PONDICHERRY UNIVERSITY

(A Central University)

DIRECTORATE OF DISTANCE EDUCATION

MASTER OF COMMERCE IN FINANCE

M.Com (Finance) – First Year

Course Code: 59 **Paper Code: MCOM1001**

CORPORATE ACCOUNTING

DDE – WHERE INNOVATION IS A WAY OF LIFE

PAPER – I CORPORATE ACCOUNTING

Author:

Prof. K. Govindarajan

Department of Commerce,

Annamalai University,

Annamalai Nagar 608 002

Chidambaram.

PAPER – I CORPORATE ACCOUNTING

TABLE OF CONTENTS

UNIT	LESSON	TITLE	PAGE NO.
I	1.1	Introduction - Accounting Concepts and Convention	4
	1.2	Accounting Standards	15
II	2.1	Profit prior to Incorporation	43
	2.2	Managerial Remuneration	55
	2.3	Company Final Accounts	69
	2.4	Issue of Bonus Shares	105
	2.5	Financial Reporting and Disclosure Practices	117
III	3.1	Valuation of Goodwill	144
	3.2	Valuation of Shares	160
IV	4.1	Internal Reconstruction	183
	4.2	Amalgamation, Absorption and External Reconstruction of Companies	207
	4.3	Statements for Liquidation of Companies	232
V	5.1	Final Statements of Accounts of Banking Companies	258
	5.2	Final Statements of Accounts of Insurance Companies	312

M.Com 1st Year **PAPER CODE: MCOM 1001**

PAPER I - CORPORATE ACCOUNTING

UNIT I

Corporate Accounting: Importance and Scope - Basic Accounting Concepts and Conventions - Generally Accepted Accounting Principles and Practices (GAAPP) recommended by the ICAI - Accounting standards issues by ICAI; AS 4 : Contingencies and Events occurring after the Balance Sheet Date - AS 11: The Effects of Changes in Foreign Exchange Rates - AS 12: Accounting for Government Grants - AS 16: Borrowing Costs - AS 19: Leases - AS 20: Earnings Per Share - AS 26: Intangible Assets - AS 29: Provisions, Contingent Liabilities and Contingent Assets.

UNIT II

Preparation of Company Final accounts: Schedule VI Part I and Part II – Profit prior to Incorporation – Managerial Remuneration – Dividend declaration out of the past and the current profits – Issue of Bonus shares – Preparation of Balance Sheet; Financial Reporting and Disclosure Practices – Corporate Governance - Norms of SEBI relating to information Disclosure in Annual Reports; Professional Chartered Accountants' Functions and Services - Code of Conduct - Professional Ethics

UNIT III

Valuation of Goodwill – Factors affecting value of Goodwill – Methods of Valuing Goodwill – Valuation of Shares – Methods of Valuation of Equity Shares.

UNIT IV

Amalgamation, Absorption and External Reconstruction of Companies – Purchase consideration – Accounting treatment – Books of Purchasing Company – Books of Vendor Company – Alteration of Share Capital and Internal Reconstruction – Scheme of Capital Reduction - Statements for Liquidation of Companies.

UNIT V

Accounting Systems and Preparation of Final Statements of Accounts of Banking and Insurance Companies.

Note: Question Paper Shall covers 20% Theory and 80% Problems

REFERENCES:

Gupta R.L. and Others: Advanced Accountancy, Sultan Chand Sons, New Delhi 2008.
Jain S.P. and K.L. Narang: Advanced Accounting, Kalyani Publisherss, Delhi 2009.
Pillai R.S., Bagavathi S. Uma: Advanced Accounting, S. Chand & Co., Delhi. 2008
Shukla M.C.: Advanced Accounts S. Chand and Co., New Delhi 2009.

Lesson 1.1 Introduction

Learning objectives

After learning this chapter, you will be able to:

- Explain the meaning of Corporate Accounting
- Importance and Scope ofCorporate Accounting
- Understand the Basic Accounting Concepts and conventions.

1.1.1 Introduction

In the evolution of forms of business organizations, company form is the third stage and the first two being sole-proprietorship and partnership firms. Since the ownership is separated from the management, company enjoys a separate legal status. Even though, the shareholders contribute towards the finances of the company but all of them do not and cannot participate in the management of the company. It is managed by a Board of Directors elected by the shareholders. Thus, in the company form of business organization a shareholder may simply acts as a renter of capital. In India, Companies are governed by the provisions of the Companies Act, 1956. The Act has been amended several times. Some of the important amendments have been in 1960, 1963, 1965, 1969, 1974, 1977, 1985, 1988, 1999, 2000, 2001, 2002 and most recently in 2006. The Companies Act 1956 was replaced by the Companies Act 2013.

1.1.2 Meaning and Definition of a Company

In common parlance, company means, an association of persons formed for the economic gain of its members. However, in law, any association of persons for any common object can be registered as a company. The object need not be the economic gain of its members, e.g., a company can be formed for purposes such as charity, research, advancement of knowledge, etc.

In the words of Justice Lindley, "A company is an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs, are members." (Late) Chief Justice Marshall of USA has defined a company as "a person, artificial, invisible, intangible and existing only in the eyes of the law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

The Companies Act defines a company as "a company formed and registered under this Act or an existing company. - An existing company means a company formed and registered under any of the former Companies Act, It is to be noted that some sole proprietorship and partnership firms use the word 'Company' as a part of their names,

e.g., Ram & Company, Shyam & Company. Such firms are not companies within the meaning of the Act.

A company thus exists, only in the contemplation of law. It has no physical existence. Right to act as a natural being is granted to it by law. Law creates it and law alone can dissolve it.

1.1.3Essential Characteristics of a Company

Essential characteristics of a company are as follows:

Voluntary association: A company is a voluntary association of persons, i.e.. it can neither compel a person to become its member nor to give up its membership. It is the personal choice of people and their objective to make profits which leads them to become members of a company.

Independent legal entity: A company is a legal entity quite distinct and separate from its members. It can hold and deal with any type of property—of which it is the owner—in any way it likes; can enter into contracts, open a bank account in its own name, sue and be sued by its members as well as outsiders.On account of this independent corporate existence, the creditors of a company are creditors of the company alone and their remedy lies against the company and its property only and not against any of its members. Law recognises the existence of the company as quite distinct, irrespective of the motives, intentions. scheme of conduct of the individual shareholders.

Perpetual existence A company has perpetual succession. The mode of incorporation and dissolution of a company and the right of the members to transfer shares freely, guarantees the continuity of the existence of the company quite independent of the life of the members. The existence of a company can be terminated only by law. Thus_, members may come and go, but the company can go on forever.

Common seal A company being an artificial entity, acts through other natural persons, who are called directors. They act as agents to the company, but not to its members. All the acts of the company are authorised by its common seal. The common seal is the official signature of the company. A document not bearing the common seal of the company will not be binding on the company.

Limited liability The liability of the members of a company is generally limited to the extent of the unpaid value of the shares held by them. In the case of a guarantee company, the members are liable to contribute a specified agreed sum to the assets of the company in the event of the company being wound up if its assets fall short of its liabilities.

Transferability of shares The shares of a joint stock company are freely transferable. However, in the case of private companies they are transferable subject to the restrictions put by the company's articles.

1.1.4Meaning of Corporate Accounting

It will be useful to discuss the meaning of the terms "Body Corporate" and "Corporation" before understanding the meaning of Corporate Accounting.

Body corporate

The term "body corporate" is wider than the expression 'company' and has been used in several sections of the Companies Act to denote not only an Indian company but also a foreign company. It also includes corporation formed under special law of India or a foreign country except as expressly excluded by the definition.

The Department of Company Law Administration has clarified the definition as follows: "Generally speaking, body corporate means, a body which has been or is incorporated under some status and which has a perpetual succession and a common seal and is a legal entity apart from the members constituting it." The term, however, does not include:

(a) a society registered under the Societies Registration Act, 1860;

(b) a corporation sole;

(c) a cooperative society registered under any law relating to cooperative societies; and

(d) any other body corporate not being a company as defined in the Companies Act, which the Central Government may, by notification in the Official Gazette, specify in this behalf [Section 2(7)].

Corporation: Corporation means anybody or institution enjoying perpetual succession and the status of an independent legal entity. It may be of two types: (a) Corporation sole and (b) Corporation aggregate.

Corporation sole refers to a single person constituted as a corporation in respect of some office or function, e.g., a Public Trustee, President, Governor, Minister, etc. It is not taken as a body corporate for purposes of this Act, but it is still a legal person and can be a member of a company.

A corporation aggregate may be defined as a collection of individuals united into one body having a perpetual succession and an independent legal entity. It may be a trading or a non-trading corporation. The examples of trading corporations are (i) Chartered companies, (ii) Companies incorporated by special Acts of Parliament, (iii) Companies registered under the Companies Act, etc. The examples of non-trading corporations are (i) Municipal Corporations, (ii) District Boards, (iii) Universities, etc.

Corporate accounting Corporate accounting is basically concerned with accounting relating to corporate bodies. In this book we are primarily concentrating on

accounting concerned with Indian corporations engaged in manufacturing trading or service activities.

1.1.5Kinds of Companies

Statutory companies A company formed by a special Act passed either by the Central or State Legislature is called a statutory company. Such companies are governed by their respective Acts, and are not required to have any Memorandum or Articles of Association. Changes in their structure are possible only by legislative amendments. These companies are usually formed to carry out some special public undertakings requiring extraordinary powers and privileges. The object of such companies is not so much to earn profits as to serve people. Though the liability of the members ofsuch companies is limited, in most of the cases, they may not be required to use the word 'limited' as part of their names. Some of the important statutory companies are Reserve Bank of India, State Bank of India, Industrial Development Bank of India, etc.

Government companies: A company of which not less than 51% of the paid up share capital is held by the Central government or by the State government or by any two or more of them together shall be a government company.

Foreign companies A company which is incorporated outside India but which has a place of business in India is termed as a foreign company.

Registered companies: Companies formed by registration under the Companies Act are known as registered companies. The working of such companies is regulated by the provisions of the Companies Act, the Memorandum of Association and the Articles of Association. These companies may be limited by shares or limited by guarantee or unlimited companies.

(i) **Companies limited by shares.** It is a company having the liability of its members limited by memorandum to the amount unpaid, if any, on the shares respectively held by them.

(ii) **Companies limited by guarantee.** Non-profit earning companies are mostly registered with a guarantee capital. They may or may not have share capital. A guarantee company is a company in which liability of its members is limited by memorandum to such amounts as the members may undertake by memorandum, to contribute to meet out the deficiency in the assets of the company, in the event of its being wound uP.- If the company has a share capital, the shareholders shall be liable to pay the amount which remains unpaid on their shares plus the amount payable under the guarantee.

(iii) **Unlimited company**. A company not having any limit on the liability of its members is an unlimited company. It may or may not have share capital.

Members are held liable for the deficiency of assets to the liabilities of the company in proportion to their interests in the company. Liability in such a case may extend to the personal property of the shareholders. Unlimited companies, though permitted by the Companies Act, are not popular in this country.

Private and Public Limited Companies

Registered companies can be further classified as private and public limited companies.

Private company: A private company means a company which has a minimum paid up capital of Rs I lakh or such higher capital as may be prescribed and which by its articles:

(a) restricts the right of its members to transfer shares,' if any;

(b) limits the number of members to fifty, excluding present and past employees of the company who are the members of the company;

(c) prohibits any invitation to the general public to subscribe for its shares or debentures; and

(d) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

A private limited company may be registered with only two members. It is required to add the words 'private limited" at the end of its name.

Public company: A public company means a company which:

(a) has a minimum paid up capital of Rs 5 lakhs or such higher paid up capital as may be prescribed;

(b) is not a private company; or

(c) is a private company which is subsidiary of a company which is not a private company. In other words a private company which is subsidiary of a public company, will also be taken as a public company.

(d) A public company needs minimum seven persons for its registration.

1.1.6 Importance of Corporate Accounting

The importance of corporate accounting is wide one. The importance of accounting is described below:

- CorporateAccounting supplies numerical information to the institution relating to its management and administration
- Exact results of the corporate are disclosed through Corporateaccounting

- The body corporate can ascertain the financial status of the business operation
- Corporate body can compare the financial position of two/more years
- Proper accounting makes the firm credible to other party
- Tax authority can assess taxes for the corporate using the accounting information
- Corporate body can determine the actual assets and liabilities
- Using accounting data a Corporate bodycan formulate policy and take many decision on future operation
- Fulfilling the legal requirements
- Corporate governess

1.1.7 Scope of Corporate Accounting

Corporate Accounting has got a very wide scope and area of application. Its use is not confined to the business world alone, but spread over in all the spheres of the society and in all professions. Theorder of the day is any corporate body need for recording and summarizing these transactions when they occur and the necessity of finding out the net result of the same after the expiry of a certain fixed period. Besides, this is also the need for interpretation and communication of that information to the appropriate persons. Only accounting use can help overcome these problems.In the modern world, accounting system is practiced not only in all the business institutions. As a matter of fact, accounting methods are used by all who are involved in a series of financial transactions.The scope of corporate accounting as it was in earlier days has undergone lots of changes in recent times. As corporate accounting is a dynamic subject, its scope and area of operation have been always increasing keeping pace with the changes in socio-economic changes and legal requirement. As a result of continuous research in this field the new areas of application of accounting principles and policies are emerged. National accounting, human resources accounting and social Accounting are examples of the new areas of application of accounting systems.

1.1.8Accounting Concepts and Convention

Accounting is the language of business. It records business transactions taking place during the accounting period. Accounting communicates the result of the business transactions in the form of final accounts. With a view to make the accounting results

understood in the same sense by all interested parties, certain accounting concepts and conventions have been developed over a course of period.

1.1.8.1Accounting Concepts

The Concepts of accounting are like the foundation pillars on which the structure of accounting is based. The Concepts of accounting are as follows:

1. Business Entity Concept

It is generally accepted that the moment a business enterprise is started it attains a separate entity as distinct from the persons who own it. According to this Concept, business is treated as a unit or entity apart from its owners, creditors and others. In other words, the proprietor of a business concern is always considered to be separate and distinct from the business which he controls. All the business transactions are recorded in the books of accounts from the view point of the business. Even the proprietor is treated as a creditor to the extent of his capital. This concept is extremely useful in keeping business affairs strictly free from the effect of private affairs of the proprietors. In the absence of this concept the private affairs and business affairs are mingled together in such a way that the true profit or loss of the business enterprise cannot be ascertained nor its financial position.

2. Money Measurement Concepts

Accounting records only those transactions which can be expressed in monetary terms. This feature is well emphasized in the two definitions on accounting as given by the American institute of certified public accountants and the American accounting principles board. The importance of this concept is that money provides a common denomination by means of which heterogeneous facts about a business enterprise can be expressed and measured in a much better way. In accounting, only those business transactions and events which are of financial nature are recorded. For example, when Sales Manager is not on good terms with Production Manager, the business is bound to suffer. This fact will not be recorded, because it cannot be measured in terms of money.

3. Accounting Period Concepts

In accordance with the going concern concept it is usually assumed that the life of a business is indefinitely long. But owners and other interested parties cannot wait

until the business has been wound up for obtaining information about its results and financial position. The users of financial statements need periodical reports to know the operational result and the financial position of the business concern. Hence it becomes necessary to close the accounts at regular intervals. Usually a period of 365 days or 52 weeks or 1 year is considered as the accounting period.

4. Going Concern Concepts

As per this assumption, the business will exist for a long period and transactions are recorded from this point of view. There is neither the intention nor the necessity to wind up the business in the foreseeable future. This concept assumes that the business enterprise will continue the accountant while valuing the assets of the enterprise does not take in to account the current resale values as there is no immediate expectation of selling it. Moreover, depreciation on fixed assets is charge do the basis of the respected life rather than on their market values. When there is conclusive evidence that the business enterprise has a limited life, the accounting procedures should be appropriate to the expected terminal date of the enterprise. In such cases, the financial statements could clearly disclose the limited life of the enterprise and should be prepared from the 'quitting concern' point of view rather than from a 'going concern' point of view.

5. Dual Aspect Concept

Dual aspect principle is the basis for Double Entry System of book-keeping. This concept is the core of accounting. According to this concept every business transaction has a dual aspect. All business transactions recorded in accounts have two aspects - receiving benefit and giving benefit. For example, when a business acquires an asset (receiving of benefit) it must pay cash (giving of benefit).

6. Revenue Realisation Concept

According to this concept, revenue is considered as the income earned on the date when it is realised. Unearned or unrealised revenue should not be taken into account. The realisation concept is vital for determining income pertaining to an accounting period. It avoids the possibility of inflating incomes and profits.

7. Historical Cost Concept

Under this concept, assets are recorded at the price paid to acquire them and this cost is the basis for all subsequent accounting for the asset. For example, if a piece of land is purchased for Rs.5,00,000 and its market value is Rs.8,00,000 at the time of preparing final accounts the land value is recorded only for Rs.5,00,000. Thus, the balance sheet does not indicate the price at which the asset could be sold for.

8. Matching Concept

Matching the revenues earned during an accounting period with the cost associated with the period to ascertain the result of the business concern is called the matching concept. It is the basis for finding accurate profit for a period which can be safely distributed to the owners.

9. Verifiable and Objective Evidence Concept

This principle requires that each recorded business transactions in the books of accounts should have an adequate evidence to support it. For example, cash receipt for payments made. The documentary evidence of transactions should be free from any bias. As accounting records are based on documentary evidence which is capable of verification, it is universally acceptable.

1.1.8.2 Accounting Conventions

1. Convention of Conservatism

It is a world of uncertainty. Hence, it is always better to pursue the policy of playing safe. This is the principle behind the convention of conservatism. According to this convention the accountant must be very careful while recognizing increases in an enterprise's profits rather than recognizing decreases in profits. For this the accountants have to follow the rule, anticipate no profit, provide for all possible losses, while recording business transactions. It is on account of this convention that the inventory is valued at cost or market price which ever is less, i.e .When the market price of the inventories has fallen below its cost price it is shown at market price i.e. The possible loss is provided and when it is above the cost price it is shown at cost price i.e. The anticipated profit is not recorded. It is for the same reason that provision for bad and doubtful debts, provision for fluctuation in investments, etc., are created. This concept affects principally the current assets.

2. Convention of Full Disclosure:

The emergence of joint stock company form of business organization resulted in the divorce between ownership and management. This necessitated the full disclosure of accounting information about the enterprise to the owners and various other interested parties. Thus the convention of full disclosure became important. By this convention it is implied that accounts must be honestly prepared and all material information must be adequately disclosed therein. But it does not mean that all information that some one desiresare to be disclosed in the financial statements. It only implies that there should be adequate disclosure of information which is of considerable value to owners, investors, creditors, government, etc. In sachar committee report (1978), it has been emphasized that openness in company affairs is the best way to secure responsible behaviour. It is in accordance with this convention that companies act, banking companies regulation act, insurance act etc., have prescribed proforma of financial statements to enable the concerned companies to disclose sufficient information. The practice of appending notes relating to various facts on items which do not find place in financial statements is also in pursuance to this convention. The following are some examples:

(a) Contingent liabilities appearing as a note
(b) Market value of investments appearing as a note
(c) Schedule of advances in case of banking companies

3. Convention of Consistency:

The aim of consistency principle is to preserve the comparability of financial statements. The rules, practices, concepts and principles used in accounting should be continuously observed and applied year after year. Comparisons of financial results of the business among different accounting period can be significant and meaningful only when consistent practices were followed in ascertaining them. For example, depreciation of assets can be provided under different methods, whichever method is followed, it should be followed regularly. However if introduction of a new technique results in inflating or deflating the figures of profit as compared to the previous methods, the fact should be well disclosed in the financial statement.

4. Convention of Materiality:

The implication of this convention is that accountant should attach importance to material details and ignore insignificant ones. In the absence of this distinction, accounting will unnecessarily be over burdened with minute details. The question as to what is a material detail and what is not is left to the discretion of the individual accountant. Further, an item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investor. Some examples of material financial information are: fall in the value of stock, loss of markets due to competition, change in the demand pattern due to changing over moment regulations, etc. Examples of insignificant financial information are: rounding of income to nearest ten for tax purposes etc. Sometimes if it is felt that an immaterial item must be disclosed, the same may be shown as foot note or in parentheses is according to its relative importance. The materiality principle requires all relatively relevant information should be disclosed in the financial statements. Unimportant and immaterial information are either left out or merged with other items.

To promote world-wide uniformity in published accounts, the International Accounting Standards Committee (IASC) has been set up in June 1973 with nine nations as founder members. The purpose of this committee is to formulate and publish in public interest, standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance. IASC exist to reduce the differences between different countries' accounting practices. This process of harmonisation will make it easier for the users and preparers of financial statement to operate across international boundaries. In our country, the Institute of Chartered Accountants of India has constituted Accounting Standard Board (ASB) in 1977. The ASB has been empowered to formulate and issue accounting standards, that should be followed by all business concerns in India.

1.1.9 Self Assessment Questions

1. What is corporate accounting? Explain its importance and scope.
2. Describe various body corporate.
3. Explain the various accounting concepts.
4. Briefly explain the various accounting conventions.

Lesson 1.2 Accounting Standards

Learning objectives

After studying this chapter, you will be able to:

- ♦ Understand the provisions of the Accounting Standards specified in the syllabus.

1.2 Introduction

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks.

