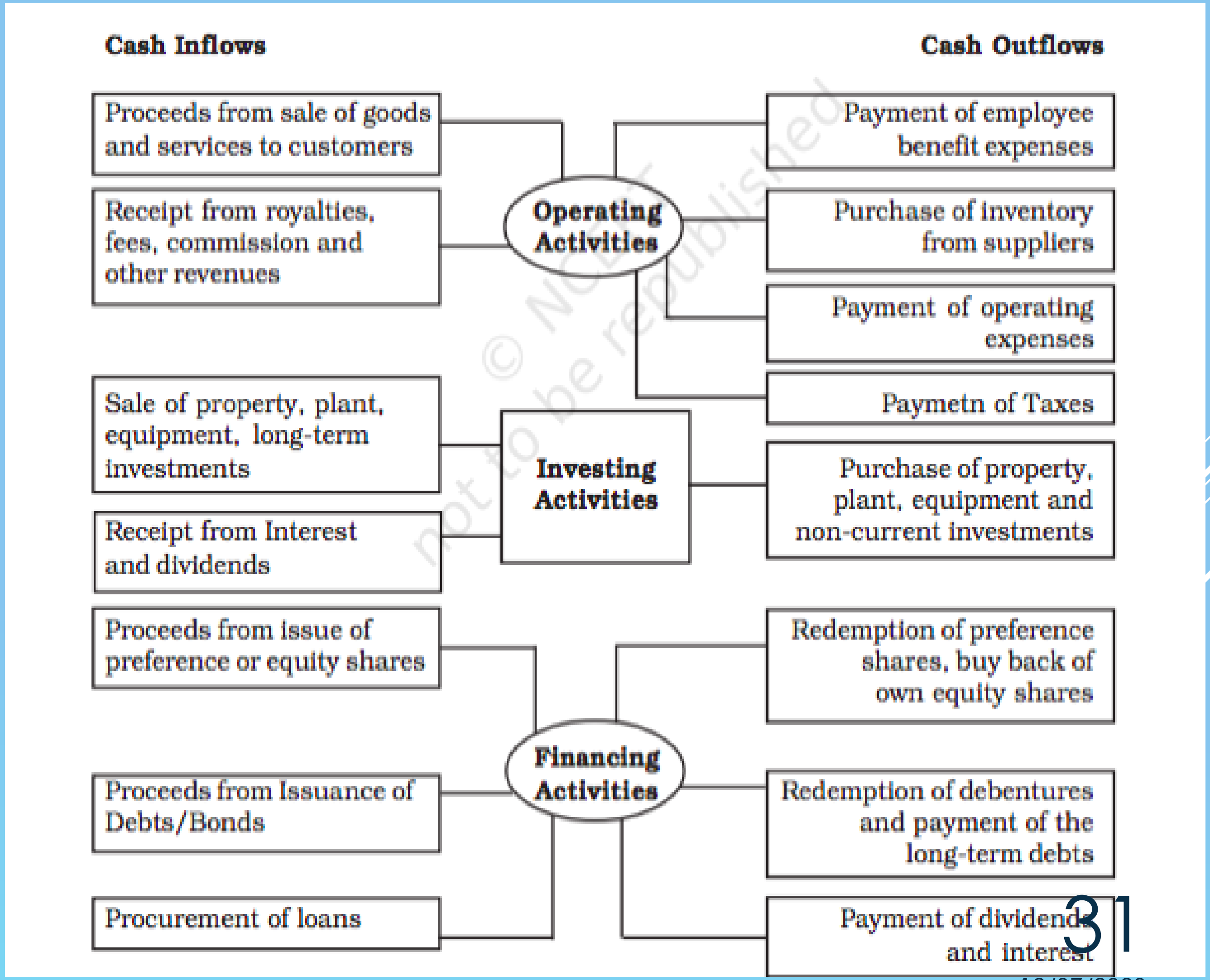
Cash Flow Statement Essentials :

A cash flow statement must depict the cash flows within the period classifying them as,

A. **Operating activities**

B. **Investing activities**

C. **Financing activities**

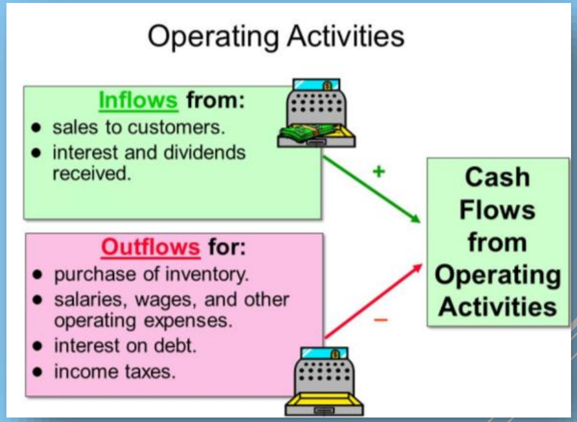


Operating Activities:

- Operating activities make up the day-to-day business, like selling products, purchasing inventory, paying wages, and paying operating expenses.

