Implementation issues in AS 2 and AS 11

13 December 2013


aluation of nventories

AS 2 – Basic concepts

3.1 Inventories are assets:

(a) held for sale in the ordinary course of business;
(b) in the process of production for such sale; or
(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

3.2 Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

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

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Scope

This Standard should be applied in accounting for inventories other than:

(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);

(b) work in progress arising in the ordinary course of business of service providers;

(c) shares, debentures and other financial instruments held as stock-in-trade; and

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries

AS 2 – Implementation Issues

Accounting for Machinery Spares:

ASI 2 "Accounting for Machinery Spares" is not a part of the accounting standards notified under Companies Accounting Standard Rules 2006. However, the notifed standards include the following references to machinery spares:

AS 2 – Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

AS 10 – Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

How should a Company account for machinery spares?

AS 2 – Implementation Issues

Conversion of fixed assets into stock in trade

A Company uses certain machines it sells as demo machines. These are classified as fixed assets since they are being held with the intention of being used for the purpose of providing services and are not held for sale in the normal course of business. Let us assume that these machines have a useful life of 5 years. At the end of year 3, the Company intend to sale these as second-hand machines. Can these be classified as stock in trade by the Company?

AS 10 provides the treatment relating to fixed assets which have been retired from active use and are held for disposal.

Para 24 states that Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

Valuation of inventories at replacement costs

24. Materials and other 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. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

	Case I	Case II	Case III
Cost of material on hand (meant for use in production)	100	100	100
Current replacement cost (price at the date of the balance sheet)	85	85	85
Expected costs of conversion (variable 100, fixed overheads 140)	240	240	240
Estimated selling fixed price of finished product	370	345	325
Estimated selling costs	10	10	10
Amount of write down of raw material	**No write down required**	**5**	**15**

Effects of changes in Foreign Exchange Rates

Objective of AS 11

AS 11 helps determine the exchange rates to use when accounting for foreign currency transactions and foreign operations

Transactions should be reported in the entity's reporting currency

Transactions

Foreign Exchange carried by way of:

Foreign Operations

Foreign operations should also be translated into the entity's reporting currency

Applicability of AS 11

Standard applies to:

- ***Foreign currency transactions***
- ***Translation of financial statements of foreign operations***
  - Integral foreign operation
  - Non - Integral foreign operation
- ***Foreign currency transactions in the nature of forwards exchange contracts***

Scope

Excludes forward exchange contracts booked based on Firm Commitments or Highly Probable Forecast Transactions

Does not specify the currency in which the financial statements must be presented

Excludes restatement of enterprise's financial statements from reporting currency to another currency for convenience or for similar purposes

Does not deal with exchange differences from borrowings to the extent they are regarded as an adjustment to interest cost

Does not deal with presentation in cash flow statement of foreign currency transactions

Reporting foreign currency transactions in the functional currency

Monetary items	*Non-monetary items at historical cost*	*Re-valued non-monetary items*
↓	↓	↓
Rate at the reporting date	*Rate at the date of transaction*	*Rate at date of valuation*

AS 11 – Implementation Issues

- *ABC Limited purchases machinery from foreign vendors.*
- *In September 2012, ABC paid an advance of USD 1 million to a foreign vendor. On the date of payment of advance, the exchange rate was 1 USD – INR 60.*
- *As at 31 December 2012 (year-end), the advance is unadjusted as the corresponding material has not been supplied by the vendor. Exchange rate as at 31 December 2012 was 1 USD – INR 65.*
- *Machinery was supplied by vendor in February 2013 and exchange rate on the date when purchase booked was 1 USD - INR 68.*

What should be the amount of advance in the books as at 31 December 2012 (year-end)?

What should be the amount at which the machinery be booked in February 2013?

Recognition of Exchange Differences

The Ministry of Corporate Affairs (MCA) had issued various notifications in March 2009, May 2011 and December 2011 to amend Accounting Standard (AS) 11, "The effects of changes in foreign exchange rates".