1.2.2 Overview

International Accounting Standards Committee (IASC)was formed in 1973 to fulfill the need for standardising of accounting on a global scale. In India, the law of the land – the Companies Act and other statutes – envisages financial statements to be true and fair in including the financial position and working results of companies. What constitutes a "true and fair" view is defined neither by statute nor by case law. Thus it is quite possible for more than one set of financial statements to show simultaneously a true and fair view of a company's performance. This lacuna has been sought to be overcome by the Institute of Chartered Accountants of India by constituting an Accounting Standard Board (ASB) on 21st April, 1997. The main function of ASB is to formulate different accounting standards after taking into consideration the applicable laws, customs, usages and business environment.

1.2.3List of Accounting Standards

The Accounting Standards Board of the Institute of Chartered Accountants of India has issued 24 definitive standards as on 31st August, 2006. These are:

AS-1. Disclosure of accounting policies.

AS-2. Valuation of inventories.

AS-3. Changes in financial position.

AS-4. Contingencies and events occurring after the Balance Sheet date.

AS-5. Prior period and extraordinary items and changes in accounting policies.

AS-6. Depreciation accounting.

AS-7. Accounting for construction contracts.

AS-8. Accounting for research and development.

AS-9. Revenue recognition.

AS-10. Accounting for fixed assets.

AS-11. Accounting for the effect of changes in Foreign exchange rates.

AS-12. Accounting for Government grants.

AS-13. Accounting for investments.

AS-14. Accounting for amalgamation.

AS-15. Accounting for retirement benefits in the financial statements of employees.

AS-16. Borrowing costs.

AS-17. Segment Reporting.

AS-18. Related Party Disclosure.

AS-19. Leases.

AS-20. Earnings Per Share.

AS-21. Consolidated financial Statements.

AS-22. Accounting for Taxes on Income.

AS-23. Accounting for investments in consolidated financial statements.

AS-24. Discontinuing operations.

1.2.4AS-4 (Revised): Contingencies and Events Occurring After the Balance Sheet Date

Introduction

This standard deals with the treatment in financial statements of Contingencies, and Events occurring after the balance sheet date.

The following subjects, which may result in contingencies, are excluded from the scope of this statement in view of special considerations applicable to them: Liabilities of life assurance and general insurance enterprises arising from policies issued;

Definitions

The following terms are used in this Statement with the meanings specified:

A contingencyis a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Events occurring after the balance sheet dateare those significant events, both favourable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

Two types of events can be identified:

(a) Those which provide further evidence of conditions that existed at the balance sheet date; and

(b) Those which are indicative of conditions that arose subsequent to the balance sheet date.

Contingencies

The term "contingencies" used in this statement is restricted to conditions or situations at the balance sheet, the financial effect of which is to be determined by future events which may or may not occur. Estimates are required for determining the amounts to be stated in the financial statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterizes a contingency. For example, the fact that estimates of useful life are used to determine depreciation does not make depreciation a contingency; the eventual expiry of the useful life of the assets is not uncertain. Also, amounts owed for services received are not contingencies as defined, even though the amounts may have been estimated, as there is nothing uncertain about the fact that those obligations have been incurred.

The uncertainty relating to future events can be expressed by range of outcomes. This range may be presenting as qualified probabilities, but in most circumstances, this suggests a level of precision that is not supposed by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable. The estimates of the outcome and of the financial effect of contingencies are determined by the judgment of the management of

the enterprise. This judgment is based on consideration of information available up to date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

Accounting Treatment of Contingent Losses

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements. The estimation of the amount of a contingent loss to be provided for the financial statements may be based on information referred to in paragraph 4.4. If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made. The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date. Accounting treatment of contingent gains are not recognized in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realization of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

Determination of the amounts at which contingencies are included in financial statements

The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are

approved. Events occurring after the balance sheet date that include that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at such contingencies are included in financial statements. In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progresses of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

Events Occurring after Balance Sheet Date

Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure. Adjustments to assets are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For, example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occur after the balance sheet date. Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events are not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to

the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may require in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions. There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements. Even occurring after the balance sheet date may include that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting concept of going concern in the preparation of the financial statements.

Disclosure

The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote. If a reliable estimate of the financial effect cannot be made, this fact is disclosed. When the events occurring after the balance sheet date are disclosed in the report of the approving authority*, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Contingencies

The amount of a contingent loss should be provided by a charge in the statement of profit and loss if:

a. It is probable that future events will confirm that, after taking into account may related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and
b. A reasonable estimate of the amount of the resulting loss can be made.

The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in this standard is not met, unless the possibility of a loss is remote. Contingent gains should not be recognised in the financial statements.

Events Occurring after Balance Sheet Date

Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumptions of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.Disclosure should be made in the report of the approving authority of those occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

If disclosure of contingencies is required by paragraph 11 of this statement, the following information should be provided:

a. The nature of the contingency;
b. The uncertainties which may affect the future outcome;
c. An estimate of the financial effect or a statement that such an estimation cannot be made.

If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this statement, the following information should be provided.

a. The nature of the event;
b. An estimate of the financial effect or a statement that such an estimate cannot be made.

1.2.5 AS-11 (Revised): Accounting for the Effects of Changes in Foreign Exchange Rates

This Standard should be applied by an enterprise: In accounting for transactions in foreign currencies and in translating the financial statements of foreign branches for inclusion in the financial statements of the enterprise.

Definitions

The following terms are used in this Statement with the meanings specified:

Reporting currency is the currency used in presenting the financial statements.

Foreign currency is a currency other than the reporting currency of an enterprise.

Exchange rate is the ratio for exchange of two currencies as applicable to the realization of a specific assets or the payment of a specific liability or the recording of specific transaction or a group of inter-related transactions.

Average rate is the mean of the exchange rates in force during a period.

Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

Closing rate is the exchange rate at the balance sheet date.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivables, payables.

Non-monetary itemsare assets and liabilities other than monetary items e.g., fixed assets, inventories, investments in equity shares.

Settlement date is the date at which a receivable is due to be collected or payable is due to be paid.

Recoverable amount is the amount which the enterprise expects to recover from the future use of an asset, including its residual value on disposal.

Foreign Currency Transactions Exchange Rate

A multiplicity of forigen exchange rates is possible in a given situation. In such a case, the term assets, 'exchange rate' refers to the rate which is applicable transaction.The term 'exchange rate' is defined in this Statement with reference to a specific asset, liability or transactions are considered inter-related transactions. For the purpose of this statement, two or more transaction or a group of inter-related if, by virtue of being set off against one another or otherwise, they affect the net amount of reporting currency that will be available on, or required for, the settlement of those transactions. Although the exchange rates applicable to realizations and disbursements in a foreign currency may be different, an enterprise may, where legally permissible, partly use the receivables to settle the payables and receivables are reported at the exchange rate as applicable to the net amount of receivable or payable. Further, where realizations are deposited into, and disbursements made out of, a foreign currency bank account, all the

transactions during a period (e.g., a month) are reported at a rate that approximates the actual rate during that period. However, where transactions cannot be considered inter-related as stated above, by set-off or otherwise, the receivables and payables are reported at the rates applicable to the respective amounts even where these are receivable from, or payable tp the same forigen party.

Recording Transactions on Initial Recognition

A transaction in a forigen currency should be recorded in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction, except as stated above in respect of inter-related transactions.

A transaction in a foreign currency is recorded in the financial records of an enterprise as at the date on which the transaction occurs, normally using the exchange rate at that date. This exchange rate is often referred to as the spot rate. For practical reasons, rate that approximates the actual rate is often used, for example, an average rate for all transactions during the week or month in which the transactions occur. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting Effects of Charges in Exchange Rates Subsequent to Initial Recognition

At each balance sheet date:

(a) Monetary items denominated in a foreign currency (e.g., foreign currency notes, balances in bank accounts denominated in a foreign currency, and receivables, payables and loans denominated in a foreign currency) should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at the rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) Non-monetary items other than fixed assets, which are carried in terms of historical cost denominated in a forigen currency, should be reported using the exchange rate at the date of the transaction;

(c) Non-monetary items other than fixed assets, which are carried in terms of fair value or other similar valuation, e.g., net realisable value, denominated in a forigen currency should be reported using the exchange rates that existed when the values were determined (e.g., if the fair values is determined as on the balance sheet date, the exchange rate on the balance sheet date may be used); and

(d) The carrying amount of fixed assets should be adjusted as stated in paragraphs 10 and 11 below.

Recognition of Exchange Differences

Paragraphs 9 to 11 set out the accounting treatment required by this statement in respect of exchange differences on foreign currency transactions.Exchange differences arising on foreign currency transactions should be recognised as income or as expenses in which they arise, except as stated in paragraphs 10 and 11 below.Exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets, which are carried in items of historical cost, should be adjusted in carrying amount of the respective fixed assets. The carrying amount of such fixed assets should, to the extent not already so adjusted or otherwise accounted for, also be adjusted to account for any increase or decrease in the liability of the enterprise, as expressed in the reporting currency by applying the closing rate, for making payment towards the whole or a part of the cost of the assets or for repayment of the whole or a part of the monies borrowed by the enterprise from any person., directly or indirectly, in foreign currency specifically for the purpose of acquiring those assets.The carrying amount of fixed assets which are carried in terms of revalued amounts should also be adjusted in the manner described in paragraph 10 above. However, such adjustment should not result in the net book value of a class of revalued fixed assets exceeding the recoverable amount of assets of that class, the remaining amount of the increase in liability, if any, being debited to the revaluation reserve, or to the profit and loss statement in the event of inadequacy or absence of the revaluation reserve.An exchange difference results when there is a change rate between the transaction date and the date of settlement of any monetary items arising from forigen currency transaction. When the transaction is settled within the

same accounting period as that in which it occurred, the entire exchange difference assets arises in that period. However, when the transaction is not settled in the same accounting period as that in which it accrued, the exchange difference arises over more than one accounting period.

Forward Exchanges Contracts

An enterprise may enter into a forward exchange contract, or another financial instrument that is in substance a forward exchange contract, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The difference between the forward rate and the exchange rate at date of transaction should be recognised as income or expense over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets, in which case, such difference should be adjusted in the carrying amount of the respective fixed assets.

The difference between the forward rate and the exchange rate at the inception of a forward exchange contract is recognised as income or expense over the life of the contract. The only exception is in respect of forward exchange contracts related to liabilities in foreign currency incurred for acquisition of fixed assets.Any profit or loss arising on cancellation or renewal of a forward exchange contract should be recognised as income or as expense for the period, except in case of a forward exchange contract relating to liabilities incurred for acquiring fixed assets, in which case, such profit or loss should be adjusted in the carrying amount of the respective fixed assets.

Depreciation

Where the carrying amount of depreciable assets has undergone a change in accordance with paragraph 10 or 11 or 13 or 15 of this statement, the depreciation on the revised unamortized depreciable amount should be provided in accordance with Accounting Standard (AS) 6, Depreciation Accounting.

Translation of the Financial Statements of Foreign Branches

The need for foreign currency translation arises in respect of the financial statements of foreign branches of the parent enterprise.The financial statements of a foreign branch should be translated using the procedures in paragraphs 19 to 25 of this statement.Revenue items, except opening and closing inventories and depreciation, should be translated into reporting currency of the reporting enterprise at average rate. In appropriate circumstances, weighted average rate may be applied e.g., where the income or expenses are not earned or expenses are not earned or incurred evenly during the

accounting period (such as in the case of seasonal business) or where there are exceptionally wide fluctuations in exchange rates during the accounting period. Opening and closing inventories should be translated at the rates prevalent at the commencement and close respectively of the accounting period. Depreciation should be translated at the rates used for the translation of the assets on which depreciation is calculated.

Monetary items should be translated using the closing rate. However, in circumstances where the closing rate does not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, the foreign currency item at the balance sheet date, a rate that reflects approximately the likely realization or disbursement as aforesaid should be used.

Non-monetary items other than inventories and fixed assets should be translated using the exchange rate at the date of the transaction.

Fixed assets should be translated using the exchange rate at the date of the transaction. Where there has been increase or decrease in the liability of the enterprise, as expressed in Indian rupees by applying repayment of the whole or a part of the cost of a fixed asset or for repayment of the whole or a part of monies borrowed by the enterprise from any person, directly or indirectly, in forigen currency specifically for the purpose of acquiring a fixed asset, the amount by which the liability is so increased or reduced during the year, should be added to, or reduced from, the historical cost of the fixed asset concerned.

Balance in 'head office account', whether debt or credit, should be reported at the amount of the balance in the 'Branch Account' in the books of the head office after adjusting for unresponded transactions.The net exchange difference resuming from the transaction of items in the financial statements of a forigen branch should be recognised as income or as expense for the period, except to the extent adjusted in the carrying amount of the related fixed assets in accordance with paragraph 22 above.Contingent liabilities should be translated into the currency of the enterprise at the closing rate. The translation of contingent liabilities does not result in any exchange difference as defined in this statement.

Disclosures

An enterprise should disclose –

(i) The amount of exchange differences included in the net profit or loss for the period;

(ii) The amount of exchange differences adjusted in the carrying amount of fixed assets during the accounting period; and

(iii) The amount of exchange differences in respect of forward exchange contracts to be recognised in the profit or loss for one or more subsequent accounting periods, as required by paragraph 13.

(iv) Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

1.2.6 AS -12: Accounting for Government Grants (AS)

This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

This Standard does not deal with:

i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

ii) Government assistance other than in the form of government grants.

iii) Government participation in the ownership of the enterprise.

Definitions

The following terms used in this statement with the meanings specified:

Government refers to government, government agencies and similar bodies whether local, national or international. Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably here a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

Capital Approach versus Income Approach

Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'incomeapproach', under which a grant is taken to income over one or more periods.

Those in support of the 'capital approach' argue as follows:

i. Many government grants are in the nature of promoters' contribution, i.e., they are given with the reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants.

   These should, therefore, be credited directly to shareholder's funds.

ii. It is inappropriate to recognize government grants in the profit and loss statements, since they are not earned but represent an incentive provided by government without related costs.

Arguments in support of the 'income approach' are as follows:

i. Government grants are rarely gratuitous. The enterprise earns grants through compliance with their conditions and meeting the envisaged. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

ii. As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

iii. In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

It is fundamental to the income approach that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods

necessary to much them with the related costs, Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standards (AS) 1, Disclosure of Accounting Policies). In most cases, the periods over which an enterprise recognizes the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

Recognition of Government Grants

Government grants available to the enterprise are considered for inclusion in accounts:

i. Where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and
ii. Where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

An appropriate amount in respect of such earned benefits, estimated on a prudent basic, is credited to income for the year even though the actual amount of such benefits may be finally settled and received after the end of the relevant accounting period.

A contingency related to government grant, arising after the grant has been recognised, is treated in accordance with accounting standard (AS) 4. Contingencies and events occurring after the balance sheet date. In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an intensive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprise. These circumstances may warrant taking the grant into income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate. Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate (See Accounting Standard (AS) 5, Prior Period and Extraordinary Item and Changes in Accounting Periods).

Non-monetary Government Grants

Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

Presentation of Grants Related to Specific Fixed Assets

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, contract or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during conditions may also be acquired or held.

There are two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under first method, the grant is shown as deduction from the gross value of the assets concerned in arriving at its book value. The grant is thus recognised in the P&L statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the assets; the asset is shown in the Balance Sheet at a nominal value.Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve assets is charged. Grants related to non depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.

However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss Account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g. 'Deferred government grants'.

The purchase of assets and the receipts of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the

statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of Balance sheet presentations.

Presentation of grants related to revenue

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as ‘other Income’. Alternatively, they are deducted in reporting the related expense. Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilities comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

Presentation of Grants of the nature of Promoters’ contribution

Where the government grants are of the nature of promoters’ contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Refund of government grants

Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item (see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies). The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e. where the book value of the asset is increased, depreciation on the

revised book value is provided prospectively over the residual useful life of the asset. Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

Disclosure

The following disclosures are appropriate:

(i) The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) The nature and extent of government grants recognised in the financial assessments, including grants of non-monetary assets at a concessional rate or free of cost.

1.2.7 AS - 16: Borrowing Costs

The objective of this standard to prescribe the accounting treatment for borrowing costs. Thisstandard should be applied in according for borrowing costs. This sstandard does not detail with the actual or imputed cost of owners' equity, including preference share capital not classified not as a liability.

Definitions

The following terms are used in this statement with the meanings specified. Borrowing costs are inherent and other costs incurred by an enterprise in commotion with the borrowing of funds.

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing costs may include:

(a) Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) Amortisation of discounts or premiums relating to borrowings;

(c) Amortisation of ancillary costs incurred in connection with the arrangements of borrowings;

(d) Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(e) Exchange differences arising from forigen currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

Borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalised as part of the cost of that asset. The amount of borrowing costs should be recognised as an expense in the period in which they are incurred.Borrowing costs are capitalised as part of the cost a qualifying asset when it is possible that they will result in future economic benefits to the enterprise and can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

The borrowing costs that are attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying assets had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

It may be difficult to identify a direct relationship between particular and qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of qualifying asset is often difficult and the exercise of judgment is required.

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 financing arrangements for a qualifying asset may result in an enterprise obtaining funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporary invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

To extant that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

When the carrying amount or the expected ultimate costs of the qualifying asset exceed its recoverable amount or net realisable value, the carrying amount is written down off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other According Standards.

Commencement of Capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) Expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) Borrowing costs are being incurred; and

(c) Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see accounting standard 12, according to Government Grants). The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of physical construction of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalization.

Suspension of Capitalisation

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for intended use are interrupted. Such costs are costs of holding partially completed assets and do not qualify the capitalisation.

Disclosure

The financial statements should disclose;

(a) The accounting policy adopted for borrowing costs; and

(b) The amount of borrowing costs capitalised during the period.

1.2.8AS – 19 – Leases

The objective of this standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and

operating leases. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership, title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Leases in the Financial Statement of Leases

(a) Financial Leases: In this case at the inception of a financial lease, the lease should recognise the lease as an asset and a liability. Such recognition should recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the stand point of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payment from the stand point of the lessee. The lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance change should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining of the liability of each period. Also a finance lease gives rise to depreciation expense for the asset as well as finance expenses for each accounting period. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life whichever is shorter.

(b) Operating Leases: Lease payments under an operating lease should be recognised as an expenses in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Leases in the Financial Statements of Lessors

(a) Finance Leases: the lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

(b) Operating Leases: The lessor should present an asset given under operating lease in its balance sheet under fixed assets. The lease income from operating leases should be recognised in the statement of the profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. The depreciation on leased should be on a basis consistent with the normal depreciation policy of the lessor company.

Sale and Lease back transaction

If a sale and lease back transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller lessee, instead it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately.

1.2.9AS -20 – Earning Per Share

Earning per share (EPS) is a financial ratio that gives the information regarding earning available to each equity share. This accounting standard gives computational methodology for determination and presentation of earning per share on the face of the statement of profit and loss account for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and audited earning per share with equal prominence for all periods presented. The standard also requires that an enterprise to present basic and diluted earnings per share even if the amounts disclosed are negative i.e. a loss per share.

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period. For the purpose of calculating basic earnings per share, the net profit or loss for the period after deducting preference dividends and any attributable tax thereof. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period. The weighted average number of equity shares

outstanding during the period reflect the fact that the amount of shareholders capital may have varied during the period as a result of a larger or lessor number of shares outstanding at any time. It is the number of equity shares bought issued during the period multiplied by the time-weighting factor.

Diluted earnings per share is calculated when there are potential equity shares in the structure of the enterprise. Potential equity share are those financial instruments which entitle the holder to the right of equity shares like convertible debentures, convertible preference shares, options warrents etc. for the purpose of calculating diluted earnings per share, thr net profit and loss for the period attributable to equity shareholders and weighted average number of shares outstanding during the period should be adjusted for the effect of all dilutive equity shares.

The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding the conversion of all dilutive equity shares.

Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations. Potential equity shares are anti-dilutive when their conversion to equity shares would be increased earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effect of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

An enterprise should be disclose the following:

(i) The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(ii) The weighted average number of equity shares as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(iii) The nominal value of shares along with the earnings per share figures.

1.2.10AS – 26 – Intangible Assets

The standard defines an intangible asset as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An intangible asset should be recignised if, and only if;

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) The cost of the asset can be measured reliably.

An enterprise should assess the profitability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset. As per the standard an intangible asset should initially be measured at cost.

Internally generated goodwill should not be recognised as an asset. Intangible asset arising from research (or from the research phase of an internal project) should not be recognised as an asset. Expenditure on research should be recognised as an expense when it is incurred.

An intangible asset from development should be recognised if and only if an enterprise can demonstrate all the following:

(a) The technical feasibility of complete the intangible asset so that it will be available for use or sale;

(b) Its intention to complete the intangible asset and used or sell it;

(c) Its ability to use or sell the intangible asset;

(d) How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonatrate the existence of a market for the output of the intangible asset or the intangible asset itself or; if it is to be used internally, the usefulness of the intangible asset;

(e) The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

This accounting standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised assets.

Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should be recognised as part of the cost of an intangible asset at a later date.

Enterprise may incur expenditure on intangible assets after these intangible are recognised in the book. The standard prescribes the conditions when such expenses should be capitalised and included in the cost of intangible.

(a) Subsequent expenses increase the future economic benefits of intangible;
(b) Subsequent expenses can be measured and attributed to the asset reliability.

If these conditions are not met, the subsequent expenses after initial recognition shall be expensed and not be capitalised.