- The important aspect for any business in the cash flow statement is the **Net Cash Flow from Operations**. This section of the statement is associated with the Current Assets and Current Liabilities sections of the Balance Sheet, as well as the Revenue and Expenses section of the Income Statement.

For example:



- Cash receipts from the sale of goods and the rendering of services;
- Cash receipts from royalties, fees, commissions and other revenue;
- Cash payments to suppliers for goods and services;
- Cash payments to and on behalf of employees;
- Cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

- Cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes

Example:

H and G Finance Holdings Ltd are a registered brokers deals in future and options and swap contracts as proprietary trades. Therefore the cash flows from these trades will be recognized under Operating activity.

Investing Activities :

Investing activities include buying and selling assets like Property and Equipment, lending money to others and collecting the principal and buying/selling of Long-Term Investment.

For instance:

- Cash receipts from disposal of fixed assets and payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

- Cash receipts/payments from disposal/acquire of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

- Cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

- Cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

- Cash receipts/payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities

Example:

H and H tech holdings Ltd is hardware manufacturing company and has invested surplus funds in futures, options and swap contracts to earn additional revenue along with their operating income, in this scenario the cash flows will be classified as investing activities.

Financing Activities:

Financial activities include borrowing from creditors and repaying loans, issuing and repurchasing equity, and collecting money from owners/investors, and payment of cash dividends.

For instance:

i. Cash received from issuing shares or other similar securities
ii. Cash received from issuing loans, debentures, bonds, notes, and other short-term or long-term borrowings
iii. Cash repaid on borrowings

Reporting Cash Flows from Operating Activities :

Direct Method :

a) The direct method is one of two accounting method used to prepare a cash flow statement. The statement of cash flows direct method uses actual cash inflows and outflows from the company's operations, instead of modifying the operating section from accrual accounting to a cash basis. Accrual accounting recognizes revenue when it is earned versus when the payment is received from a customer.

b) Conversely, the cash flow direct method measures only the cash that's been received, which is typically from customers and the cash payments or outflows, such as to suppliers. The inflows and outflows are netted to arrive at the cash flow. *The direct method is also known as the income statement*.

c) **Examples** : Salaries paid to employees , cash paid to vendors and suppliers etc.

Indirect Method :

a) The indirect method uses increases and decreases in balance sheet line items to modify the operating section of the cash flow statement from the accrual method to cash method of accounting.

b) **Example** of the Indirect Method :

- Under the accrual method of accounting, revenue is recognized when earned, not necessarily when cash is received. If a customer buys a Rs.500 widget on credit, the sale has been made but the cash has not yet been received. The revenue is still recognized in the month of the sale.

Cash Flow Statement
Direct Versus Indirect Method

Direct Method		
Cash from Customers		
	Sales Revenue	+
	Accounts Receivable	+/- Δ
	Unearned Revenue	+/- Δ
Cash to Suppliers		
	Cost of Goods Sold (COG!	-
	Inventory	+/- Δ
	Accounts Payable	+/- Δ
Cash for Operating Expenses		
	Prepaid Expenses	+/- Δ
	Supplies	+/- Δ
	Accrued Liabilities	+/- Δ
	Wages	+/- Δ
Cash for Interest		
	Interest Expense	+/- Δ
Cash for Taxes		
	Tax Expense	+/- Δ
Total:		**Net Cash**

Indirect Method	
Net Income	+
Amortization Expense	+
Depreciation Expense	+
Loss	+
Gain	-
Accounts Receivable	+/- Δ
Inventory	+/- Δ
Prepaid Expenses	+/- Δ
Supplies	+/- Δ
Accounts Payable	+/- Δ
Accrued Liabilities	+/- Δ
Wages	+/- Δ
Interest	+/- Δ
Taxes	+/- Δ
Total:	**Net Cash**

Reporting Cash Flows from Investing and Financing Activities :

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described below which are report on net basis :

Reporting Cash Flows on a Net Basis:

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

a) Cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and
b) Cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short
c) Cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date
d) The placement of deposits with and withdrawal of deposits from other financial enterprises; and
e) Cash advances and loans made to customers and the repayment of those advances and loans.

Treatment of Some Peculiar Items :

Extraordinary Items

1. Extraordinary items :

Extraordinary items are not the regular phenomenon, e.g.loss due to theft or earthquake or flood. Extraordinary items are non-recurring in nature and hence *cash flows associated with extraordinary items should be classified and disclosed separately as arising from operating, investing or financing activities*.

This is done to enable users to understand their nature and effect on the present and future cash flows of an enterprise.

Example :

Badam Dairy and Food Products Pvt Ltd. Is into selling of milk and other dairy products, the milk (raw material) is procured from the farm animals. It has a 50 acres of green land which is utilised for livestock. During the cyclone amphan, the shed of these animals was destroyed. The expenditure incurred towards repair and restoration of these sheds will be considered as extraordinary items under operating activities.