These amendments provide companies with an irrevocable option to capitalise forex differences arising on all long term foreign currency monetary item:

- *either as an adjustment to the cost of a related depreciable asset*
- *or by accumulating these differences in a Foreign Currency Monetary Item Translation Difference Account (FCMITDA), if the borrowing does not relate to a depreciable asset.*

Paragraphs 46 and 46A have been added to AS 11 (the same have been discussed in detail in subsequent slides).

Relaxation in forex accounting norms (Para 46)

AS 11 as amended by 31 March 2009 notification of MCA gave companies an option in accounting for exchange differences arising on reporting of long term foreign currency monetary items. As per the option, such exchange differences could be

- adjusted to cost of the asset, where the item related to acquisition of a depreciable capital asset; or
- accumulated in 'Foreign currency monetary item translation difference account' (FCMITDA) and amortised over balance period of long-term monetary asset/liability till 31 March 2011

As per the 2009 notification, the option was available for accounting periods commencing on or after 7 December 2006 and ending on or before 31 March 2011

- MCA has issued a notification extending the option in accounting for exchange differences arising on long term foreign currency monetary items by another year i.e. till accounting periods ending on or before 31 March 2012. Later, in December 2011, the date was extended to 31 March 2020

Relaxation in forex accounting norms (para 46A)

Significant relaxation has been made by MCA with regard to the option in accounting for exchange differences arising on reporting of long term foreign currency monetary items. Such exchange differences (except those on net investment in a non-integral foreign operation) can now be indefinitely

- adjusted to cost of the asset, where the monetary item relates to acquisition of a depreciable capital asset
- in other cases, accumulated in 'Foreign currency monetary item translation difference account' (FCMITDA) and amortised over balance period of long-term monetary asset/liability

Long term foreign currency monetary item is an asset or liability expressed in foreign currency which has a term of 12 months or more at the date of origination of the asset or liability

Relaxation in forex accounting norms (para 46A)

- Option available to all companies including those which did not avail the option earlier in 2009

  Relaxation for companies which had not availed the option earlier is available in respect of accounting periods commencing on or after 1 April 2011

- Option is irrevocable and must be applied to all long term foreign currency monetary items
- Option is available indefinitely i.e. till further notification
- Financial statements should disclose the fact of exercise of option and of unamortised amount till the relevant exchange difference remains unamortised

Applicability of Para 46/46A of AS-11

lready using para . of -.

ontinue capitalising foreign exchange differences pertaining to fixed assets

create . . . . . for all other forex differences as per para . until . arch .

se para . and both options are available.

- *apitalise foreign exchange differences pertaining to fixed assets*
- *reate an . . . . . for other forex differences (indefinitely)*

. irst time application of para . (i.e. not applying para . earlier)

Interaction between AS 16 and AS 11 – Capitalisation of foreign exchange differences (1/3)

- ***AS 11 generally applies to exchange differences on all foreign currency transactions, except exchange differences arising on foreign currency borrowings to the extent regarded as an adjustment to interest cost (AS 16, para 4(e))***

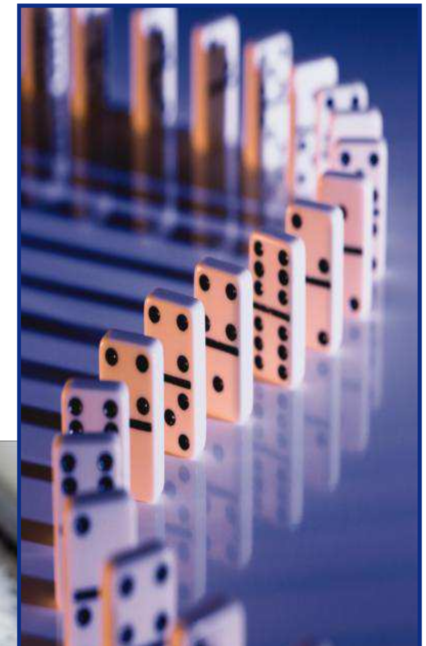
Foreign exchange differences on foreign currency loans