After initial recognition, an intangible asset should be carried at its less any accumulated amortisation and accumulated impairment losses.

The accounting standard states that the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the asset is available for use. Amortisation should commence when the asset is available for use.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless;

(a) The legal rights are renewable; and
(b) Renewal is virtually certain.

The amortisation method used should reflect the pattern in which the assets economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another accounting standard permits or requires it to be included in the carrying amount of another asset.

The residual value of an intangible asset should be assumed to be unless;

(a) There as a commitment by a third party to purchase the asset at the end of its useful life; or
(b) There is an active market for the asset and;
    (i) Residual value can be determined by reference to that market; and
    (ii) It is probable that such a market will exist at the end of the asset's useful life'

The amortisation period and the amortisation method should be reviewed at least at each financial year end.

The financial statements should disclose the following for each class of intangible asset, distinguishing between internally generated intangible asset and other intangible asset;

(a) The useful lives or the amortisation rates used;
(b) The amortisation methods used;
(c) The gross carrying amount and the accumulated amortisation at the beginning and end of the period;
(d) A reconciliation of the carrying amount at the beginning and end of the period.

1.2.11AS -29 – Provisions, Contingent Liabilities and Contingent Assets

A provision is a liability, which can be measured only by using a substantial degree of estimation.

A contingent liability is:

(a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
(b) A present obligation that arises from past events but is not recognised because:
    (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    (ii) A reliable estimate of the amount of the obligation cannot be made.

A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not only wholly within the control of the enterprise. This standard specifies that a provision should be recognised when:

(a) An enterprise has a present obligation as a result of past event;
(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) A reliable estimation can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.An enterprise should not recognise a contingent liability or contingent asset. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted

to its present value. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, th reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be reviewed if the enterprise settle the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement. Provisions should not be recognised for future operating losses. For each class of provision, an enterprise should disclose the following:

(a) The carrying amount at the beginning and end of the period;
(b) Additional provisions made in the period, including increases to existing provisions;
(c) Amounts used during the period; and
(d) Unused amounts reversed during the period.

In addition an enterprise should also disclose the following for each class of provision.

(a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits.
(b) An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and
(c) The amount of any expected reimbursement stating the amount of any asset that has been recognised for that expected reimbursement.

1.2.12 Self Assessment Questions

1. Explain shortly the list of accounting standards.
2. Discuss the accounting standards 4,11, and 12.
3. Explain the AS 16andAS 19 Accounting for Lasing.
4. Explain the AS 20 and AS24.
5. Describe the **AS -26** and **AS -2**

Lesson 2.1 Profit Prior to Incorporation

Learning Objectives

After reading this lesson you should be able to

- Understand the meaning and importance of profit prior to Incorporation.
- Gain the knowledge about the appropriation of expenses and income pre and post incorporation
- Compute the profit prior to incorporation
- Give the proper accounting treatment of Profit prior to incorporation.

2.1.1 Introduction

A company comes into existence from the date of issue of the certificate of incorporation by the Registrar of Companies. Sometimes, a newly incorporated company agrees to take over a running business *w.e.f.* a date prior to its incorporation. Such an agreement is made to avoid the necessity of preparing the final accounts of the vendor's business from the date it prepared its last final accounts till the date on which the business is actually acquired. The assets and liabilities of the vendor's business are agreed as per the date of its last balance sheet. In such a case, the company becomes entitled to the entire profit or liable for the entire loss since the date it agrees to acquires the vendor's business. For example, a company incorporated on 1st August 2013, agrees to take over a running business from 1st April 2013 and it closes its accounts on 31st March, the company is entitled (or liable) not only to the profit (or loss) made by the business from 1st August to 31st March, but also to the profit (or loss) made by the vendor from 1st April to 31 July. Any profit (or loss) to which the company is entitled (or liable) before its incorporation is termed as 'profit (or loss) prior to incorporation' and is of a capital nature. While preparing its final accounts, it is necessary that such profit or loss is separated from the profit or loss earned or suffered by the company after its incorporation such profit while any should be transferred to capital reserve. While any loss prior to incorporation being of capital nature should be debited to separate account called Loss Prior to Incorporation Account, and shown under Miscellaneous Expenditure on the assets side of Balance Sheet to the extent not written off.

Loss prior to incorporation can be dealt with in any of the following manner:

(i) It may be written off against capital profits of the company

(ii) It may be treated as Goodwill and debited to Goodwill Account

(iii) Such loss can be treated as Deferred Revenue Expenditure and written off out of the profits of the company over a period of years.

2.1.2 Cut-off Date

A private company can commence business soon after its incorporation, while a public company can commence business only after obtaining the certificate of commencement of business. This means that in case of a private company, any profit made before incorporation and in case of a public company any profit made before commencement of business should be taken as a capital profit. However, it has now been widely accepted that since once the certificate of commencement of business is given, the company's power to carry on the business related back to the date of incorporation and hence ***the date of incorporation should be taken as the relevant date for apportionment of profits between pre- and post-incorporation periods.***

2.1.3 Basis of Apportionment

In order to apportion the profit between pre- and post-incorporation periods, the following steps should be taken:

(i) The gross profit to the business should generally be calculated for the full period withoutapportioning it between pre-incorporation and post-incorporation periods.

(ii) The gross profit calculated as above should be divided between pre- and post-incorporation periods on the basis of sales of the two periods. In the absence of any instructions in the question, the sales may be presumed to be evenly made over the whole period.

(iii) Expenses which vary in proportion to sale, *e.g.* bad debts, commission on sales etc., should be divided on the basis of sales ratio between preand postincorporation periods.

(iv) Expenses which vary according to time *e.g.* rent, salary, depreciation, interest etc., should be divided on the basis of time ratio between pre and postincorporation periods.

(v) Expenses which solely relate to pre-incorporation period should be charged to the pre-incorporation period only. For example, salary to partners, interest on capital should be charged only to the profits of the pre-incorporation period.

(vi) Expenses which relate solely to the post-incorporation period, should be charged only against the profits of that period. Examples of such expenses are interest on debentures, dividends, preliminary expenses, etc.

2.1.4 Practical Problems and Solution

Illustration 1

Samy Ltd. was incorporated on 1st October2012 to acquire the running business of Sun & Co., with effect from 1st April 2012. The following was the profit and loss account of the company on 31st March2013.

	₹		₹
To Office expenses	54,000	By Gross profit b/d	2,25,000
To Formation expenses (written off)	10,000		
To Stationery and Postage`	5,000		
To Selling Expenses	60,000		
To Directors' Fees	20,000		
To Net Profit	76,000		
	2,25,000		2,25,000

You are required to prepare a statement showing profit earned buy the company in the pre and post incorporation periods. The total sales for the year took place in the ratio of 1:2 before and after incorporation respectively.

Solution

Statement showing pre and post incorporation profits of Samy Ltd. for theYear ended 31st March 2013.

Particulars	Basis of Apportionment	Total	Pre incorporation	Post incorporation
		₹	₹	₹
Gross profit (A)	Sales ratio1:2	2,25,000	75,000	1,50,000
Expenses:				
Office expenses	Time Ratio	54,000	27,000	27,000
Stationery & postage	1:1	5,000	2,500	2,500
Formation expenses	(Written off)	10,000	-----	10,000
Director's fees		20,000	-----	20,000
Selling expenses	Sales Ratio 1:2	60,000	20,000	40,000
Total Expenses (B)		1,49,000	49,500	99,500
Net profit(A-B)		76,000	25,500	50,500

Working Notes: Time Ratio: Pre incorporation period (from 1.4.2012 to 1.10.2012) six months and Post incorporation period (from 1.10.2012 to 31.03.2013) six months. The time ratio is 1:1

Illustration 2

Star Ltd was incorporated on 1st July, 2011 to acquire a running business with effect from 1st April, 2011. The accounts for the year ended 31st March, 2012 disclosed the following:

(i) There was a gross profit of₹3,00,000.
(ii) The sales for the year amounted to ₹ 12,00,000 of which ₹ 2,40,000 were for the first six months.
(iii) The expenses debited to the Profit and Loss Account included – directors' fees: ₹15,000; bad debts: ₹3,600; advertising: ₹ 12,000 (under a contract amounting to ₹1,000 per month); salaries and general expenses: ₹ 64,000; preliminary expenses written off ₹ 5,000; and donation to a political party given by the company ₹5,000.

Prepare a statement showing the amount of profit made before and after incorporation.

Solution

Star Ltd.Statement showing apportionment of Profit between Pre and Postincorporation Period

Particulars	Notes	Basis	Total ₹	Pre – incorporation 1.4.2011 to 30.6.2011 to (3 months) ₹	Post – incorporation 1.7.2011 to 31.3.2012 (9 months) ₹
I. Revenue from the Operations	1	Sales (1:9)	3,00,000	30,000	2,70,000
II. Other Income			-	-	-
III. Total Revenue(I+II)				30,000	2,70,000
IV Expenses					
Bad Debts		Sales (1:9)	3,6000	360	3,240
Advertising		Direct	12,000	3,000	9,000
Salaries and General Expenses	2	Time (1:3)	64,000	16,000	48,000
Director's Fees	3	Direct	15,000	-	15,000
Preliminary Expenses			5,000	-	5,000
Donation			5,000	-	5,000
Total Expenses			94,600	19,360	85,240
V Profit (III-IV)			1,95,400	10,640	1,84,760
				Capital Profit	Net Profit

Working Notes:

(1) Total sales for the year 2011-12 = ₹12,00,000. Sales for the first 6 months (1.4.2011to 30.09.2011) = ₹2,40,000.

Therefore, sales per month during first 6 months = ₹ 2,40,000 / 6 = ₹ 40,000.

In effect, sales of first three months (1.4.2011 to 30.6.2011) = ₹40,000 × 3= ₹1,20,000.

Sales of next nine months (1.7. 2011 to 31.3. 2012) = ₹12,00,000 – ₹1,20,000 = ₹10,80,000.

Ratio of Sales = 1,20,000; 10,80,000 = 1:9. It is assumed that sales are evenly occurred during first six months.

(2) These expenses generally accrue evenly throughout the year and are, therefore, divided on the time basis, i.e., 3:9 or 1:3.

(3) Director's fees are paid in case of company only. These must naturally be shown in the post – incorporation period.

Tutorial Note : Capital profit is transferred to Capital Reserve Account and Net profit is transferred to Profit and Loss Appropriation Account.

Illustration 3

Red Private Limited was incorporated on 1 July 2012, to take over the running business of Mr. Block with effect from 1 April 2012. The following Profit and Loss account for the year ended 2013 was drawn up:

PROFIT AND LOSS ACCOUNT (₹ in '000)

Particulars	₹	*Particulars*	₹
To Commission	2,625	By Gross Profit	98,000
To Advertisement	5,250	By Bad Debt realized	500
To Managing Director's	9,000		
To Depreciation	2,800		
To Salaries	18,000		
To Insurance	600		
To Preliminary Expenses	700		
To Rent and Taxes	3,000		
To Discount	350		
To Bad Debts	1,250		
To Net Profit	54,925		
	98,500		**98,500**

The following details are available.

(i) The average monthly turnover from July 2012, onwards was double than that of the previous months.

(ii) Rent for the first three months was paid @ ₹ 2,00,000 p.m. and thereafter at a rate increased by ₹ 50,000 p.m.

(iii) Bad Debts ₹ 3,50,000 related to sales effected after 1 September, 2012 and the realization of bad debts was in respect of debts written off during 2012-13.

(iv) Advertisement expenses were directly proportionate to the sales.

You are required to find out the profit prior to incorporation and to state the treatment thereof in the books of the Company.

Solution

Red Private Limited

Statement showing apportionment of Profit between Pre and Postincorporation Period

Particulars	Basis	Total ₹	Pre – incorporation ₹	Post – incorporation ₹
I. Revenue from the Operations	Sales (1:6)	98,000	14,000	84,000
II. Other Income		500	500	-
III. Total Revenue(I+II)		98,500	14,500	84,000
IV Expenses				
Commission	Sales (1:6)	2,625	375	2,250
Advertisement	Sales (1:6)	5,250	750	4,500
Depreciation	Time (1:3)	2,800	700	2,100
Salaries	Time (1:3)	18,000	4,500	13,500
Insurance	Time (1:3)	600	150	450
Rent and taxes	Rent-Actual Taxes-Time	3,000	638	2,362
Discount	Sales (1:6)	350	50	300
Bad debts	Actual	1,250	386	864
Managing Director's remuneration	Direct	9,000	-	9,000
Preliminary expenses	Direct	700	-	700
Total Expenses		43,575	7,549	36,026
V Profit (III-IV)		54,925	6,951	47,974
			Capital Profit	Net Profit

Working Notes:

(i) If ₹ 1 is monthly average turnover for first three months, the monthly average for the

next nine months will be ₹ 2. The ratio therefore comes to 3 × 1 : 9 × 2 or 3 : 18.

(ii) Time basis: 3 months: 9 months or 1 : 3.

(iii) Rent: Pre-incorporation	600	Post-incorporation	2,250
Taxes: (Time Basis)	38		112
Total	638		2,362

(iv) Bad Debts excluding ₹ 350 after 1 September.

Basis—Turnover (April-June) 3: (July-August) 4. ₹ 386 thousand therefore relates to the pre-incorporation period and ₹ 514 thousand to post-incorporation period.

Pre-incorporation Profit is capital profit, and hence not available for dividends. It should be transferred to Capital reserve.

Illustration 4

The promoters of proposed Mohan (P) Ltd. Purchased a running business on 1st April, 2014 from Mr. Kannan. Mohan (P) Ltd was incorporated on 31st July, 2014. The combined Profit and Loss Account of the company prior to any after the date of incorporation is an under:

Profit & Loss Account for the year ended on 31.03.2015

	₹.		₹.
To Rent, rates, insurance	90,000	By Gross profit	15,00,000
To Directors sitting fees	36,000	By Discount received from creditors	60,000
To Salaries	30,000		
To Preliminary expenses	49,000		
To Carriage outwards	55,000		
To Interest paid to Vendors	1,00,000		
To Profit	12,00,000		
	15,60,000		15,60,000

Following further information in available

(1) Sale up to 31.7.2014 were ₹ 30,00,000 out of total sales of ₹ 1,50,00,000 of the year.

(2) Purchases up to 30.7.2014 were ₹ 30,00,000 out of total purchases of ₹ 90,00,000 of the year.

(3) Interest paid to Vendors on 1.02.2015 @ 12% p.a on ₹ 10,00,000 being purchase consideration.

From the above information, prepare Profit and Loss Account for the year ended 31stMarch 2015, showing the profit earned prior to and after incorporation and also show the transfer of the same to the appropriate accounts.

Solution

Mohan (P) Ltd.

Statement showing apportionment of Profit between Pre and Post-incorporation Period

31st March, 2015(₹in '000)

Particulars	Basis	Total ₹	Pre – incorporation ₹	Post – incorporation ₹
I. Revenue from the Operations II. Other Income	Sales (1:6)	1500 60	300 20	1200 40
III. Total Revenue(I+II)		1560	320	1240
IV Expenses Rent and Insurance Salaries Director's Setting Fees Preliminary expenses Carriage Outward Interest to Vendor	Time (1:2) Time (1:2) Actual Actual Sales (1:4) Time (1:3)	90 30 36 49 55 100	30 10 - - 11 40	60 20 36 49 44 60
Total Expenses		360	91	269
V Profit (III-IV)		1200	229	971
			Capital Profit	Net Profit

Pre-incorporation Profit is capital profit, and hence not available for dividends. It should be transferred to Capital reserve.

Working Notes:

(1) For 4 months to 31st July, sales amounted of ₹ 3,00,000 and for the remaining 8 months, sales were (₹15,00,000 – ₹3,00,000) ₹12,00,000. Gross profit is apportioned in the ratio of 3:12 or 1:4 (assuming the gross rate was uniform throughout the year). Therefore, the gross profit is apportioned in the ratio of 1:4

(2) These expenses generally accrue evenly throughout the year and are therefore divided on the time basis, prepost 4 months: 8 months or 1:2.

(3) Director's sitting fees and preliminary expenses are generally found in case companies. These must naturally be shown in post incorporation period and it can be written off against post-incorporation profit.

(4) Carriage outward has been apportioned in the ratio of sales,

(5) Since interest accrues on the basis of time, it is divided on the time basis. The total amount of interest paid for a period of 10 months (April to January). 4

months related to pre- incorporation period and 6 months to post – incorporation period. Hence the appropriate time ratio is 2:3.

(6) Discount received is apportioned on the basis of sales ratio of 3:6 or 1:2. Therefore discount received is purchase ratio.

2.1.5 Self Test Questions

Theory

1. What is theaccounting treatment of profit prior to incorporation?
2. Explain the method of ascertaining 'Profit prior to Incorporation'.
3. What is the need for calculating 'Profit prior to Incorporation'? What are the various purposes for which profit prior to Incorporation can be used?
4. What are the different 'ratios' used in computing 'profit prior to incorporation'? Briefly describe each of them.
5. How do you apportion various expenses and incomes between pre and post incorporation periods?
6. Enumerate the expenses which are exclusively charged to post incorporated period.

Problems

1. A company was incorporated on 30th September 2013 to acquire the business of Mohan as from 1st April 2013. The accounts for the year ended 31st March 2014 disclosed the following:

a) There was a gross profit of ₹ 2,40,000
b) The assets for the year amounted to ₹ 12,00,000 of which ₹ 5,40,000 were for the first six months.
c) The expenses debited to profit and loss account included:

	₹ in 000
Directors fees	15,000
Bad debts	3,600
Advertising (Under a monthly contract of ₹ 1,000)	12,000
Salaries	64,000
Preliminary expenses written off	5,000
Donation to political parties given by the company	5,000

Prepare a statement showing profits made before and after incorporation.

2. Mathivanan Company Ltd. was incorporated on 1st August2014 to take over a business as a going concern from 1st April of the same year. The turnover for the year ended 31st March 2015 was ₹2,00,00,000, namely ₹60,00,000for the first period upto 1st August2014 and ₹1,40,00,000 for the rest of the period. From the profit and loss account given below for the year ended 31st March 2015, you are required to ascertain profits prior to incorporation.

Profit & Loss Account for the year ended 31st March 2015

Particulars	₹	Particulars	₹
To Rent & Rates	3,24,000	By Gross Profit	70,00,000
To Insurance	72,000		
To Lighting	2,04,000		
To Salaries	7,80,000		
To Director's fees	2,00,000		
To Sales Discount	5,00,000		
To Sales Commission	10,00,000		
To General expenses	2,40,000		
To Carriage outwards	3,00,000		
To Bank Charges	42,000		
To Repairs	1,38,000		
To Bad Debts	60,000		
To Interest on Loan	1,20,000		
To Net Profit	30,20,000		
	70,00,000		70,00,000

3. Ram and Gopal in partnership floated a Ltd. Company i.e., Shanthi Ltd. The company was incorporated on 1st July 2012 though the partnership business was transferred to the company on 31st March 2012 itself. Business was carried on till 31st March 2013 on which date the following P&L A/c was prepared.

Particulars	₹ in 000	*Particulars*	₹in 000
To Office rent	4,000	By Gross profit b/d	80,000
To Salaries	20,000	By Bad debts recovered	4,000
To Advertising	5,000		
To Partners, salary	3,000		
To Carriage	2,000		
To Provision for doubtful debts	1,000		
To Interest on loan	2,000		
To Underwriting commission	1,000		
To Insurance	3,000		
To Discount allowed	2,000		
To Net profit c/d	41,000		
	84,000		84,000

Additional information:

(i) The company's sales were uniform till the end of July but thereafter recorded an increase of 50% on an average.

(ii) The partner's salary was for the period before incorporation.

(iii) Interest on loan included ₹ 5,00,000 which was on in August 2012.

(iv) Bad debts recovered were from debtors written off in the year 2009.

You are required to ascertain the amount of profit made before and after incorporation.

4. XYZ Ltd. was formed on 1st April 2012 to take over the business of a firm as from 1st April 2012. All the profits made from this earlier date were to the benefit of company but interest on the purchase price of ₹ 50,000 was to be paid at 60% p.a. to the vendors upto the date of settlement in full on 1September 2012. The following was the statement of profit and loss for the year ended 31st March 2013.

Particulars	₹	*Particulars*	₹
To Management expenses	3,050	By Gross trading profits	20,000
To Bad debts	200		
To Director's fees	1,000		
To Interest to vendors	1,250		
To Preliminary expenses	1,250		
To Depreciation	1,000		
To Net profit	12,250		
	20,000		20,000

Out of the bad debts written off, ₹ 100 related to the period prior to incorporation. Apportion the profit earned between pre incorporation and post incorporation periods by preparing profit and loss account. You may assure that turnover was spread evenly over the entire year.

5. Public Ltd. Company was formed to take over a running business with effect from 1.04.2012. The company was incorporated on 1.08.2012 and the certificate of commencement of business was received on 1.10.2012.The following is the P&L A/c for the period 1.04.2012 to 31.03.2013

Particulars	₹ in 000	*Particulars*	₹ in 000
To Salaries	24,000	By Gross profit b/d	1,60,000
To Printing & stationery	2,400		
To Advertisement	8,000		
To Travelling expenses	8,400		
To Trade expenses	18,900		
To Rent	13,200		
To Electricity charges	2,100		
To Director's fees	5,600		
To Bad debts	1,600		
To Commission to selling agents	8,000		
To Audit fees	3,000		
To Debenture interest	1,500		
To Interest paid to vendors	2,100		
To Selling expenses	12,600		
To Depreciation	4,800		
To Net profit	43,800		
	1,60,000		1,60,000

Additional information:

a) Total sales for the year amounted to ₹ 96,00.00,000. This was even upto the date of certificate of commencement, thereafter they recorded an increase of two thirds during the rest of the year.

b) Rent was paid @ ₹ 10,00,000 per month upto September 2012 and thereafter it was increased by ₹ 2,00,000 per month.

c) Travelling expenses include ₹ 24,00,000 towards sales promotion.

d) Depreciation included ₹ 3,00,000 for assets acquired in the post incorporation period.

e) Purchase consideration was discharged by the company on 30th September 2012 by issuing equity shares of ₹ 10 each.