2- Interest, Dividend and Dividend Tax:

In case of a financial enterprise (whose main business is lending and borrowing), interest paid, interest received, and dividend received are classified as operating activities while dividend paid is a financing activity.
In case of a non-financial enterprise, as per AS-3, it is considered more appropriate that payment of interest and dividends are classified as financing activities whereas receipt of interest and dividends are classified as investing activities.

Example :

Bindra and Bindra Finance Ltd has three subsidiaries : Bindra Tech (An Associate),Bindra Investments (Wholly Owned Subsidiary) .
The above subsidiaries are providing Interest and dividend to Bindra and Bindra Ltd. interest and dividend received by the parent company form Bindra Tech and Bindra Investments is classified as operating activity since it is a financial enterprise.
In case of Bindra Investment, the dividend payment as well as dividend tax will be considered as financing activity, whereas interest payment will result into operating activity.
Furthermore, in case of non-financial unit i.e Bindra Tech payment of dividend and interest will be considered as financing activity.

3-Taxes on Income and Gains :

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

Capital gains tax paid on sale of fixed assets should be classified under investing activities.

Examples are income tax (tax on normal profit), capital gains tax (tax on capital profits).

Non-cash transactions

4- Non-cash Transactions :

Investing and Financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement.

Example :

Limca Ltd. has agreed to pay its CEO an annual salary of 2 crores and issued 50,000 shares of Rs 100 each subject to performance being approved by Board.

In this case, the salary component will be recognised as cost whereas the shares portion being ESOP will not be recognised in the books in accordance with accounting standards and it is amounts to non-cash transaction.

<u>5 - Acquisitions and Disposal of Business Units including Subsidiaries:</u>

The aggregate cash flows which arise from acquisition and from the disposal of business units including subsidiaries must be *shown as investing activities and reported separately.*

Enterprises must present, in total, with respect to both the acquisitions and disposals of other business units including subsidiaries within the period the followings:

(a) Aggregate purchase or disposal value

(b) The amount of purchase or disposal value which is discharged by way of cash and cash equivalents.

<u>Example</u> :

Socialbook acquired Talkup at a purchase price of Rs 4 Crores in cash and remaining Rs 12 Crores in socialbook shares whereas the purchase consideration of talkup was Rs 21.8 Crores. Therefore any cashflow arising with respect to both socialbook and talkup will be shown as investing activity and shall be reported separately.

6-Foreign Currency Cash Flows :

Cash flows that arise from the transactions in the foreign currencies must be recorded in the company's reporting currency by using the below method:

Foreign currency amount * FX rates between the reporting and foreign currency at the date of cash flow.

A rate which approximates actual rate might be used in case the outcome is largely the same as it would have been if the rate at the date of cash flows was used.

The impact of changes in the exchange rate on cash and cash equivalents which is held in the foreign currencies must be reported as a distinct and separate part of the reconciliation of changes in the cash and cash equivalent during the relevant period.

Disclosure :

1. Enterprises must disclose, along with management commentary, the amount of substantial cash and cash equivalents held by an enterprise which isn't available for use.

2. Commitments that may arise from discounted bills of exchange and other similar obligations that are undertaken by an enterprise are typically disclosed in financial statements by means of notes, even in case the probability of loss is remote.

3. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise.

4. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is investing adequately in the maintenance of its operating capacity.

Question No 1:
As a part of single negotiation, an entity has disposed a subsidiary and acquired another subsidiary. The entire package was negotiated together, however transfer of cash took place independently for the two transactions. Should the same be shown separately or netted-off in the cash flow statement?
Ans:

Question No 2:
The scheme of an arrangement of demerger between A limited (Demerged Company) and an entity B Limited (Resulting company) with the appointed date on 1st April 2018, has been sanctioned by National Company Law Tribunal, by an order dated 1st July 2019. The demerger is effective from 1-4-2018.
All transactions of B limited are carried out by A limited till 1st July 2019. While preparing Cash flow of A Limited and B Limited for 2018-19, what treatment to give for transactions carried out in the books of A limited which is on behalf of B limited up to 1st July 2019. where the entire consideration of assets and liabilities assumed is settled through issue of equity shares. Whether such assets and liabilities and consideration needs to be disclosed in cash flow statement? What would be the disclosure of goodwill in cash flow statement?
Please guide in context of para 38 (a) and Para 41
Ans:

1. All the expenses incurred by A Ltd and reimbursed by B Ltd will have to be disclosed in B Ltd cash flow statement. Since Goodwill will be non-cash transaction the same will have to be excluded from the cash flow statement.

Question no 3:
There is disposal of subsidiary in the mid of the year. The holding company had given loan to subsidiary which it had repaid after the disposal. how the impact of the same will be given in the cash flows?
Ans:
The repayment of loan will have to be disclosed separately and the proceeds from the disposal net of repayment of loan will have to be disclosed separately.

Thanking You!

CA. Premal Gandhi