AS 11

- ***Exchange differences on borrowings recognised in P&L; or***
- ***MCA notification - accounting alternative under para 46/46A permits capitalisation to cost of the asset/ FCMITDA for long term borrowings even if construction is complete***

AS 16

- ***Exchange differences to the extent of interest differential (difference between INR and Fx interest rate) considered borrowing costs***
- ***Capitalised under para 4(e) during construction and post construction expensed as borrowing costs***



Interaction between AS 16 and AS 11 – Capitalisation of foreign exchange differences (2/3)

Issues to consider

- ***Scope of paragraphs 46 / 46 A of AS 11***

  Position prior to the clarification issued on 9 August 2012

  - *AS 11 excludes from its scope exchange differences covered under para 4 (e) of AS 16.*
  - *Therefore, the alternative accounting treatment under paragraphs 46 / 46A would apply only to exchange differences in excess of those covered under AS 16*
  - *As a result, exchange differences that are considered an adjustment to borrowing costs for a qualifying asset may be capitalised during construction but are charged to P&L post construction.*

  Position post the clarification issued on 9 August 2012

  - *Companies that have adopted paragraph 46A of AS 11 will now be permitted to fully capitalise such foreign exchange differences without separation of the borrowing cost element under paragraph 4(e) of AS 16.*
  - *Capitalisation under AS 11 will continue even subsequent to the completion of construction of a qualifying asset, unlike borrowing costs which are required to be charged to the profit or loss account subsequent to construction*

Interaction between AS 16 and AS 11 – Capitalisation of foreign exchange differences (3/3)

Issues to consider

- Bifurcation of exchange differences between AS 11 and AS 16 is not required for the purpose of application of Para 46A.
- Exchange differences pertaining to acquisition of all depreciable capital assets to be taken to cost of such assets. AS 16 only allows exchange difference relating to qualifying assets.
- Exchange difference after the date of capitalisation continues to be capitalised as the cost of asset.
- Clarification is only applicable for companies which have opted for paragraph 46A and not applicable for paragraph 46 unless specific clarification has been taken from MCA.
- Companies have option to continue with paragraph 46 (if earlier adopted) or adopt paragraph 46A.
- Balance in FCMITDA to be presented under Reserves and Surplus.

Illustration to understand impact of clarification (1/2)

- Entity A has borrowed USD 10,000 in foreign currency on April 1, 20X1 at 5% p.a. annual interest. The corresponding interest rate for a borrowing in Entity A’s local currency on that date was 11% p.a. The exchange rates and exchange differences at March 31, 20X2 are as follows:

Date	Exchange Rate (USD/INR)	Exchange Difference
April 1, 20X1	48	Nil
March 31, 20X2	51	30,000

- The interest differential under paragraph 4(e) would be computed as follows:
- USD interest = USD 10,000 * 5% * 51 = INR 25,500
- INR interest = USD 10,000 * 11% * 48 = INR 52,800
- Interest differential 4(e) = 52,800 –25,500 = INR 27,300

Illustration to understand impact of clarification (2/2)

Prior to the clarification:

- ***Under para 46 A, accounting treatment for the foreign exchange differences of INR 30,000 would be as follows:***

Exchange Difference	Construction period (if used for qualifying asset)	Post construction/ not for a qualifying asset
Borrowing cost component (INR 27,300)	Capitalise under AS 16 para 4(e)	Expense as borrowing cost
Additional (INR 2,700)	Capitalise under AS 11 para46A	Capitalise under AS 11 para46A

Post clarification:

- ***Subsequent to the August 9, 2012 clarification, Entity A would be permitted to capitalise the entire exchange difference of INR 30,000 during the construction period as well as post-construction period if the borrowing relates to a depreciable asset. If the borrowing does not relate to a depreciable asset, Entity A would still be permitted to amortise the entire exchange difference over the life of the borrowing using the FCMITDA***

Questions & Answers

Answers

&

Questions

Thank you

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