Calculate the profits prior to incorporation and post incorporation periods.

Lesson 2.2 Managerial Remuneration

Learning Objectives

After reading this lesson you should be able to

- Understand the important provisions relating to managerial remuneration
- Calculate the managerial remuneration
- Do the proper accounting treatment for managerial remuneration.

2.2.1 Introduction

The Companies Act lays down restrictions on the managerial remuneration to be provided by a public company or a private company which is a subsidiary of a public company. The section does not apply to private company unless it is a subsidiary of a public company. The term managerial remuneration includes remuneration payable to the Managing Director, Manager and Directors. It excludes executives who are not members of the Board of Directors. The Profit and Loss Account must contain, or give by way of a note, detailed information relating to all payments made or to be made to the company's managerial personal i.e., Directors, Managing Director or Manager, if any, by way of Companies Act, the total remuneration, commission or other benefits or perquisites.

2.2.2. Important Provisions Relating to Managerial Remuneration

Under section 198 of the companies act, the total remuneration payable to all the managerial staff – directors including any managing or whole time director or manager, in any financial year cannot exceed eleven per cent of the net profits of the company for that year. This limit of 11% does not include any fees payable to directors for the meetings of board or committee thereof, as per Section 198(2).

In case of no profits or inadequacy of profits in any year, the company pays, subject to the approval of the Central Government, in all by way of minimum remuneration up to ₹75,000 exclusive of any fees payable to directors for attending the meeting of board or a committee thereof.

However the Central Government may sanction an increase in the minimum remuneration (to such sum, for such period and subject to the such conditions as it may specify) where monthly payment is being made to any managing or whole time director

or manager to any one or more of them and the government is satisfied for efficient conduct of the company's business the minimum remuneration of ₹75,000 per annum is insufficient.

A whole time director or a managing director may be paid remuneration either by way of a monthly remuneration or at a specified percentage of net profits of a company or partly by one way and partly by other. But except with the approval of the central government such remuneration shall not exceed.

(a). 5% of the net profit for one such director

(b). 10% of the net profits for all of them together, if there are more than one such director.

A manager may get his remuneration by way of monthly payment or by a way of a specific percentage of the net profits or partly by way of monthly payments and partly by way of a percentage on the net profits (computed in accordance with sections 349-351). The total remuneration shall not normally exceed 5% of the net profits.

Managerial remuneration includes the following:

1. Any expenditure incurred by the company in providing any rent free accommodation of any other benefit or amenity in respect of accommodation free of charge to any of its managerial personal referred above.
2. Any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the aforesaid persons.
3. Any expenditure incurred by the company in respect of any obligation or service which but for such expenditure by the company, would have been incurred by any of the persons aforesaid.
4. Any expenditure incurred by the company to effect and insurance on the life of, or provides any pension, annuity or gratuity for any of the aforesaid persons, his spouse or child.

Section II - Remuneration payable by companies having no profit or inadequate profit without Central Government approval:

Where in any financial year during the currency of tenure of a managerial person, acompany has no profits or its profits are inadequate, it may, without Central

Governmentapproval, pay remuneration to the managerial person not exceeding the higher of the limitsunder (A) and (B) given below:—

(A):

Where the effective capital is	Limit of yearly remuneration payable shall not exceed (Rupees)
(i) Negative or less than 5 crores	30 lakhs
(ii) 5 crores and above but less than 100 crores	42 lakhs
(iii) 100 crores and above but less than250 crores	60 lakhs
(iv) 250 crores and above	60lakhs plus 0.01% of the effective capital in excess of ₹. 250 crores:

Provided that the above limits shall be doubled if the resolution passed by the shareholders is a special resolution. Explanation.—It is hereby clarified that for a period less than one year, the limits shall be pro-rated.

(B) In the case of a managerial person who was not a security holder holding securities of the company of nominal value of rupees five lakh or more or an employee or a director of the company or not related to any director or promoter at any time during the two years prior to his appointment as a managerial person, — 2.5% of the current relevant profit: Provided that if the resolution passed by the shareholders is a special resolution, this limit shall be doubled:

Section III.— Remuneration payable by companies having no profit or inadequate profit without Central Government approval in certain special circumstances:

In the following circumstances a company may, without the Central Government approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:—

(a)where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under section 197.

(b)where the company—

(i)is a newly incorporated company, for a period of seven years from the date of its incorporation, or

(ii)is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law Tribunal, for a period of five years from the date of sanction of scheme of revival, it may pay remuneration up to two times the amount permissible under Section II.

(c)where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal:

Provided that the limits under this Section shall be applicable subject to meeting all the conditions specified under Section II and the following additional conditions:—

(i) except as provided in para (a) of this Section, the managerial person is not receiving remuneration from any other company;

(ii)the auditor or Company Secretary of the company or where the company has not appointed a Secretary, a Secretary in whole-time practice, certifies that all secured creditors and term lenders have stated in writing that they have no objection for the appointment of the managerial person as well as the quantum of remuneration and such certificate is filed along with the return as prescribed under sub-section (4) of section 196.

(iii)the auditor or Company Secretary or where the company has not appointed secretary, a secretary in whole-time practice certifies that there is no default on payments to any creditors, and all dues to deposit holders are being settled on time.

(d)a company in a Special Economic Zone as notified by Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India, and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any financial year, may pay remuneration up to ₹ 24,00,000 per annum.

Section IV: Perquisites not included in managerial remuneration:

1. A managerial person shall be eligible for the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III:

(a)contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961(43 of 1961);

(b)gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and

(c)encashment of leave at the end of the tenure.

2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III—

(a) Children's education allowance: In case of children studying in or outside India, an allowance limited to a maximum of Rs. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

b) Holiday passage for children studying outside India or family staying abroad: Return holiday passage once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad to India if they are not residing in India, with the managerial person.

c) Leave travel concession: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

Explanation I.— For the purposes of Section II of this Part, "effective capital" means companies.

(B) "Remuneration" means remuneration as defined in clause (78) of section 2and includes reimbursement of any direct taxes to the managerial person.

Section V. —Remuneration payable to a managerial person in two companies:

Subject to the provisions of sections I to IV, a managerial person shall draw remuneration from one or both companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from any one of the companies of which he is a managerial person.

2.2.3 Computation of Net Profit for Managerial Remuneration

Net profit for the calculation of managerial remuneration to be computed in accordance with Section 249 and 350. The following credits or incomes in addition to the Gross Profit should be taken into account:

Bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

It prohibits giving of credit for the following items:

a) Premium on shares or debentures issued or sold by the Company.
b) Profits on sales by the company of forfeited shares.
c) Profits of a capital nature including profits from the sale of the undertaking or any of the undertaking or any of the undertakings of the Company, or any part thereof, and
d) Profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling such property or assets. Outgoing inclusive of contributions made under 293 (1) (e). This includes contributions made to charitable and other funds. That is up to ₹50,000 or 5%

From the income of the company the following to be deducted:

1. All the usual working charges.
2. Director's remuneration.
3. Bonus or commission paid or payable to any member of the Company's staff, or to any engineer, technician or persons employed or engaged by the Company, whether on a whole time or on a part time basis.
4. Any tax notified by the Central Government as being in the nature of tax on excess or abnormal profits.
5. Any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf.
6. Interest on debentures issued by the company.
7. Interest on mortgages executed by the Company and on loans and advances secured by a charge on its fixed or floating assets.
8. Interest on unsecured loans and advances.
9. Expenses on repairs whether to immovable or to movable property, provided the repairs are not of a capital nature.

10. Depreciation to the extent specified in section 350.
11. The expenses of expenditure over income which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained.
12. Any compensation or damages to be paid in virtue of any legal liability, including a liability arising from a breach of contract.
13. Any sum paid by way of insurance against the risk of meeting any liabilities such as is referred to in clause 13.
14. Debts considered bad and written off or adjusted during the year of accoun

The following sums shall not be deducted (section 349):

1. Income tax and super tax payable by the company under the Income tax Act 1961 or any other tax on the income of the company not falling under (4) and (5) above.
2. Any compensation, damages or payments made voluntarily, that is to say, otherwise than the virtue of a liability such as is referred in clause 13 above.
3. Loss of a capital nature is including loss on sale of the undertakings or any part thereof not including any excess referred to in the provision to section 350 of the written down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value.

2.2.3. 1 CHART SHOWING OVERALL PICTURE OF MANEGERIAL REMUNERATION

Different categories of managerial personal entitled to remuneration	*Maximum percentage of net profits*
1. Total managerial remuneration to all directors, managing director(s) or manager and/or whole-time director(s)	11% and if there are no profits or inadequate profits Rs. 75,000 to Rs. 2,00,000 per month per person depending on the effective capital of the company.
2. All directors when there is no manager or managing director or whole-time director.	3%
3. All directors when there is a manager or managing director or whole-time director.	1%
4. Whole-time director (when there is one such director)	5%
5. Managing director (when there is one such director)	5%

6. Managing director and whole-time director taken together or when number of whole-time directors or managing directors is two or more than two	10%
7. Manager (there is no provision of having more than one manager).	5%

Net Profit for the purpose of calculating managerial remuneration can be arrived in two different methods viz. Gross Profit Method and Net Profit Method.

2.2.3.1.1 Gross Profit Method:

In this method gross profit is considered as base and the income shown in the credit side are added. Allowable expenses in the P&L A/c are to be deducted. It is simply exhibited in the following format:

	₹	₹
Gross Profit as per P&L A/c		xxx
Add: Income to be taken into account		
Bounties and subsidies received from Government	xxx	
Capital Profit on the Sale of Fixed Assets	xxx	xxx
(Sale Proceeds – Original Cost)	xxx	xxx
Less; Expenses Allowable		
(i) Salaries & Wages	xxx	
(ii) Rent, Rates & Taxes	xxx	
(iii) Repairs & Renewals	xxx	
(iv) Misc. Expenses		
(v) Workmen Legal Compensation (not Voluntary Compensation)	xxx	xxx
(vi) Interest on Bank Draft	xxx	
(vii) Interest on Debentures	xxx	
(viii) Director's Fees	xxx	
(ix) Donation's as per Income Tax Act	xxx	
Depreciation as Income Tax Act	xxx	
Debenture Trustees Remuneration	xxx	
Net Profit for the purpose of calculating commission		xxx

2.2.3.1.2 Net Profit Method:

In this method net profit is considered as base and the items not allowable are added and allowable expenses are to be deducted. It is simply exhibited in the following format:

	₹	₹
Gross Profit as per P&L A/c		xxx
Add:Items not allowable:		

Managing Director's Remuneration	xxx	
Scientific Research Expenditure	xxx	
Provision for doubtful Debts	xxx	
Tax Provision	xxx	
Preliminary Expenses	xxx	
Depreciation (Already debited to P&L A/c – Depreciation Allowable under XIV of the Companies Act)	xxx	
Loss on the Sale of Investment	xxx	
Proposed Dividend	xxx	
Ex-Gratia Payment to Employees	xxx	
Manager's Salary	xxx	
Commission to Manager (on Account)	xxx	
Capital Expenditure	xxx	
Less: Items Allowable		
Bonus (Liability as per Payment of Bonus Act – Bonus already debited to P&L A/c)	xxx	
Capital Profit on Sale of Fixed Assets (in excess of original cost) (Sale Price i.e., Book Value +Profit – Original Cost)		
Profit on Sale of Investment (Capital Profit)	xxx	
Profit for the Purpose of Managerial Commission		

2.2.4 Practical Problems

Illustration: 1

The following is the Profit and Loss Account of Suresh Ltd. for the year ended 31st March 2012, before providing for the following:

1. Director's commission of 1% on Net Profit.
2. Managerial commission of 10% on Net Profit.

	₹		₹
To Depreciation on Fixed assets	30,000	By Gross Profit	5,00,000
To Compensation (Voluntary)	5,000	By Profit on Investment sold (Non-trading)	20,000
To Other expenses	3,40,000		
To Net Profit	1,45,000		
	5,20,000		5,20,000

Note: Depreciation allowance for income tax purposes amount to ₹ 25,000.

Redraft the Profit and Loss Account after providing for the amount of managerial commission on net profit due in accordance with the provisions of the Companies Act and show the computation of such amount of commission.

Solution:

Profit and Loss Account
for the year ended at 31st March 2012

Dr. Cr.

	₹		₹
To Depreciation	30,000	By Gross Profit	5,00,000
To Other expenses	3,40,000	By Profit on Investment	20,000
To Commission (Director – 1% of net profit)	1,216		
To Compensation	5,000		
To Managerial Commission (10% of net profit)	12,162		
To Net Profit	1,31,622		
	5,20,000		5,20,000

Note: Computation of commission:

Net profit computation of commission:

		₹
Gross Profit		5,00,000
Less: Permissible Expenses:		
Depreciation	25,000	
Other expenses	3,40,000	3,65,000
Net profit before charging commission:		1,35,000

(1) Commission ₹ 1,35,000 x 11/111 = ₹ 13,378

Directors' commission: (1,35,000 x 1/111) = ₹ 1,216

Managerial Commission: (1,35,000 x 10/111) = ₹12,162

Illustration: 2

The Manager of M/s Gayathri Ltd. is entitled to get salary of ₹ 2,500 per month plus 1% commission on the net profits of the company after such salary and commission. The following is the Profit and Loss Account of the Company for the year ended 31st March 2012.

	₹		₹
To Salaries, wages and bonus	1,92,500	By Gross Profit	9,00,000
To General expenses	74,000	By Subsidy from	
To Depreciation	82,000	Government	60,000
To Expenditure on Scientific Research (Cost of apparatus)	14,000	By Profit on sale of assets (Cost of ₹ 2,50,000 Written	
To Manager's salary	30,000	down value: ₹1,80,000)	1,00,000
To Manager's Commission (on account)	6,000		
To Bad Debts Reserve	17,500		
To Income Tax provision	2,40,000		
To Proposed Dividend	1,00,000		
To Balance c/d	3,04,000		
	10,60,000		10,60,000

Depreciation as per income tax rules amount to ₹81,000. Calculate the remuneration payable to the manager.

Solution:

Computation of Commission Payable

		₹	₹
Gross Profit			9,00,000
Add: Subsidy from Government			60,000
Profit on sale of assets		1,00,000	
Sale Price 1,80,000 + 1,00,000 =	2,80,000		
Less original cost	2,50,000	30,000	70,000
			10,30,000
Less: Salaries, Wages and bonus		1,92,500	
General expenses		74,000	
Depreciation as per income tax rules		81,000	
Manager's salary		30,000	3,77,500
			6,52,500

Commission payable = 6,52,500 x 1/101 = ₹ 6,460

Already paid = ₹6,000

Balance due ₹ 460

Illustration: 3

From the following particulars of Mathavan Limited, you are required to calculate the managerial remuneration in the following situation:

i. There is only one whole time director
ii. There are two whole time directors.
iii. There are two whole time directors, part time director and manager

Net profit before provision for income tax and managerial remuneration, but after depreciation and provision for repairs	₹ 17,40,820
Depreciation provided in the books	₹ 6,20,000
Provision for repairs of machinery during the year	₹ 50,000
Depreciation allowable under Schedule XIV	₹ 5,20,000
Actual expenditure incurred on repairs during the year	₹ 30,000

Solution:

Calculation of Net Profit under Section 349 of the Companies Act, 1956

		₹	₹
Net profit before provision for income tax and managerial remuneration, but after depreciation and provision for repairs			17,40,820
Add back: Depreciation provided	6,20,000		
Provision for repairs of machinery		50,000	6,70,000
			24,10,820
Less: Depreciation allowable under schedule XIV		5,20,000	
Actual expenditure on repairs		30,000	5,50,000
Profit as per Section 349			18,60, 820

Calculation of Managerial Remuneration as per Section 198 and 309

i) When there is only one whole time director

Managerial Remuneration = 5% of ₹18,60, 820= ₹93,041

ii) When there are two whole time directors

Managerial Remuneration = 10% of ₹18,60, 820= ₹1,86,082

iii) When there are two whole time directors, a part time director and a manager

Managerial Remuneration = 11% of ₹. 18,60, 820= ₹2,04,690.

Illustration: 4

From the following figures extracted from the books of a company calculate the maximum permissible managerial remuneration to the Managing Director under the Company Law: Net Profit ₹98,970; Provision for taxation ₹1,50,650; Remuneration to Managing Director ₹19,360; Preliminary expenses ₹15,000; Provision for doubtful debts ₹13,000; Depreciation ₹.48,300;Donation to another concern ₹.15,000; Voluntary payment to returning employee ₹.5,000. All these items have been adjusted in arriving at the above net profit. Depreciation admissible under income tax rules ₹45,000. There are no other managerial personnel.

Solution

CALCULATION OF NET PROFIT UNDER SECTION 349 OF THE COMPANIES ACT, 1956

		₹	₹
	Net profit(given)		98,970
Add:	Remuneration to Managing Director	19,360	
	Provision for income tax	1,50,650	
	Preliminary expenses	15,000	
	Provision for doubtful debts	13,000	
	Donation to another concern	15,000	
	Voluntary payment to returning employee	5,000	
	Excess Depreciation chaged (48,300-45,000)	3,300	2,21,310
Net profit for managerial remuneration			3,20,280

Commission to full-time director at maximum 5% permitted by law

= 3,20,280x5/100 = ₹16,014

2.2.5 Self Test Questions

Theory

1. What is maximum rate of managerial remuneration in case of public limited company?
2. Explain the provisions relating to managerial remuneration under the Companies Act.
3. Describe the methods of computing managerial remuneration.

Problems

1. Calculate the managerial remuneration from the following particulars of Ankit & Co. Ltd. Due to the managing directors of the company at the rate of 5% of the profits. Also determine the excess remuneration if any:

Particulars	₹
Net Profit	4,00,000
Net profit is calculated after considering the following	
i. Depreciation	55,000
ii. Preliminary expenses	10,000
iii. Provision for Taxation	4,20,000
iv. Directors fees	16,000
v. Bonus	30,000
vi. Profit on sale of fixed assets (original cost ₹. 40,000; WDV –	31,000
₹22,000)	18,000
vii. Provision for doubtful debts	35,000
viii. Scientific research expenditure (for setting up new machinery)	30,000
ix. Managing directors remuneration paid	40,000
Other Information:	36,000
i. Depreciation allowable under income tax rules	
ii. Bonus liability as per payment of Bonus Act 1965	

2. The following is the profit & loss account of Charles & Rahim Ltd. Calculate

i. The overall maximum remuneration under section 198 and
ii. The maximum commission permissible to directors
   a. When not assisted by managing director or manager or whole time directors,
   b. When assisted by a managing directors/ manager/whole time directors.

Profit & loss A/c

	₹		₹
To Salaries & wages	4,20,000	By Gross profit	75,75,000
To Directors' fees	1,80,000	By Subsidy from	
To Repairs & renewals	1,80,000	Central Govt.	3,60,000

To Miscellaneous expenses To Workmen's compensation including Rs. 30,000 legal compensation To Loss on sale of investments To Scientific Research (new laboratory) To compensation for breach of contract To Donation to charitable institutions To Depreciation (including development rebate ₹ 75,000 and initial depreciation ₹ 30,000) To Provision for income tax To Proposed dividend To Interest on debentures To Interest on unsecured loans To Balance c/d	1,44,000 75,000 3,75,000 6,00,000 36,000 1,05,000 6,00,000 18,00,000 12,00,000 1,50,000 30,000 34,80,000	By profit on sale of a fixed asset Cost 24,40,000 WDV <u>12,00,000</u>	14,40,000
	93,75,000		93,75,000

4. From the following particulars of Bharathi Ltd. determine the maximum remuneration payable to the part time directors and manager under section 309 and 387 of the Companies Act. Before charging any such remuneration, the Profit & Loss Account showed a credit balance of ₹. 23,10,000 for the year ended 31st March 2015 after taking into account the following matters:

		₹
i.	Capital expenditure	5,25,000
ii.	Subsidy received from Government	4,20,000
iii.	Special Depreciation	70,000
iv.	Multiple shift allowance	1,05,000
v.	Bonus to foreign technicians	3,15,000
vi.	Provision for taxation	28,00,000
vii.	Compensation paid to injured workman	70,000
viii.	Ex-gratia to an employee	35,000
ix.	Loss on sale of fixed assets	70,000
x.	Profit on sale of investment	2,10,000

Company is providing depreciation as per section 350 of the companies Act.

Lesson 2.3 Company Final Accounts

Learning Objectives

After reading this lesson you should be able to

- Know the important provisions relating to final accounts of joint stock companies
- Familiar with the prescribed formats of the Profit and Loss Account and Balance Sheet of a company
- Understand the mode of disclosure of accounting policies adopted by a company and accounting treatment for specific adjustment in final accounts
- Prepare final accounts of companies.

2.3.1 Introduction

It is not obligatory to sole proprietors and partnership firms to prepare the final accounts as per the statute. But, according to Section 210 of Indian Companies Act 1956 it is a statutory obligation to a joint stock company to prepare its final accounts. The final accounts of a company consist of (a) Balance Sheet and (b) Profit and Loss Account.

2.3.2 Final Accounts of Companies

There is no statutory obligation upon sole proprietorship or partnership firms to prepare final accounts, but companies have a statutory obligation to prepare final accounts as required by section 210 of the companies act. The general principles of preparing the final accounts of joint stock companies are the same as in the case of the sole proprietorship or partnership firms. But in addition to these principles, a joint stock company must conform to certain legal provisions as given in the companies act, 1956 in respect of forms and contents of the final accounts. It may be remembered that the provisions of the Companies Act, 1956 relating to forms and contents of the final account do not apply to insurance, banking and electricity companies which are governed by special acts relating to such companies.

2.3.3 Legal Position Regarding Final Accounts of Companies

Section 209 to 220 of the Companies Act, 1956 deals with the legal position relating to the final accounts of joint stock companies. A brief mention of these legal provisions is given below:

Section 209: As per this section, books of accounts should be maintained on accrual basis and according to the double entry system of accounting to the double entry system of accounting to ensure that these represent true and fair view of the affairs of the company. The books of account should not suppress any transaction nor should they contain any fictitious transaction.

Section 210: It deals with the preparation and presentation of the final accounts of a joint stock company.

Section 211: It deals with form and contents of the Balance Sheet and P&L A/c.

Section 212: It deals with the disclosure of certain particulars in the Balance Sheet of a holding company in respect of its subsidiaries.

Section 213: It makes provision for extension of the financial year of the holding company and subsidiary.

Section 214: It makes provisions regarding rights of holding company's represent activities and members to inspect books of accounts kept by any of its subsidiaries.

Section 215: As per this section, the Balance Sheet and P&L A/c of a company shall be authenticated, (i.e., signed) on behalf of the Board of Directors by its manager or secretary, if any, and by not less than two directors of a company, one of whom shall be a managing director, where there is one. When only one of the directors of a company is for the time being in India, the balance sheet an P&L A\c shall be signed by such a director, but in such a case, there shall be attached to the balance sheet and P&L A/c a statement signed by him explaining the reasons for the non-compliance.

Section 216: As per this section, the P&L A/c shall be treated as an annexure to the balance sheet and the auditors' report as an enclosure thereto.

Section 217: The report of Board of Directors shall be attached to every Balance Sheet laid before the shareholders in general meeting.

Section 218: It provides for penalty for improper issue, circulation or publication of Balance Sheet and P&L A/c.

<u>Section 219</u>: It deals with the right of the member to copies of Balance Sheet and P&L A/c, auditors' report and other documents required by law to be annexed or attached to the Balance Sheet, which is to be presented in the general meeting.

<u>Section 220:</u> According to this section, three copies of the Balance Sheet and P&L A/c shall be filed with Registrar within 30 days after the annual general meeting.

2.3.4 Preparation and Presentation of the Final Accounts

In respect of preparation and presentation of the final accounts the requirement of section 210 of the companies act are quoted below:

1. At every annual general meeting of a company in pursuance of section 166, the Board of Directors of the company shall lay before the company: (a) a balance sheet as at the end of the period specified in sub-section(3); and (b) a P&L A/c for that period.
2. In the case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of P&L A/c and all references to "P&L A\c", "profit" and "loss" in this section and elsewhere in this act shall be construed, in relation to such a company as references respectively to the income and expenditure account", "the excess of income over expenditure" and "the excess of expenditure over income".
3. The profit and loss account shall relate:
   (a) In the case of the first annual general meeting of the company to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months; and
   (b) In the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months or in case where an extension of time has been granted for holding the meeting under the second provision to sub-section (I) of section 166, by more than six months and the extension so granted.
4. The period of which the account aforesaid relates is referred to in this act as a financial year and it may be less or more than a calendar year, but it shall not exceed fifteen months.
5. If any person, being a director of a company, falls to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees or with both:

   Provided that in case of any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that a competent and

realiable person was charged with the duty of seeing that the provisions of this section were complied with and in a position to discharge that duty.

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed willfully.

6. If any person, not being a director of the company, having been charged by the Board of Directors with the duty of seeing that the provisions of this section be complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may exceed to six months, or with fine which may extend to one thousand rupees or with both:

   Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

2.3.5 Constitution of National Advisory Committee on Accounting Standards

Section 210A

1) The Central Government may, by notification in the Official Gazette, constitute an Advisory Committee to be called the National Advisory Committee on Accounting Standards (hereafter in this section referred to as the "Advisory Committee") to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies or class of companies under this act.
2) The Advisory Committee shall consist of the following members, namely:
   (a) A Chairperson who shall be a person of eminence well versed in accountancy, finance, business administration, business law, economics or similar discipline:
   (b) One member each nominated by the Institute of Chartered Accountants of India constituted under the Chartered Accountant Act, 1949 (38 0f 1949), the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 (23 of 1959) and the Institute of Companies Secretaries of India constituted under the Company Sectaries Act, 1980 (56 of 1980).
   (c) One representative of the Central Government to be nominated by it;
   (d) One representative of the Reserve Bank of India to be nominated by it;
   (e) One representative of the comptroller and Auditor-General of India to be nominated by him;
   (f) A person who holds or has held the office of professor in accountancy, finance or business management in any university or deemed university;
   (g) The chairman of the central board of direct taxes constituted under the central boars of revenue Act, 1963 (54 of 1963) or his nominee;
   (h) Two members to represent the chambers of commerce and industry to be nominated by the Central Government; and
   (i) One representative of the securities and exchange board of India to be nominated by it.

3) The Advisory Committee shall give its recommendations to the Central Government on such matters of accounting policies and auditing as may be referred to it for advice from time to time.

4) The members of the Advisory Committee shall hold office for such terms as may be determined by the Central Government at the time of their appointment and any vacancy in the membership in the committee shall be filled by the Central Government in the same manner as the member whose vacancy occurred was filled.
5) The non-official members of the Advisory Committee shall be entitled to such fees, travelling, conveyance and other allowances as are admissible to the officers of the Central Government of the highest rank.

2.3.6 Compliance with the Accounting Standards

According to section 211 as amended by the Companies (Amendment) Act, 1999, every profit and loss account and balance sheet of a company shall comply with accounting standards. As per Section 211 (3A, 3B & 3C) of the Companies Act, 1956, the accounting standards recommended by the Institute of Chartered Accountants of India and prescribed by central government in consultation with National Advisory Committee on Accounting Standards are mandatory and applicable to all companies while preparing profit and loss account and balance sheet. Where the Profit & Loss Accountand the Balance Sheet of a company do not comply with the accounting standards, such a company shall disclose in its profit and loss account and balance sheet (a) the deviation from the accounting standards; (b) the reasons for such deviation and (c) the financial effect, if any, arising due to such deviation.

2.3.7 Form and Contents of Profit & Loss Account

Sub-section (2) of Section 211 of the companies act, 1996 requires – “Every profit & loss a/c of a company shall give true and fair view of the profit of loss of the company for the financial year and comply with the requirements of Part II of Schedule VI so for as they are applicable thereto.

Provided that nothing continued in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of profit and loss account has been specified in or under the act governing such class of company.”

It is also given in sub-section (3) of Section 211 that the Central Government may by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements in Schedule VI if, in its opinion, it is necessary to grant exemption in the public interest. Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

2.3.8 Form and Contents of Balance Sheet

Section 210 of the companies act requires that at every annual general meeting of the shareholders, the board of directors of the company shall lay before the company a balance sheet as at the end of each trading period. It is laid down in section 211 (1) that every balance sheet of a company shall be prepared in the form given in part I of the schedule VI of the Companies Act, 1956, or as near thereto as circumstances admit, or in such other form as may be approved by the Central Government either generally or in a particular case. It further states that in preparing the Balance Sheet due regard shall be had, as far as may be, to the general instructions for preparation of the Balance Sheet. The objective of prescribing the form for the Balance Sheet in Schedule VI is to make sure that Balance Sheet exhibits a true and fair view of the state of affairs of the company. There should be no room for window dressing, showing a better position than what actually is and secret reserves showing a worse picture than what actually is.

Ministry of Corporate Affairs, Government of India has recently replaced the existing Schedule VI by a revised Schedule VI wherein several changes in the presentation and disclosures requirements have been made. The most important change in that the financial statements will be presented in the vertical format. Revised Schedule VI shall come into force for the Balance Sheet and Profit and Loss Statement to be prepared by all the companies for the financial year commencing on or after 1-4-2011 i.e., financial year 2011-12 onwards.

"SCHEDULE VI"

(See section 211)

GENERAL INSTRUCTIONS FOR PREPRATION OF BALANCE SHEET AND STATEMENT OF PROFIT AND LOSS OF A COMPANY IN ADDITION TO THE NOTES INCORPORATED ABOVE THE HEADING OF BALANCE SHEET UNDER

General Instructions

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes inter as, in the financial statements or statements forming part thereof, the same shall be made and the requirements of the Schedule VI shall stand modified accordingly.
2. The disclosure requirements specified in Part I and Part II of this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 1956. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the

face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregation's of items recognised in those statements and (b) information about items that do not qualify for recognition in those statements.

   Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing information as a result of too much aggregation.

4. Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as below:

Turnover	Rounding off
To the rupees	Less than one hundred crore nearest hundreds, thousands, lakhs or millions or decimals thereof.
To the rupees or more	Nearest, lakhs, millions or crores, or decimals thereof.

   Once a unit of measurement is used, it should be used uniformly in the Financial Statements.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of this schedule, the terms used herein shall be as per the applicable Accounting Standards.

Notes: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I – Form of BALANCE SHEET

Name of the Company.....................................

Balance Sheet at... (Rupees in..........)

Particulars	*Note No.*	*Figures as at the end of the current reporting period*	*Figures as at the end of the previous reporting period*
1		3	4
I. EQUITY AND LIABILITIES			
(1) Shareholder's funds			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-current liabilities			
(a) Long-term borrowings			
(b) Deferred tax liabilities (Net)			
(c) Other Long term liabilities			
(d) Long-term provisions			
(4) Current liabilities			
(a) Short-term borrowings			
(b) Trade payables			
(c) Other current liabilities			
(d) Short-term provisions			
TOTAL			
II. ASSETS			
(1) Non-current Assets			
(a) Fixed Assets			
(i) Tangible Assets			
(ii) Intangible assets			
(iii) Capital work-in-progress			
(iv) Intangible assets under development			
(b) Non-current investments			
(c) Deferred tax assets (Net)			
(d) long-term loans			
(e) Other non-current assets			
(2) Current Assets			
(a) Current investment			
(b) Inventories			
(c) Trade Receivables			
(d) Cash and cash equivalents			
(e) Short-term loans and advances			
(f) Other current assets			
TOTAL			

See accompanying notes to the financial statements.

PART II –FORM OF STATEMENT OF PROFIT AND LOSS

Name of the Company....................................

Profit and Loss Statement for the year ended.............................

	Particulars	Note No.	Figures for the current reporting period	Figures for the previous reporting period
I.	Revenue from operations		xxx	xxx
II.	Other Income		xxx	xxx
III.	Total Revenue (I+II)		xxx	xxx
IV.	Expenses:			
	Cost of materials consumed		xxx	xxx
	Purchases of Stock-in-Trade		xxx	xxx
	Changes in inventories of finished goods work-in-progress and Stock-in-Trade		xxx	xxx
	Employees benefits expense			
	Other expenses			
	Total expenses		xxx	xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)		xxx	xxx
VI.	Exceptional items		xxx	xxx
VII.	Profit before extraordinary items and tax (V-VI)		xxx	xxx
VIII.	Extraordinary items		xxx	xxx
IX.	Profit before tax (VII-VIII)		xxx	xxx
X.	Tax expenses:			
	(1) Current tax			
	(2) Deferred tax			
XI.	Profit/(loss) for the period from continuing operations (VII-VIII)		xxx	Xxx
XII.	Profit/(loss) from discontinuing operations		xxx	Xxx
XIII.	Tax expense of discontinuing operations		xxx	xxx
XIV.	Profit/(loss) from discontinuing operations (after tax) (XII-XIII)			
XV.	Profit/(Loss) for the period (XI+XIV)		xxx	xxx
XVI.	Earnings per equity share:			
	(1) Basic		xxx	xxx
	(2) Diluted		xxx	xxx

See accompanying notes to the financial statements

2.3.9 Accounting treatment for the special transactions

Provision for taxation

Income tax is payable in the assessment year on the income earned during the previous year. A company will estimate the tax payable for the current accounting period and on this basis it will make provision for taxation. Provision for taxation is debited to Profit and loss Account and it will appear on the liability side of balance sheet under the head 'Provisions'. When assessment completed, the provision for tax will be adjusted. If the assessed tax is more than the provision made in the previous year, the excess has to be shown on the debit side of Profit and Loss Appropriation Account. If the assessed tax is less than the opening provision, such excess provision should be credited to the Profit and Loss Appropriation Account.

Dividend

The divisible profit (profit available to shareholders) of a company is distributed among the shareholders of the company on the basis of number of shares held. This is called dividend. The Board of Directors recommends the amount of dividend and the shareholders in their annual general meeting declare the dividend recommended by the Board of Directors. Dividend is usually paid on paid up capital.

Proposed dividend

It is the dividend recommended by Board of Directors after the close of the books of account. When it is approved by the shareholders in the annual general meeting, it becomes final dividend.

Interim dividend

Interim dividend refers to the dividend paid by the company before the preparation of final accounts. It is declared between two annual general meetings.

Final dividend

It is the dividend which is proposed and declared at the end of the accounting year after the close of the books of account.

Unclaimed dividend

It refers to the dividend not yet claimed by the shareholders within 30 days of declaration of dividend. It is shown as a current liability in the balance sheet.

Corporate Dividend Tax (CDT)

The companies distributing dividend are required to pay tax on such dividends. It is called Corporate Dividend Tax (CDT). CDT is payable on any amount declared, distributed or paid by a company as dividend. At present, the rate of CDT is 16.995 %(17%). Corporate Dividend Tax is shown on the debit side of Profit and Loss Appropriation Account and on the liability side of Balance sheet under the head 'Current liabilities and Provisions' (Provisions).

Transfer to Reserves

Generally, Board of Directors has the discretionary power regarding the transfer of profit to the reserve. However, as per Section 205(2A) of the Act, it is compulsory for a company to transfer certain minimum amount to the reserve at a rate not exceeding 10%. Amount of transfer to reserve depends on the rate at which dividend is to be declared as follows:

i. If the dividend proposed exceeds 10% but not exceed 12.5% of the paid up capital, the amount to be transferred to the reserve shall not be less than 2.5% of the current profits.

ii. If the dividend proposed exceeds 12.5% but not exceed 15% of the paid up capital, the amount to be transferred to the reserve shall not be less than 5% of the current profits.

iii. If the dividend proposed exceeds 15% but not exceed 20% of the paid up capital, the amount to be transferred to the reserve shall not be less than 7.5% of the current profits.

iv. If the dividend proposed exceeds 20% of the paid up capital, the amount to be transferred to the reserve shall not be less than 10% of the current profits.

v. **Difference between Reserves and Provisions**

Reserves	Provisions
1. It is an appropriation of profit. Hence it is debited to Profit and Loss Appropriation Account	1. It is a charge against profit. Hence it is debited to Profit and Loss Account
2. It needs not be created when profits are inadequate.	2. It must be made irrespective of whether profit or loss.
3. It is shown on the liability side of balance sheet under the head 'Reserves and Surplus'.	3. It is usually shown by way of deduction from the amount of the item for which it is created.
4. It can be utilized for distribution of dividend.	4. It cannot be utilized for distribution of dividend.

2.3.10 Practical Problems

Illustration 1

Prepare a balance sheet in vertical form as at 31st March, 2012 from the following information of ABC Ltd as required under Part I of Schedule VI of the Companies Act, 1995:

	₹.		₹.
Term loan	10,00,000	Loss for the year	3,58,000
Sundry creditors	11,45,000	Sundry debtors	12,25,000
Advances	3,72,000	Loans from debtors	2,00,000
Cash & bank balance	2,75,000	Provision for doubtful debts	20,200
Staff advances	55,000	Stores	4,00,000
Taxes payable	1,70,000	Fixed assets (WDV)	51,50,000
Securities premium	4,75,000	Finished goods	7,50,000
Loose tools	50,000	General reserve	20,50,000
investments	2,25,200	Capital work-in-progress	2,00,000

Additional Information

1) Share capital consists of :
   a. 3,000 equity shares of ₹ 100 each fully paid up.
   b. 10,000 – 10% redeemable preference shares of ₹ 100 each fully paid up.
2) Term loans are secured.
3) Depreciation on assets ₹ 5,00,000.
4) Schedules need not be given. However, groupings should form part of the answer.

Solution:

ABC Limited's Balance Sheet

as on March 31, 2012 (₹. In 000)

	Note No.	*As on 31-3-2012*	*As on 31-3-2012*
Equity and Liabilities		₹	₹
1) Shareholder's funds:			
(a) Share Capital	A	13,00,000	
(b) Reserve and Surplus	B	21,67,000	34,67,000
2) Non-Current Liabilities			10,00,000
Long-term Borrowings (secured loans)			
3) Current Liabilities			
Trade Payable (Sundry Creditors)		11,45,000	
Other Current Liabilities	G	3,70,000	15,15,000

4) Suspense Account (Balancing Figure) Total Equity and Liabilities			27,00,000 86,82,000
Assets *Non-Current Assets* (1) Fixed Assets: Tangible Assets Non-Current investments (assumed)	 I K		 53,50,000 2,25,000 55,75,200
(2) Current Assets: a) Inventories b) Sundry Debtors c) Cash & Cash Equivalents d) Short-Term loans and Advances	O P Q R	12,00,000 12,04,800 2,75,000 4,27,000	 31,06,800 86,82,000

Accompanying Notes to the Balance Sheet

A. *Share Capital:*

	₹
3,000 Equity Shares of Rs. 100 each	3,00,000
10,000 – 10% Redeemable Preference Shares of Rs. 100 each	10,00,000
	13,00,000

B. *Reserve & Surplus:*

Securities Premium	4,75,000
General Reserve	20,50,000
	25,25,000
Less: Loss for the year	3,58,000
	21,67,000

G. *Other Current Liabilities*

Loan from Debtors	2,00,000
Taxes Payable	1,70,000
	3,70,000

I. *Tangible Assets*

Fixed Assets at cost	56,50,000
Less: Depreciation	5,00,000
Capital Work-in-progress	2,00,000
	53,50,000

O. *Inventories:*

Finished Goods	7,50,000
Stores	4,00,000
Lose Tools	50,000
	12,00,000

P. *Sundry Debtors:*

	12,25,000
Less: Provision for Doubtful Debts	20,200
	12,04,800

Q. *Cash and Cash Equivalents:*

Cash & Bank Balance	2,75,000

R. *Loans & Advances:*

Advances	3,72,000
Staff Advances	55,000
	4,27,000

Illustration 2

The authorised capital of X Ltd is ₹5,00,000 consisting of 2,000 (6%) preference shares of ₹100 each and 3,000 equity shares of ₹10 each. Following was the trial balance sheet of X Ltd as on 31-03-2012:

TRIAL BALANCE

As on 31-03-2012

	Dr. ₹	*Cr.* ₹
Investment in shares at cost	50,000	
Purchases	4,90,500	
Selling expenses	79,100	
Stock as on 1-4-2011	1,45,200	
Salaries & Wages	68,500	
Cash on hand	12,000	
Interim preference dividend for the half year to 30-09-2011	6,000	
Bills receivable	41,500	
Investment on bank overdraft	7,800	
Investment on debentures upto 30-9-2011	3,750	
Sundry debtors and creditors	50,100	87,850
Freehold property at cost	4,86,500	
Furniture at cost less depreciation of ₹ 15,000	35,000	
6% Preference share capital		2,00,000
Equity share capital fully paid up		2,00,000
5% Mortgage debentures secured on freehold properties		1,50,000
Income Tax paid in advance for 2011-12	10,000	
Dividends		4,250
Surplus A/c (1-4-2011)		28,500
Sales (Net)		6,70,350
Bank Over-draft secured by hypothecation of stocks and receivables		1,50,000
Audit fees	5,000	
	14,90,950	14,90,950

You are required to prepare the statement of P&L for the year ended 31-3-2012 and the balance sheet as on that date after taking into account the following:

(a) Closing stock was valued at ₹1,42,500

(b) Salaries and wages include ₹5,000 worth of goods and articles distributed among valued customers

(c) Salaries and wages include ₹2,000 being wages incurred for installation of electrical fitting which were recorded under "Furniture".

(d) Bills receivables include ₹ 1,500 being dishonoured bills 50% of which had been considered irrecoverable.
(e) Bills receivable of ₹2,000 maturing after 31-3-2012 were discounted.
(f) Depreciation on furniture is to be charged at 10% on written down value.
(g) Interest on debentures for half year ending on 31-3-2012 was due on that date.
(h) Provide provision for taxation ₹4,000.
(i) Salaries debtors include ₹6,000 debts due for more than six months.
(j) Corporate dividend tax is to be ignored.

Solution:

X Ltd

PART II – STATEMENT OF PROFIT & LOSS

For the year ending 31st March, 2012 *(₹ in 000)*

Particulars	*Note No.*	*Years Ending 31-3-2012*	*Year Ending 31-3-2011*
I. Revenue from operations	1	670.35	
II. Other income: Dividends		4.25	
III. Total Revenue (I+II)		674.60	
IV. Expenses:			
Cost of goods sold:	2	488.20	
Employees Benefits Expenses	3	56.50	
Finance Costs	4	15.30	
Depreciation	5	3.70	
Other expenses	6	99.85	
Total Expenses		663.55	
V. Profit before tax (III – IV)		11.05	
VI. Tax expenses: Provision for taxation		4.00	
VII. Profit for the period (V – VI)		7.05	

Note Forming Part of Statement of Profit and Loss

Revenue from Operations*(₹. In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Sales (Net)	670.35	

Cost of Goods Sold(₹. *In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Opening Stock	145.20	
Add: Purchases 490.50		
Cost of goods distributed among valued customers treated as advertisement - 5.00		
	485.50	
	630.70	
Less: Closing Stock	142.50	
	488.20	

Employees Benefits Expenses(₹. *In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Salaries & Wages	68.50	
Less: Wages for installation of electrical fittings capitalised	2.00	
	66.50	
	10.00	
Less; Closing Stock	56.50	

Finance Costs(₹. *In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Investment on Bank Overdraft	7.80	
Interest on Debentures (3,750 + 3,750 Outstanding)	7.50	
	15.30	

Depreciation and Amortisation Expenses (₹. *In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Depreciation on Furniture – 10% on Rs. 37.00	3.70	

Other Expenses (₹. *In 000)*

	Years Ending 31-3-2012	*Years Ending 31-3-2011*
Selling Expenses	79.10	
Advertisement Expenses (Goods distributed among valued customers)	5.00	
Director's Remuneration	10.00	
Audit fees	5.00	
Bad debts	0.75	
	99.85	

X Ltd.

PART I – BALANCE SHEET

As on 31-3-2012 (*₹. In 000)*

Particulars	*Note No.*	*Figures as at 31-3-2012*	*Figures as at 31-3-2011*
I. Equity and Liabilities			
(1) Shareholders' Funds			
Share capital	A	400.00	
Reserve & Surplus	B	29.55	
		429.55	
(2) *Non-Current Liabilities*			
Long-term borrowings	C	150.00	
(3) *Current Liabilities*			
Trade Payable (Creditors)		87.85	
Other Current Liabilities	G	153.75	
Short-term provisions	H	4.00	
		245.60	
Total of Equity and Liabilities (1) +(2) + (3)		825.15	
II. Assets			
Non-Current Assets			
1) Fixed Assets			
Tangible Assets	I	519.80	
Non-current Investments	K	50.00	
		569.80	
2) *Current Assets*			
Inventories	O	142.50	
Trade Receivables	P	90.85	
Cash and Cash Equivalents	Q	12.00	
Other Current Assets	S	10.00	
		255.35	
Total oaf all Assets (1) + (2)		825.15	

Notes Forming Part of Balance Sheet

Share Capital*(₹. In 000)*

	31-3-2012	*31-3-2011*
Authorised		
2,000 (6%) Preference Shares of Rs. 100 each	200.00	
30,000 Equity Shares of Rs. 10 each	300.00	
	500.00	
Issued, Subscribed & Paid up capital		
2,000 (6%) Pref. Shares of Rs. 100 each fully paid up	200.00	
20,000 Equity Shares of Rs. 10 each fully paid up	200.00	
	400.00	

Reserve and Surplus(₹. *In 000)*

	31-3-2012	*31-3-2011*
Surplus		
Balance as on 1-4-2011	28.50	
Net Profit for the year ending 31-3-2012 7.05		
Less: Interim Preference Dividend	1.05	
6.00	29.55	

Long-term Borrowings(₹. *In 000)*

	31-3-2012	*31-3-2011*
5% Mortgage Debentures (Secured on Freehold Property)	150.00	

Other Current Liabilities(₹. *In 000)*

	31-3-2012	*31-3-2011*
Interest on debentures outstanding	3.75	
Bank overdraft (secured by hypothecation of stocks and re ceivables)	150.00	
	153.75	

Tangible Assets(₹. *In 000)*

	31-3-2012	*31-3-2011*
Freehold Property (at Cost)	48.50	
Furniture at Cost (35 + 15 Dep. + Addition) 52.00		
Less: Depreciation to date (15 + 3.7)	33.30	
18.70	519.80	

Non-Current Assets((*₹. *In 000)

	31-3-2012	*31-3-2011*
Investment in Shares (at Cost)	50.00	

Inventories(₹. *In 000)*

	31-3-2012	*31-3-2011*
Closing Stock (Finished Goods assumed)	142.50	

Trade Receivables(₹. *In 000)*

			31-3-2012	*31-3-2011*
Sundry Debtors:				
a). Debtors Out standings for a period ----- --- exceeding 6 months		6.00		
b). Other Debtors		44.100		
Dishonored Bill	1.50			
Less: Bad Debts (50%)	0.75			
		0.75044.85		
Bills Receivables		41.50	50.85	
Less: Bills Dishonoured		1.50		
			40.00	
			90.85	

Cash and Cash Equivalents(₹. *In 000)*

	31-3-2012	*31-3-2011*
Cash in Hand	12.00	

Other Current Assets(₹. *In 000)*

	31-3-2012	*31-3-2011*
Advanced Income Tax	10.00	

T. Contingent Liabilities and Commitments

1. A contingent liability for bills discounted ₹ 2,000 which will mature after 31-3-2012.
2. Fixed preference dividend for half year @ 6% p.a. on ₹ 2,00,000 preference capital is not provided for the accounts.

Working Note:

(1) Calculation of depreciation and Gross value of furniture

		₹.
Furniture at cost less depreciation as on 1-4-2011		35,000
Add: installation of electrical fittings		2,000
		37,000
Less: Depreciation 10% for 2011-12		3,700
		33,300
Book value as at 31-3-2012	₹.	
Add: Accumulated depreciation up to 31-3-2011	15,000	
Depreciation for 2011-12	3,700	18,700
Furniture at cost		52,000

Illustration 3

Following balances are extracted from the books of Cloth Trading Company Private Ltd. for the year ended 31st March, 2012:

	₹
Share Capital:	
Authorised, Issued and fully paid (50,000 Equity Shares)	5,00,000
General Reserve (as at 1-4-2011)	1,50,000
Furniture (including additions of Rs. 5,000 during 2011-12)	35,000
Office Equipments (as at 1-4-2011)	22,000
Motor Car (purchased on 1-4-2011)	30,000
Sundry Debtors (unsecured)	8,50,000
Advances to staff (unsecured)	10,000
Balance with Post Office in Savings Account (on 28-3-2012)	20,000
Cash in hand	2,000
Balance with Bank of India (including Fixed Deposits ₹1,00,000)	1,20,000
Loans from Directors (unsecured)	2,00,000

Liability for Expenses and goods supplied	2,67,000
Provision for Taxation (1-4-2011)	1,00,000
Surplus Account (as 1-4-20110	3,000
Closing Stock of cloth (20,000 meters)	3,00,000
Advances Tax paid	1,90,000
Depreciation written off upto 31-3-2011 (Furniture ₹ 5,000 Office Equipment ₹ 2,000)	
Opening stock of cloth (10,000 meters)	7,000
Legal charges (including ₹ 3,000 paid to auditors for tax representation)	1,50,000
Salaries to Staff	10,000
Miscellaneous Expenses (including travelling expenses of ₹ 4,000 in India and ₹36,000 for visit abroad for exports by	50,000
Managing Director)	2,00,000
Purchase of Cloth (2.10 lac metres)	30,39,000
Audit Fees	4,000
Interest on Fixed Deposits with Bank	5,000
Sales (2 lac metres)(including expert sales of ₹10 lacs)	35,00,000

Following further information is also given to you:

a) Rate of depreciation for (1) Furniture 10%; (2) Office Equipments 15%; (3) Motor Car 20%;
b) Managing Director is entitled to outstanding to commission @ 10% 0on Net Profits subject to maximum of ₹ 36,000 per month.
c) Sundry debtors include ₹ 1,50,000 outstanding for more than 6 months. Out of this ₹20,000 is considered doubtful for which provision is to be made in the accounts for 2011-12.
d) Tax liability for 2011-12 is estimated at ₹2 lacs for which provision is to be made.
e) The directors have decided to transfer ₹ 50,000 out of the net profit to General Reserve and have proposed to pay dividend @ 6% on Equity Shares.
f) Provide Corporate Dividend Tax as per law.

You are required to prepare Balance Sheet, Statements of Profit and Loss and notes on accounts requirements of the Companies Act.

Solution:

Cloth Trading Company Private Ltd.

Statement of Profit and Loss *For the year ending 31st March, 2012 (₹.In 000)*

	Particulars	*Note No.*	*Figure as at 31-3-2012*	*Figures as at 31-3-2011*
I.	Reserve from operations	1	3,500.00	
II.	Other Income		5.00	
III.	Total Revenue (I + II)	2	3,505.00	
IV.	Expenses:			
	Cost of Goods Sold		2,889.00	
	Employee Benefits Expense	3	50.00	
	Finance Costs	4	Nil	
	Depreciation and Administration Expenses	5	12.00	
	Other Expenses	6	268.00	
	Total Expenses	7	3.219.00	
V.	Profit before Tax		286.00	
VI.	Tax Expenses		200.00	
VII.	Profit for the period (V – VI)		86.00	

Accompanying Notes to the Statement of Profit & Loss

Revenue from Operations*(₹In 000)*

	Year ended 31-3-2012	*Year ended 31-3-2011*
Sales (including export sales of Rs. 10 Lakhs) 2 lac metres of cloth	3500.00	

Other Income*(₹. In 000)*

	Year ended 31-3-2012	*Year ended 31-3-2011*
Interest on Fixed Deposit	5.00	

Cost of Goods Sold *(₹ In 000)*

	Year ended 31-3-2012	*Year ended 31-3-2011*
Opening Stock of Cloth (10,000 metres)	150.00	
Add: Purchase of cloth (2.10 lac metres)	3,039.00	
	3,189.00	
Less: Closing Stock of Cloth (20,000 metres)	300.00	
	2,889.00	

Employees Benefits Expenses*(₹. In 000)*

	Year ended 31-3-2012	*Year ended 31-3-2011*
Salaries	50.00	

Depreciation and Amortisation Expenses(₹. *In 000)*

	Year ended 31-3-2012	Year ended 31-3-2011
Depreciation on W.D.C		
On Furniture !0%	3.00	
On Office Equipment 15%	3.00	
On Motor Car @ 20%	6.00	
	12.00	

Other Expenses(₹. *In 000)*

		Year ended 31-3-2012	Year ended 31-3-2011
Travelling Expenses		40.00	
Legal Charges		7.00	
Payment to Auditors:			
Audit Fees	4.00		
Tax Representation	3.00	7.00	
Provision for Doubtful debts		20.00	
Managing Director's Remuneration(1)		34.00	
Miscellaneous Expenses		160.00	
		268.00	

(1) Note on Managerial Remuneration ₹ In 000

Net Profit before Tax as per Statement of Statement of Profit and Loss	286.00
Add: Provision for Doubtful Debts	20.00
Managing Director's Remuneration	34.00
Profit for the purpose of Managerial Remuneration	340.00

Remuneration @ 10% thereof (340.000 x 10/100) 34.00

Companies Act, 1956 does not permit remuneration @ 10% if there is only one managing director because the permissible limit is 5%. A commission of 10% can be paid only with the approval of the Government.

Cloth Trading Company Private Ltd.

BALANCE SHEET*As on 31.3.2012* (₹ *In 000)*

Particulars	*Note No.*	*Figure as at 31-3-2012*	*Figures as at 31-3-2011*
I. Equity and Liabilities			
(1) Shareholders' Funds			
a. Share capital	A	500.00	
b. Reserve & surplus	B	203.90	
		703.90	
(2) Non-Current Liabilities			
Long-Term Borrowings	C	200.00	

(3) Current Liabilities		267.00	
Trade Payables	G	34.00	
Other current liabilities	H	335.10	
Short-term provisions		636.10	
		1,540.00	
Total of Equity and Liabilities (1) + (2) + (3)			
II. Assets			
i) Fixed Assets	I	68.00	
Tangible Assets			
ii) Current Assets	O	300.00	
Inventories	P	830.00	
Trade Receivables	Q	142.00	
Cash and Cash Equivalents	R	200.00	
Short-term Loans & Advances		1,472.00	
Total of all assets (i) + (ii)		1,540.00	

Accompanying Notes to the Balance Sheet

Share Capital*(₹In 000)*

	31-3-2012	*31-3-2011*
Authorised Issued, Subscribed and Paid-up Capital		
50,000 Equity Shares of Rs 10 each, fully paid up	500.00	

Reserve and Surplus*(₹. In 000)*

			31-3-2012	*31-3-2011*
General Reserve as on 1-4-2011		150.00		
Add: Addition during the year		50.00		
			200.00	
Surplus i.e., Balance in Statement of -----				
----P&L as on 1-4-2011		3.00		
Add: Net Profit for the year.		86.00		
89.00				
Less: Transfer to General Reserve	50.00			
Proposed Dividend @ %	30.00			
Corporate Dividend Tax	5.10	85.10	3.90	
			203.900	

Note: Corporate dividend tax is as per Income Tax Act.

Long-term Borrowings*(₹. In 000)*

	31-3-2012	*31-3-2011*
Unsecured Loans: Loans from Directors	200.00	

Trade Payables*(₹In 000)*

	31-3-2012	*31-3-2011*
Sundry Creditors for Goods and Expenses	267.00	

Other Current Liabilities*(Rs. In 000)*

	31-3-2012	*31-3-2011*
Remuneration Payable to Managing Directors	34.00	

Short-Term Provisions(₹*In 000)*

	31-3-2012	31-3-2011
Provision for Taxation as on 1-4-2011	100.00	
Add: Provided during the year	200.00	
	300.00	
Proposed Dividend	30.00	
Provision for Corporate Dividend Tax	5.10	
	335.10	

Tangible Assets(₹*In 000)*

		31-3-2012	31-3-2011
Furniture at Cost	30.00		
Add: Additions during the year	5.00		
35.00			
Less: Accumulated Depreciation to date	8.00		
		27.00	
Motor Car at cost (purchased during the year)	30.00		
Less: Depreciation for the year	6.00		
		24.00	
Office Equipment at Cost	22.00		
Less: Accumulated Depreciation to date	5.00	17.00	
		68.00	

Inventories *(₹ In 000)*

	31-3-2012	31-3-2011
Stock of Cloth (20,000 metres)	300.00	

Trade Receivables *(₹. In 000)*

	31-3-2012	31-3-2011
Sundry Debtors (Unsecured)		
Outstanding for more than 6 months	150.00	
Others	700.00	
	850.00	
Less: Provision for Doubtful Debts	20.00	
	830.00	

Cash and Cash Equivalents(₹. *In 000)*

	31-3-2012	31-3-2011
Post Office Savings Account	20.00	
Balance with Bank of India	20.00	
Cash in Hand	2.00	
Fixed Deposit with Bank of India	100.00	
	142.00	

Short-term Loans & Advances(₹. *In 000)*

	31-3-2012	31-3-2011
Loans and Advances;		
Advance to Staff	10.00	
Advance Tax Paid	190.00	
	200.00	

Statistical Information required under Schedule VI (to the extent available)

Opening Stock as on 1-4-2011	10,000 metres
Closing Stock as on 31-3-2012	20,000 metres
Purchase during the year	2,10,000 metres
Sales	2,00,000 metres
Expenditure in Foreign Currency (for visit abroad)	₹ 36,000
Foreign Exchange earned by Export sales	₹10,00,000

Illustration 4

Following balance have been extracted from the books of Pioneer Traders Ltd. as on 31st March, 2012:

(₹. In 000)

	Dr.	*Cr.*
Share Capital (Authorised and Issued):		
Equity (15,00,000 Shares of ₹. 100 each)	--	1,50,000
8% Redeemable preference (40,000 shares)	--	4,000
Securities Premium	--	2,500
Preference Share Redemption	4,800	--
General Reserve	--	10,000
Land (Cost)	30,000	--
Building (cost less Depreciation)	70,000	--
Furniture (Cost less Depreciation)	2,000	--
Motor Vehicle (Cost less Depreciation)	3,500	--
Trading Account – Gross Profit	--	90,000
Establishment Charges	25,000	--
Rate, Taxes and Insurance	1,200	--
Commission	600	--
Discount received	--	500
Interest on Investments	--	800
Depreciation	6,000	--
Sundry Office Expenses	6,000	--
Payment to Auditors	400	--
Sundry debtors and Creditors	10,660	2,560
Surplus Account (as on 31-3-2011)	--	1,000
Unpaid dividend	--	200
Cash in hand	1,200	--
Cash at Bank in Current Account	19,500	--
Security Deposit	1,000	--
Outstanding Expenses	--	600
Investments in G.P.Notes	20,000	--
Stock in Trade(at or below cost)	35,300	--
Provision for taxation(year ended 31-3-2011)	--	700
Income Tax paid under dispute (year ended 31-3-2011)	10,000	--
Advance Payment of Income- Tax	22,000	--
	2,69,160	2,69,160

Following further details are available:

i. The preference shares were redeemed on 1st April, 2011 at a premium of 20% but no entries were passed for giving effect thereto, except payment standing to the debit of preference Share Redemption account.
ii. Depreciation as Provided upto 31st March, 2012 is as follows:
   a. Building — ₹2, 10, 00,000.
   b. Furniture — ₹20, 00,000.
   c. Motor vehicles— ₹60, 00,000.
iii. Establishment charges include ₹18,00,000 paid to managing directors as remuneration in terms of agreement which provides for a remuneration of 5% of annual net profits.
iv. Payment to auditors includes Rs.1,00,000 for taxation work in addition to audit fees.
v. Market value of Investments on 31st March, 2012 is ₹1,80,00,000.
vi. Sundry debtors include ₹40,00,000 due for a period exceeding six months.
vii. All receivables and deposits are considered good for realization.
viii. Income-tax demand for the year ended 31st March, 2011₹1,00,00,000 has not been provided for against which appeal is pending.
ix. Income-tax is to be provided @ 34%. Also provide for tax on divisible profit @ 17%.
x. Directors recommended payment of dividend on equity shares at the rate of 12%.
xi. Ignore previous year's figures.

You are required to prepare the Statement of Profit and Loss for the year ended 31st March, 2012 and a Balance Sheet at that date.

Solution:

Pioneer Traders Ltd.
STATEMENT OF PROFIT AND LOSS
for the year ended 31st March, 2012

		Note No	*Year Ending 31-3-2012*	*Year Ending 31-3-2011*
			(₹. '000)	(₹. '000)
I.	Gross profit from operations		90,000	
II.	Other income	1	1,300	
III.	Total Revenue (I+ II)		91,300	
IV.	Expenses:			
	Employees Benefits Expenses	2	23,300	
	Finance costs		Nil	
	Depreciation and Amortisation Expense	3	6,000	
	Other Expenses	4	10,895	
	Total Expenses		40,095	
V.	Profit before Tax		51,205	
VI.	Tax Expense (provision for tax @34 of 51,205)		17,410	
VII.	Profit for the Period (V- VI)		33,795	

Accompanying Notes to the Profit and Loss statement.

Other Income

	Year Ending 31-3-2012	Year Ending 30-9-2011
	(₹000)	(₹ '000)
Discount Received	500	
Interest on Investments	800	
	1,300	

Employee Benefits Expenses

		Year Ending 31-3-2012	Year Ending 30-9-2011
	(₹ '000)	(₹.' 000)	(₹. '000)
Establishment Charges	25,000		
Less: Remuneration to managing directors			
Included therein	1,800		
		23,200	

Depreciation and Amortisation Expenses

	Year Ending 31-3-2012	Year Ending 30-9-2011
	(₹. '000)	(₹. '000)
Depreciation for the Current Year	6,000	
(Break-up of Depreciation on Different Assets is not given in the absence of information		

Other Expenses

		Year Ending 31-3-2012	Year Ending 31-3-2011
		(₹ '000)	(₹ '000)
Rent, Taxes and Insurance		1,200	
Commission		600	
Sundry Office Expenses		6,000	
Payment to Auditors:			
----Audit Fees	300		
----Fee for Taxation Work	100	400	
		2,695	
Remuneration to Managing Directors (i)		10,895	

Calculation of Remuneration Payable to the Managing Director

		₹.*000*	₹ *000*
Total Revenue			91,300
Less: Employee Benefit Expense		23,200	
Depreciation	6,000		
Rent, Taxes and Insurance		1,200	
Commission		600	
Sundry Office Expenses		6,000	
Payment to Auditors		400	37,400
			53,900

Remuneration Payable to Managing Director, @5% of 53,900 2,695

Pioneer Traders Ltd.
Balance Sheet *as at 31-3-2012*

	Note No	*31-3-2012*	*31-3-2011*
		(₹. '000)	(₹. '000)
I. Equity and Liabilities			
1. *Shareholder's Fund*			
a. Share Capital	A	1,50,000	
b. Reserves & Surplus	B	22,435	
		1,72,435	
2. *Non-Current Liabilities*		Nil	
3. *Current Liabilities*			
Trade payable (sundry crs.)		2,560	
Other Current Liabilities	G	1,695	
Short Term provisions	H	48,470	
		52,725	
Total of Equity and Liabilities (1) + (2) + (3)		2,25,160	
II. Assets			
Non- Current Assets			
1. Fixed Assets	I	1,05,000	
Tangible Assets	K	20,000	
Non- Current Investments		1,25,500	
2. Current Assets		35,300	
Inventories	O	10,660	
Trade Receivables	P	20,700	
Cash & Cash Equivalents	Q	33,000	
Short-term Loans &	R	99,660	
Advances		2,25,160	
Total of All Assets (1) + (2)			

Accompanying Notes to the Balance Sheet

Share Capital(₹. *In 000)*

	31-3-2012	*31-3-2011*
Authorised		
15,00,000 Equity Shares of ₹ 100 each	1,50,000	
8% Redeemable pref. shares of ₹100 each	4,000	
	1,54,000	
Issued, Subscribed and Paid-up Capital		
15,00,000 Equity Shares of ₹ 100 each fully paid up	1,50,000	

Reserve and Surplus(₹. *In 000)*

		31-3-2012	*31-3-2011*
Capital Redemption Reserve A/c		4,000	
(Created on Redemption of pref. shares)			
Securities Premium as on 1-4-2011	2,500		
Less: premium @20% on redemption of preference			
shares 800		1,700	
General Reserves as at 1-4-2011	10,000		

Less: Transfer to capital redemption Reserve A/c	4,000		
6,000			
Add: 2.5% of current profit 33,795 for declaration			
Of dividend as per section 205 (2) of the companies act	845	6,845	
Surplus as at 1-4-2011	1,000		
Add: Profit for the year	33,795		
	34,975		
Less: Additional provisions for Taxation as per income tax demand for the year 2010-11 (☐ 10,000- ☐ 7,000 Existing provision as on 1-4-2011)	3,000		
	31,795		
Less: 2.5% of current profit ☐ 33,795 for declaration of dividend	845		
	30,950		
Less: proposed Dividend@12% on			
Paid up capital (1,50,000)	18,000		
Tax on Distributed profit@17% on 18,0003,060	21,060		
		9,890	
		22,435	

Other Current Liabilities(₹*In 000)*

		31-3-2012	*31-3-2011*
Unpaid Dividend		200	
Outstanding Expenses		600	
Remuneration payable to Managing			
Director @ 5% of profit	2,695		
Less: Already paid	1,800	895	
		1,695	

Short Term Provisions(₹*In 000)*

		31-3-2012	*31-3-2011*
Provision for Taxation			
For 2010-11 (7,000 + 3,000)	10,000		
For 2011-12	17,410		
		27,410	
Proposed Dividend		18,000	
Provision for Tax on Distributed Profit		3,060	
		48,470	

Tangible Assets(₹*In 000)*

		31-3-2012	*31-3-2011*
Land at Cost		30,000	
Building at Cost	91,000		
Less: Depreciation to date	21,000	70,000	
Furniture at Cost	4,000		
Less: Depreciation to date	2,000	2,000	
Motor vehicle at Cost	9,500		
Less: Depreciation to date	6,000	3,500	
		1,05,500	

Non-CurrentInvestments(₹ i*n 000)*

	31-3-2012	31-3-2011
Investments in G.P. Notes (assumed to be long term) (Market value 18,000)	20,000	

Inventories*(₹In 000)*

	31-3-2012	31-3-2011
Stock in trade (at or below cost)	35,300	

Trade Receivables*(₹In 000)*

		31-3-2012	31-3-2011
Sundry Debtors:			
Debts Outstanding for more than 6 months	4,000		
Others	6,660	10,660	

Cash and Cash Equivalents*(₹In 000)*

	31-3-2012	31-3-2011
Bank Balance in Current A/c	19,500	
Cash in hand	1,200	
	20,700	

Short-term Loans & Advances*(₹. In 000)*

	31-3-2012	31-3-2011
Security Deposits	1,000	
Income Tax paid under Dispute (for the year ended 31-3-2011)	10,000	
Advanced Payment for Tax	23,000	
	33,000	

5.2.11Self Test Questions

Theory

1. What are the purposes served by Schedule VI of the Companies Act 1956?
2. In accordance with the provisions of the Companies Act it is necessary to group the item appearing in the company's balance sheet under certain headings. What are these headings?
3. What do you mean by contingent liabilities? Give four examples of r such liabilities. How are these liabilities shown in the Balance Sheet of a company?
4. What are the various heads under which profits are usually appropriated by companies and for what reasons?

Problems

1. Shanthi Ltd., was incorporated with a nominal capital of ₹ 60,00,000 in equity shares of ₹ 100 each. On 31st March, 2013, 30,000 shares were fully called up. The following balances were extracted from the ledger of the company as on 31st March, 2013:

Particulars	₹	**Particulars**	₹
Stock	5,00,000	Advertisement	38,000
Sales	42.50,000	Bonus	1,05,000

Purchases	30,00,000	Debtors	3,87,000
Wages	7,00,000	Creditors	3,52,000
Discount Allowed	42,000	Plant and Machinery	8,05,000
Discount Received	31,500	Furniture	1,71,000
Insurance upto 30.6.2015	67,200	Cash at Bank	13,47,000
Salaries	1,85,000	General Reserve	2,50,000
Rent	60.000	Loan from Managing Director	1,57,000
General Expenses	89,500	Bad debts	32,000
Profit and Loss Account	62,200	Calls – in – arrear	1.00,000
Printing and Stationary	24,000		

You are required to prepare Profit and Loss Account for the year ended 31st March, 2013 and Balance Sheet in the prescribed form as on that date. The following further information is given to you:

(i) Closing stock was ₹ 9,15,000.
(ii) Depreciation is to be charged on plant and machinery and furniture at 15% and 10% respectively.
(iii) Outstanding liabilities on 31st March, 2013 were: Wages ₹ 52,000; Salary ₹ 12,000; and Rent ₹ 6000.
(iv) Provided dividend for the year ended 31st March, 2013@ 5%.
(v) Make a provision for taxation @ 50%.

2. The Bangalore Manufacturing Co. Ltd. was registered with a nominal capital of ₹ 15,00,000 dividend into equity shares of ₹ 100 each. On 31st March 2012, the following ledger balances were extracted from the company's books:

	₹		₹
Equity share capital called up		Preliminary expenses	12,500
and paid up	11,50,000	Freight and Duty	32,750
Calls-in-arrears	18,750	Goodwill	62,500
Plant and Machinery	9,00,000	Wages	2,12,000
Stock (1.4.2012)	1,87,500	Cash in hand	5,875
Fixtures	18,000	Cash at bank	95,750
Sundry Debtors	2,17,500	Director's fees	14,350
Buildings	7,50,000	Bad debts	5,275
Purchases	4,62,500	Commission paid	18,000
Interim dividend paid	18,750	Salaries	36,250

Rent	12,000	6% Debentures	7,50,000
General expenses	12,250	Sales	10,37,500
Debenture interest	22,500	4% Government Securities	1,50,000
Bills payable	95,000	Reserve for doubtful debts	8,750
General Reserve	62,000	Sundry creditors	1,25,000
Profit & Loss A/c(Cr.)			
1.4.2003	36,250		

The stock on 31st March 2012 was estimate at ₹ 2,52,000.
The following adjustments were made:

1. Final dividend at 5% to be provided.
2. Depreciation on plant and machinery at 10% and on fixtures at 5%
3. Preliminary expenses to be written off by 20%.
4. ₹ 25,000 were to be transferred to general reserve.
5. A provision for income tax to the extent of ₹62,500 on sundry debtors.
6. The provision for bad debts to be maintained at 5% on sundry debtors.

You are required to prepare the trading and P&L A/c and P&L Appropriation A/c for the year ended 31st March 2012 and the balance sheet as on that date.

3. The following trial balance sheet was extracted from Vindhya Limited as on 31.3.2012:

	₹		₹
Cash in hand	250	Authorised capital:	
Unpaid calls	600	15,000 shares of ₹ 10 each	1,50,000
Income tax paid	12,570	Issued capital:	
Sundry debtors	1,27,000	8,000 shares of ₹ 10 each	80,000
Office equipment	10,600	Provision for income tax	16,900
Motor expenses	5,000	Profit and loss A/c	44,000
Purchases	8,72,400	Bank overdraft	16,000
Motor vehicles at cost	83,900	Sales	10,42,000
Stock as on 1.4.2003	69,000	Motor vehicles	
Travelling expenses	16,330	depreciation upto	
Rent rates etc.	14,450	31.3.2003	34,000
Repairs	9,600	Reserves for bad debts	4,200
Printing and stationary	7,900	Sundry creditors	62,000
Salaries and wages including Director's fees	69,500		
	12,99,100		12,99,100

The following are the other particulars:

(1) Debts amounting to ₹ 3,600 are to be written off and a reserve for bad and doubtful debts is to be increased to ₹ 6,150.
(2) Sundry debtors include goods supplied on sale or return basis ₹ 4,800. These goods cost ₹4,000 and one half was retain by the customers.
(3) Stock on 31.3.2004 was ₹ 81,000.
(4) Motor expenses include licences for the year ending 31.12.2004 which cost ₹1,200 and insurance for the year ending 30.9.2004 which cost ₹ 2,000.
(5) Depreciation to be provided at 20% an original value of motor vehicle and 10% on office equipment.
(6) Income tax liability for the year ended 31.3.2003 (Assessment year 2003-04) was agreed at ₹ 15,050. For the accounting year ended 31.3.2004 (Assessment year 2004-05) the provisions for taxation is to be ₹. 23,500.

Prepare final accounts in the prescribed form.

4. Bluebell Ltd. has a normal capital of ₹6,00,000 divided into shares of ₹ 10 each. The following trial Balance is extracted from the books of the company as on 31.3.2014.

	₹		₹
Calls in arrears	7,500	6% debentures	3,00,000
Premises (₹. 60,000 added on 1.7.2014)	3,60,000	P&L A/c 1.4.2013	14,500
		Creditors	50,000
Machinery	3,00,000	General reserve	25,000
Interim dividend paid	7,500	Share capital (called up)	4,60,000
Purchases	1,85,000	Bills Payable	38,000
Preliminary expenses	5,000	Sales	4,15,000
Freight	13,100	Reserve for bad debts	3,500
Director's fees	5,740		
Bad debts	2,110		
45 Government securities	60,000		
Stock 1.4.2013	75,000		
Furniture	7,200		
Sundry Debtors	87,000		
Goodwill	25,000		
Cash	750		
Bank	39,900		
Wages	84,800		
General expenses	16,900		
Salaries	14,500		
Debenture interest	9,000		
	13,06,000		13,06,000

Prepare final account for the year ending 31.3.2014 in the prescribed form after taking into account the following adjustments:

a) Depreciate Machinery 10% and furniture 5%.

b) Write off ½ of the preliminary expenses.
c) Wages include Rs. 10,000 paid for the construction of a compound wall to the premises and no adjustment was made.
d) Reserve 5% for bad debts.
e) Transfer ₹ 10,000 paid for the construction of a compound wall to premises and no adjustment was made.
f) Provide for income tax ₹. 25,000.
g) Stock on 31.32014 was ₹ 1,01,000

4. The Silver Ore Co. Ltd**.** was formed on April 1, 2013 with an authorised capital of 6, 00,000 in shares of ₹ 10 each. Of these 52,000 shares had been issued and subscribed but there are calls-in-arrears on 100 shares. From the following trial balance as on March 31, 2014, prepare the trading and profit and loss a/c and the balance sheet.

	₹		₹
Cash at bank	1,05,500	Advertising	5,000
Share capital	5,19,750	Cartage on plant	1,800
Plant	40,000	Furniture and building	20,900
Sales of silver	1,79,000	Administrative expenses	28,000
Mines	2,20,000	Repairs to plant	900
Promotion expenses	6,000	Coal and oil	6,500
Interest on F.D. upto Dec. 31	3,900	Cash	530
Dividend on investment		Investments : Shares of tin	80,000
Royalties paid	3,200	mines	
Railway track and wagons	10,000	Brokerage on above	1,000
Wages of miners	17,000	6% F.D. in Syndicate Bank	89,000
	74,220		

(i) Depreciation plant and railways by 10%; furniture and building by 5%;
(ii) Write off one third of the promotion expense;
(iii) Value of silver ore on March 31, 2014 ₹ 15,000. The directors forfeited on Dec. 20, 2013, 100 shares on which only ₹ 7.50 had been paid.

5. The Alfa Manufacturing Company Limited was registered with a nominal capital of ₹60,00,000 in Equity Shares of ₹ 10 each. The following is the list of balances extracted from its books on 31st March 2015: ₹

Calls in arrear … … 75,000

Premises	…	…	30,00,000
Plant and Machinery	…	…	33,00,000
Interim dividend paid on 1st November 2014		…	3,92,500
Stock, 1st April,2014	…	…	7,50,000
Fixtures	…	…	72,000
Sundry Debtors	…	…	8,70,000
Goodwill	…	…	2,50,000
Cash in hand	…	…	7,500
Cash at Bank	…	…	3,99,000
Purchases	…	…	18,50,000
Preliminary Expenses	…	…	50,000
Wages	…	…	8,48,650
General Expenses	…	…	68,350
Freight and Carriage	…	…	1,31,150
Salaries	…	…	1,45,000
Directors' Fees	…	…	57,250
Bad Debts	…	…	21,100
Debenture Interest paid	…	…	1,80,000
Share Capital	…	…	40,00,000
12 % Debentures	…	…	30,00,000
Profit and Loss account	…	…	2,62,500
Bills Payable	…	…	3,70,000
Sundry Creditors	…	…	4,00,000
Sales	…	…	41,50,000
General Reserve	…	…	2,50,000
Bad Debts Provision 1st April 2014		…	35,000

Prepare Trading and profit and Loss Account and Balance Sheet in proper form after making the following adjustments:

(i) Depreciate Plant and Machinery by 15%

(ii) Write off ₹5,000 from Preliminary Expense.

(iii) Provide for half years debenture interest due.

(iv) Leave bad and Doubtful Debts Provision at 5% on Sundry Debtors.

(v) Provide for Income Tax @ 50%.

(vi) Stock on 31st March, 2015 was ₹ 9,50,000

6. Moon and Start Co.Ltd. Is a company with an authorizes capital of ₹.5,00,000 divided into 5,000 equity shares of ₹.100 each on 31.3.2015 of which 2,500 shares were fully called up. The following are the balances extracted from the ledger as on 31.3.2015.

Trail Balance of Moon &Star Co.Ltd.

Debit	`	Credit	`
Opening Stock	50,000	Sales	3,25,000
Purchase	2,00,000	Discount received	3,150
Wages	70,000	Profit and Loss A\c	6,220
Discount allowed	4,200	Creditors	35,200
Insurance (upto 31.3.2015)	6,720	Reserves	25,000
Salaries	18,500	Loan from managing director	15,700
Rent	6,000	Share capital	2,50,000
General Expense	8,950		
Printing	2,400		
Advertisements	3,800		
Bonus	10,500		
Debtors	38,700		
Plant	1,80,500		
Furniture	17,100		
Bank	34,700		
Bad debts	3,200		
Calls-in-arrears	5,000		
	6,60,270		6,60,270

You are required to prepare Profit and Loss Account for the year ended 31 3.2015 and a balance sheet as on that date. The following further information is given:

(a) Closing stock was valued at ₹1,91,500.
(b) Depreciation on plant at 15% and on furniture at 10% should be provided.
(c) A tax provision of ₹.8,000 is considered necessary.
(d) The directors declared an interim dividend on 15.11.2014 for 6 months ending October 30, 2014 @ 6%.

Lesson 2.4 Issue of Bonus Shares

Learning Objectives

After reading this lesson you should be able to

- Know the important provisions relating to issue of Bonus Shares
- Understand the accounting treatment for the issue of bonus shares
- To do the problems relating to issue of bonus shares

2.4.1 Introduction

Profits available for dividend to shareholders are known as Divisible Profits. Only those profits are divisible profits which are legally available for dividend to shareholders. The principles of determination of profits available for distribution are now governed by section 205 of the Companies Act.If a large amount of reserves are accumulated with the companies which are undistributed past profits, and the companies like to distribute these accumulated profits. In such cases, the company may pay bonus to the shareholders either cash bonus or capital bonus.

2.4.2 Bonus Shares

Bonus Shares implies an extra dividend to the shareholders of a company. It may be distributed by a way of Cash Bonus or Share Bonus. Cash Bonus is paid up by the company when it is large accumulated profits as well as cash to pay dividend. Bonus Shares are issued by a company it wants to pay dividend by issuing shares fully paid to its members. This implies that an increase in share capital and without affecting the working capital of the company. The following points may be noted:

1. The Bonus Shares are issued to the existing shareholders only.
2. Issue of such shares are made out of credit balance accumulated profits.
3. It must be issued by fully paid shares and no cash is received against the issue.

It may be noted here that the Share Premium Account under section 78(2) and the Capital Redemption Reserve Account under sec. 80(5) can also be applied towards the issue of fully paid bonus shares.Such shares can be issued as per the guidelines of SEBI.

2.4.4.1 Advantages of the Issue of Bonus Shares

From the point of view the company, the following advantages are noted:

1. Dividend can be paid without disturbing the liquid position of the company.
2. The disparity between effective capital and actual capital can be eliminated.

3. The rate of dividend will come down to a normal level on account of distribution over an increased number of shares and thereby avoiding resentment either from the workers for increased wages or from the customers for reduced price.
4. It is an inexpensive way to raise capital for expansion.

From the point of view of the shareholders, the following advantages are noted:

1. It is equivalent to cash dividend because the shareholders can have money by selling the shares in the market.
2. The shareholders are provided with an opportunity to invest their income in a prosperous company which they are not likely to get in the market except at a high premium.
3. It the bonus fully paid is applied in extinguishing liability in respect of uncalled capital, the share will become fully paid up without involving the shareholders to pay further cash.
4. The shareholders are not required to pay any income tax which they would have to pay had the dividend been paid in cash

2.4.4.2 SEBI Guidelines

SEBI guidelines on bonus issue of a company are as follows:

1. No bonus shares shall dilute other issues:

Issue of bonus shares shall not be made pending conversion of fully convertible debentures or partly convertible debentures unless sufficient number of shares is reserved for allotment to the holders of the said FCDs or PCDs after conversion.

2. Bonus issue from free reserves:

Bonus shares can be issued only out of free reserves built out of genuine revenue profits or share premium collected in cash.

3. Revaluation reserve not eligible:

Reserve created by revaluation of assets cannot be capitalized for issue of bonus shares.

4. Issue in lieu of dividend:

Bonus issue shall not be made in lieu of dividend.

5. Partly paid shares not eligible:

Partly paid shares, if any, will not be eligible for bonus shares. Such partly paid shares, if any, must be made fully paid before a bonus issue is contemplated.

6. No default of payment of interest, etc.:

The issuing company shall not have defaulted in the payment of interest or principal in respect of fixed deposits and interest payment on dentures or repayment of principal on redemption of debentures. The company must be certain that it has not defaulted in respect of payment of statutory dues of the employees, such as contribution of provident fund, gratuity, bonus, etc.

7. Time within which bonus issue shall be made:

A company which announces a bonus issue after the approval of its Board of Directors must implement the proposal within a period of six months from the date of such approval.

8. Bonus proposal cannot be withdrawn:

A company which has announced its proposal to issue bonus shares, cannot have the option to change its decision.

9. Provision in the articles:

There must be a suitable provision in the Articles of Association of the company for capitalisation of reserves. If not, the company must pass a special resolution and incorporate a suitable provision in the Articles of Association, before initiating action for a bonus issue.

10. Increase in authorized capital:

Where necessary, before action on a bonus issue is taken, the company shall increase its authorised capital so as to permit the proposed bonus issue.

11. Prohibition of issue of bonus shares by revaluation of assets:

The Department of Company Affairs has vide Circular No. 9/94 dated 6-9-1994, informed all companies (listed as well as unlisted) that no company shall venture to issue bonus shares out of reserves created by revaluation of fixed assets.

2.4.4.3 Accounting Treatment

Cash Bonus

In case bonus is paid in cash:

Profit and Loss Appropriation A/c Dr. To Bonus Payable A/c	
Bonus Payable A/c Dr. To Bank A/c	

Bonus Shares

It mean such bonus shares result in conversion of company's profits into share capital i.e., Capitalization of profits. There are two ways of such capitalization :

(A) Utilising profits in paying unpaid amount on the shares held by the members.

When amount transferred for bonus payable to members	Profit & loss appropriation A/C Dr. General Reserves A/C Dr. Capital Profits A/C Dr. To Bonus to Shareholders A/C
On making final call on shares	Share Final Call A/C Dr. To Share capital A/C
On adjustment of bonus towards final call	Bonus to Shareholders A/C Dr. To Share Capital A/C

(B) Issuing new fully paid shares :

For transferring the amount for issue of bonus shares	Profit & loss Appropriation A/C Dr. General Reserves A/C Dr. Capital Redemption Reserves A/C Dr. Share Premium A/c Dr. Any other Reserve A/C Dr. To Bonus to Shareholders A/c
On issue of bonus shares at par or at premium:	Bonus to Shareholders A/c Dr. To Share Capital A/c To Share Premium A/c

2.4.4.4 Practical Problems

Illustration 1(Bonus in the form of fully paid shares at par)

A company has a share capital of ₹ 7,50,000 in Equity shares of ₹10 each. Out of the above 50,000 shares were issued and fully paid up. The company's General Reserves amounts to ₹ 5,00,000. The directors now propose to utilise the necessary amount from the general reserve for the purpose of declaring a bonus of ₹ 2,50,000 as fully paid bonus shares. The Articles of the company permit such a course and necessary sanction has been obtained.

You are required to give journal entries in the books to record the new issue of bonus shares.

Solution:

Journal

		Dr. ₹	Cr. ₹
	General Reserve Account Dr. To Bonus to Shareholders account (being bonus decleared)	2,50,000	2,50,000
	Bonus to Shareholders account Dr. To Share Capital account (Being utilization of bonus towards issue of ₹ 25,000 shares of ₹ 10 each, and distribution in the ratio of one share for every two share held)	2,50,000	2,50,000

Illustration 2 (Bonus in the form of fully paid shares at premium)

A company has a share capital of ₹ 7,00,000 in Equity Shares of ₹10 each which are quote in the market at Rs 20. The company now declares a bonus share of ₹ 6,00,000 out of its reserve and this bonus is to be paid by issue of fully paid Equity Shares of ₹10 each at a premium of ₹ 5 per share. Give journal entries to record the transactions.

Solution:

Journal

	Dr.	Cr.
	₹.	₹.
Reserve Account Dr. To Bonus to Shareholders Account (Being the declared)	6,00,000	6,00,000
Bonus to Shareholders Account Dr. To Share Capital Account To Share Premium Account (Being 40,000 bonus shares of ₹ 10 each Issued at ₹ 15 each)	6,00,000	4,00,000 2,00,000

Illustration 3 (To make partly paid shares as fully paid up)

A Limited Company with a subscribed capital of ₹5,00,000 in shares of ₹ 10 each had called up ₹ 8 per share. As the company built up a big reserve it was resolved that a bonus of ₹1,00,000 would be declared out of the reserve to be applied in making the shares fully paid. Give journal entries in the books to record the transaction.

Solution:

Journal

		Dr.	Cr.
		₹	₹
Reserve Account Dr. To Bonus to Shareholders Account (Being the declaration of bonus)		1,00,000	1,00,000
Share Final Call Account Dr. To Share Capital Account (Being the call of ₹ 2 per share on 50,000 shares)		1,00,000	1,00,000
Bonus to Shareholders Account Dr. To Share Capital Account (Being utilization of bonus towards payment of final call account)		1,00,000	1,00,000

Illustration 4

The Balance Sheet of Cable Ltd. is given below as on 31st March.

	₹
Authorised Capital:	
20,000 Equity Share of ₹ 10 each	2,00,000
Issued and Subscribed Capital:	
7,000 Equity Shares of ₹ 10 each	70,000
Reserve Fund	36,000
Profit and Loss Account	29,000

The Board of Directors passes a resolution to capitalise a part of existing reserves and profits by issuing Bonus Shares. One Bonus share is being issued for every Equity Shares held at present. For this purpose, ₹10,000 are to be provided out of Reserve Fund and the balance out of the Profit and Loss Account.

Show the journal entries to give effect to the resolution, and also show how they would affect the Balance Sheet of the Company.

Solution:

Journal

	Dr. ₹	Cr. ₹
Reserve Fund Account Dr.	10,000	
Profit and Loss Account Dr.	7,500	
To Bonus to Shareholders Account		17,500
(Being the required amount as per resolution, to the Bonus t Shareholders Account)		
Bonus to Shareholders Account Dr.	17,500	
To Equity Shares Capital Account		17,500
(Being issue of 1,750 Equity shares of Rs 10 each as fully paid bonus shares)		

Balance Sheet of Cables Ltd.
as on 31st March…..

Liabilities	₹
Authorized Share Capital:	2,00,000
20,000 Equity Shares of ₹10 each	
Issued and Subscribed:	87,500
8,750 Equity Shares of ₹10 each, fully paid up (Of the above, 1,750 shares were issued as bonus shares as per resolution)	
Reserve Fund	26,000
Profit and Loss Account	21,500

Illustration 5

The following particulars appear in the Balance Sheet of Bharat Ltd. as on 31st March

Liabilities		₹
Authorized Share Capital:		2,00,000
20,000 Equity Shares of₹10 each		
Issued and Paid up:		80,000
10,000 Equity Shares of ₹10 each		
₹ 8 per share paid up:		
Reserve and Surplus:		
Share Premium Account	2,000	
Capital Redemption Reserve A/c	4,000	
General Reserve A/c	40,000	46,000

The Company passed the following resolutions:

1. That the General Reserve be utilised in making the partly paid shares as fully paid up.
2. That further 1,000 fully paid Equity Bonus Shares of ₹ 10 each be issued to the existing shareholders. For this purpose, general reserve should be utilised to the minimum extent.

You are required to pass the journal entries to record the above, and show the necessary items in the Balance Sheet as would appear after giving effect to the resolution.

Solution:

Journal

		Dr. ₹	Cr. ₹
1.	General Reserve Account Dr. To Bonus to Shareholders Account (Being amount transferred to Bonus to Shareholders Account)	20,000	20,000
	Share Final Call Account Dr. To Equity Share Capital Account (Being final call money due on 10,000 Equity Shares @ ₹ 2 per share)	20,000	20,000
	Bonus to Shareholders Account Dr. To Equity Share Final call Account (Being Bonus to Shareholders Account adjusted against the call money)	20,000	20,000
2.	Share Premium Account Dr. Capital Redemption Reserve Account Dr. General Reserve Account Dr. To Bonus to shareholders Account (Being amount transferred for issue of Bonus shares)	2,000 4,000 4,000	 10,000

	Bonus to Shareholders Account Dr. To Equity Share Capital Account (Being issue of 1,000 Equity Share of ₹ 10 each as bonus)	10,000	10,000

Balance Sheet of Bharat Ltd.
as on 31st March ……

Liabilities	₹
Authorized Share Capital: Dr.	
20,000 Equity Share of ₹ 10 each	2,00,000
Issued and Subscribed:	
11,000 Equity Shares of ₹ 10 each	1,10,000
(Of the above 1,000 shares have been issued as	
Bonus shares, as per resolution)	
General Reserve: 40,000 – (20,000 + 4,000)	16,000

Illustration 6

The Balance Sheet of India Ltd. as on 31st March 2012 is given below:

Liabilities	₹	Assets	₹
Share Capital Authorised:		Fixed Assets:	
30,000 Equity Shares of		Freehold Property	1,00,000
₹ 10 each	3,00,000	Current Assets:	
Issued and paid up:		Stock	1,20,000
20,000 Equity Shares of		Sundry Debtors	80,000
₹10 each	2,00,000	Cash and Bank	2,20,000
Reserve and Surplus:			
Profit and Loss	1,40,000		
Secured Loans:			
6% Debentures	1,20,000		
Current Liabilities:			
Sundry Creditors	60,000		
	5,20,000		5,20,000

At the Annual General Meeting it was resolved:

(1) To pay a dividend of 10%
(2) To issue one bonus for every four shares held as on date of last Balance Sheet.
(3) To give existing shareholders the option to purchase one share of ₹10 each at ₹ 14 for every four shares held prior to the issue of bonus share.
(4) To repay the debentures at a premium of 4%.

All the shareholders exercised the option in (3) above. Give necessary journal entries and prepare the balance sheet after the resolution have given effect to ignore taxes.

Solution

	Journal	Dr.	Cr.
		₹	₹
1.	Profit and Loss Appropriation A/c Dr. To Bonus Payable Account (Being Dividend @10% declared in the Annual General Meeting)	20,000	20,000
2.	Profit and Loss A/c Dr. To Bonus to Shareholders A/c (Being amount transferred for issue of Bonus Share)	50,000	50,000
	Bonus to Shareholders Account Dr. To Equity Share Capital Account (Being bonus shares issued to existing Shareholders in the ratio of 1:4)	50,000	50,000
3.	Bank Account (5,000 x Rs 14) Dr. To Equity Share Capital Account To Share Premium Account (Being issue of 5,000 new shares at ₹ 14 each)	70,000	50,000 20,000
4.	Debenture Account Dr. Premium on Redemption of DebentureA/cDr. To Bank Account (Being redemption of debentures at a premium of 4%)	1,20,000 4,800	1,24,800

India Limited's Balance Sheet

as on March 31, 2012 (₹. In 000)

	Note No.	*As on 31-3-2012*	*As on 31-3-2012*
Equity and Liabilities		₹	₹
5) Shareholder's funds:			
(c) Share Capital			
25,000 Equity Shares of ₹10 each for cash			
5,000 Equity Shares of ₹10 each issue as Bonus Shares	A	3,00,000	
(d) Reserve and Surplus	B	90,000	3,90,000
6) Non-Current Liabilities			
Long-term Borrowings (secured loans)			
7) Current Liabilities			
Trade Payable (Sundry Creditors)	G	60,000	
Other Current Liabilities-Dividend payable		20,000	80,000
8) Suspense Account (Balancing Figure)			
Total Equity and Liabilities			4,70,000

Assets			
Non-Current Assets			
(3) Fixed Assets:			
Tangible Assets	I	1,00,000	1,00,000
Intangible asset	K	4,800	4,800
Premium on Redemption of Debentures A/c			
Non-Current investments (assumed)			
(4) Current Assets:			
e) Inventories			
f) Sundry Debtors	O	1,20,000	
g) Cash & Cash Equivalents	P	80,000	
h) Short-Term loans and	Q	1,65,200	
Advances	R	-	3,65,200
Total Assets			4,70,000

2.4.5 Self Test Questions

Theory

1. What are the souses from which bonus shares can be issued?
2. What do you mean by corporate dividend tax? Give its accounting treatment.
3. Discuss the sources from which bonus shares can be issued by a company and the latest guidelines issued by the SEBI for the issue of bonus shares.

Problems

(1) The capital of a limited company consisted of 12,500% preference shares of ₹10 each and 25,000 equity shares of ₹10 each and the company has accumulated, out of profits, a reserve fund of ₹1 lakh. It further issued 5,000 equity shares during the year at a premium of ₹15 per share, and the whole amount has been realised. At the end of the year an independent valuation of its assets increased the balance sheet figures as follows: Land and Building by ₹ 3,25,000, plant and machinery of ₹1,50,000: permanent way by ₹1,25,000. The valuation reduced the amount of the following: Goodwill by ₹ 75,000, concession rights by ₹. 50,000.

It was decided (i) to redeem 15,000 debentures of ₹.100 each at 5% premium; (ii) to allot one bonus share of ₹ 10 fully paid up for every equity share held, and (iii) to adopt new valuation. Make journal entries and comment on the proposal.

(2) The following balance sheet of Krishna Ltd. as at 30th June:

Liabilities	₹.	*Assets*	₹.
10,000 Equity shares of ₹ 100 each fully paid.	10,00,000	Fixed Assets	15,00,000
		Stock, Debtors etc;	4,00,000
1,000 Redeemable Preference shares of ₹100 each fully paid	1,00,000	Bank	2,00,000
General Reserve A/c	8,00,000		
Current Liabilities and Provisions	2,00,000		
	21,00,000		21,00,000

The board of directors decided to issue bonus shares out of the general reserve in the ratio of one share for every five equity shares held. The directors also decided to redeem the preference shares. The decisions are very out. Pass journal entries and also draw the balance sheet as it will appear after the above decisions have been carried out.

(3) The authorised capital of a company is ₹. 12,00,000 divided into 12,000 Equity shares of ₹ 100 each out of which 8,000 shares have been, subscribed and on these ₹ 75 per share has been paid up.

The company has the following undisposed balances:

(i) ₹ 2,30,000 (Cr.) in profit & Loss A/c

(ii) ₹. 85,000 in the general reserve A/c

The company has decided in general meeting to capitalise the necessary parts of the above balances:

(a) By paying as bonus of ₹25 per share on the partly paid shares in order to make them fully paid: and

(b) By issuing 1,000 fully paid equity shares at par at the rate of one fully paid share for eight shares already subscribed and paid for. The balance of the P&L A/c is first to be exhausted and then the general reserve is to be drawn upon.

Give journal entries to give effect to the above transaction.

(4) The following is the balance sheet of X Ltd. as on 31st March

Liabilities	₹	*Assets*	₹
Share Capital: 1,000 shares of ₹200 each ₹100 paid	1,00,000	Sundry Assets	3,40,000
Share Premium A/c	10,000		
Reserve A/c	80,000		
P&L A/c	60,000		
Sundry Creditors	90,000		
	3,40,000		3,40,000

The company resolves to distribute ₹80,000 as bonus to utilise in paying up a call of ₹ 80 per share. Minimum reduction is to be made from free reserve. Show journal entries.

(5) The balance sheet of Y Ltd. as on 31st March 2012 Was as follows:

Liabilities	₹	*Assets*	₹
4,000 Equity Shares of ₹ 100 each ₹ 80 paid	3,20,000	Sundry Assets	10,00,000
Share Premium A/c	60,000		
Capital redemption reserve A/c	70,000		
General Reserve A/c	1,00,000		
P&L A/c	3,00,000		
Sundry Creditors	1,1,50,000		
	10,00,000		10,00,000

The directors recommended the following with a view to capitalising whole of share premium A/c, capital redemption reserve A/c, general reserve and ₹ 50,000 out of profit and loss account.

a. The existing share be made fully paid without the shareholders having to pay anything.
b. Each shareholder to be given fully paid bonus shares at a premium of 25% for the remaining amount in proportion to their holdings.

Assuming that the scheme is accepted and that all formalities are gone through, give journal entries and also show in what proportion bonus shares will distributed among shareholders.

Lesson 2.5 Financial Reporting and Disclosure Practices

Learning objectives

After learning this chapter, you will be able to:

- Explain Financial Reporting and Disclosure Practices
- importance and Scope o fCorporate Governance
- know the Norms of SEBI relating to information Disclosure in Annual Reports.
- understand the Professional Chartered Accountants' Functions and Services.
- know the Code of Conduct and Professional Ethics

2.5.1 Introduction

Corporate financing reporting system and the preparations of financial statement are essential prerequisites to be good accountant or a financial analyst. Without the proper knowledge about the conceptual bases of this, the main purpose of the reporting system may not be achieved. The main objective of this chapter is to enlighten the corporate financial system and issues involved. Regulatory framework of corporate financial reporting in India and practice of Indian Companies are also covered. The norms of SEBI relating to information disclosure in annual report, functions and services of chartered accountants, and code of conduct and professional ethics also tobe discussed in this chapter.

2.5.2Concept of Corporate Financial Reporting System

Financial reporting is the communication of financial reporting information of an enterprise to the external world. Bedford conceptualises the financial reporting progress as accounting of four procedural steps:

1. Preparation of significant activity of the accounting entity or in the environment in which entity performs. Implicit in the traditional preparation is the belief that financial transactions represent the significant activities.

2. Symbolising the perceived activities in such fashion that a database of the activities is available that can be analysed to grasp an understanding of the interrelationships of mass of perceiving activities. Conventionally, this symbolisation has taken the form of recordings in accounts, journals, and ledgers using well-established bookkeeping and measurement procedures.
3. Analysis of the model of activities in order to summarise the relationship among activities and to provide a status picture or map of the entity. Traditionally, this analysis process has been viewed as one of developing accounting reports to provide insights into the nature.
4. Communication (transmission) of the analysis to users of the accounting products to guide decision makers in directing future activities of the entity or in changing their relationship with the entity.

First two steps constitute the process of accounting **measurement,** and step 3 and 4 of the financial reporting process constitute **disclosure.** Hence, measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance. Accountants prepare financial statements in accordance with corporate policies, industry practices and regulatory guidelines.

As per Section 2(40) the Companies Act, 2013, the Financial statement of the company includes:-

1. a balance sheet at the end of the financial year;
2. a profit and Loss account, or in the case of a company carrying on any activity not for profit ,an income and expenditure account for the financial year;
3. cash flow statement for the financial year;
4. a statement of change in equity, if applicable; and any explanatory note annexed to, or forming part of, any document referred to in sub-clause(i) to sub-clause (iv).

The cash flow statement may not included by One-man Company, small company or dormant company. The financial statements, amplified by footnotes and supplementary data (often referred to as 'Notes on Accounts' or 'Notes to the Accounts' in India) are intended to provide relevant, reliable and timely information essential for making investment, credit and similar decision. Such financial statements are called

general purpose financial statements. Financial reporting includes other means of communicating information that relates, directly or indirectly to the information generated through accounting process. Financial reporting includes not only the financial statements different information in different form.

2.5.2.1Users of Financial Statements

According to the Framework for the Preparation and Presentation of Financial Statements issued by the ICAI in 2000 (hereinafter referred to as 'ICAI Conceptual Framework') the users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

These different user groups have different objectives and diverse information needs. But, general purpose financial statements are prepared to meet the common needs of all types of users. Such a report cannot provide the information needed by the specific users. Multiplicity and conflicts of objectives of a wide variety of potential users for general purpose reports make it difficult to design a single set of published statements that can simultaneously provide all necessary information to all possible users.

Traditionally, investors (both existing and potential) are singled out as the dominant user-group of published financial statements. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The ICAI Conceptual Framework states that the provision of financial statements, which meet the investors' needs, will also meet most of the needs of other users. Also in practice, top priority is given to the information needs of the investors while deciding what items of information should be disclosed in general purpose financial statements.

2.5.2.2 Objectives of Corporate Financial Reporting

Corporate financing reporting is not anend in itself but is a means to certain objectives. The conceptual framework provides the conceptual basis for generally accepted accounting principles (GAAP). It outlines the characteristics accounting information must possess to be useful in investment and other economic decisions. Like other standard setting bodies, paragraph 22 of the Framework states that the objective of financial statements is to provide information about financial position, performance and

cash flows of an enterprise that is useful to a wide range of users in making economic decisions. The Framework specifies present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public as the users of financial statements.

In USA, the FASB has identified the following major objectives of financial reporting:

(i) Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

(ii) Financial reporting should provide information to help investors, creditors, and others to assess the amount, timing and uncertainly of prospective net cash inflows to the related enterprise.

(iii) Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.

(iv) Financial reporting should provide information about an enterprise's financial performance during a period.

(v) The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components.

(vi) Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

(vii) Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.

(viii) Financial reporting should provide information that is useful to managers and directors in making decisions in the interest of owners.

Apart from investment decision making another objective of financial reporting is to provide information on management accountability. Management accountability is

a broad concept that encompasses stewardship. The accountability relationship may be created by a constitution, a law, a contract an organization make, a custom or even by informal moral obligation. It is considered that management of an enterprise is periodically accountable to the owners not only for safekeeping of resources but also for their efficient and profitable use. Management accountability objective mainly emphasizes reliability aspect of accounting information. Accordingly, compared to relevance, verifiability through adequate documents, records and system is considered dominant consideration for inclusion of any piece of information in the financial statement.

Corporate financial reporting being user oriented and users' need of information being not same, the role of accounting and financial reporting may vary from country to country. But, financial reporting is central to the process of allocating financial resources in capital markets. Hence, primary purpose of providing useful information to all users, which help them in decision making, is common in all countries.

2.5.2.3 Qualitative Characteristics of Information in Financial Report

Qualitativecharacteristics are the attributes that make the information provided in the financial statement useful to the users. ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic. A piece of information is considered to be material when its disclosure or non- disclosure would affect decision or would make a difference in the valuation of the firm. But, in the ICAI Conceptual Framework, materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

2.5.2.3.1 Understandability

Information in annual reports should be presented in such a way thatit is readily understandable by users. ICAI Conceptual Framework states that the criterion of understandability requires that the users have a reasonable knowledge of business and economic activities, accounting, and a willingness to study the information with reasonable diligence. It has also suggested that information, which is relevant to the

economic decision-making needs of some of the users should not be excluded merely on the ground that it may be difficult to understand by others.

2.5.2.3.2 Relevance

The concept of relevance is directly related to the decision making needs ofusers. Information is said to be relevant if it can influence 'the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluation. It is suggested that all those items of information, which may aid the users in making predictions or decisions, should be reported. Information, which does not assist users in making decisions is irrelevant and hence, should be omitted. Thus, relevance is the dominant criterion of taking decisions regarding information disclosure. *Timeliness* is an important aspect of relevance. Information loses value rapidly in the financial world. As time passes and the future becomes the present, past information became increasingly irrelevant.

2.5.2.3.3 Reliability

Information is reliable if it is free from material error and bias, and faithfullyrepresents what it purports to represent. Information is reliable to the extent a user can depend upon it to represent the economic conditions or events that it aims to represent. Being free from bias implies impartial measurement and reporting by enterprise of its events and transactions.

2.5.2.3.4 Comparability

The ICAI Conceptual Framework emphasizes that users must be able tocompare financial statements, of an enterprise through time in order to identify trends in its financial position, performance and cash flows, and of different enterprises in order to evaluate their relative financial position, performance and cash flows. For this purpose, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way. The Framework indicates that the important implication of comparability is that users should be informed of the accounting policies employed in the preparation of financial statements, any changes of those policies and the effects of such changes. For achieving comparability, the Framework (paragraph 40) suggests compliance with relevant accounting standards including the disclosure of accounting policies used by the enterprise.

2.5.2.4 Constraints on Relevant and Reliable Information

2.5.2.4.1 Timeliness

If there is undue delay in the reporting of relevant information it may lose its relevance. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known thus impairing the reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

2.5.2.4.2 Balance between Benefit and Costs

The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from any information should exceed the cost of providing it. FASB says in its conceptual framework, "the benefits and costs from financial information are usually difficult or impossible to measure objectively. Different persons will honestly disagree about whether the benefits of the information justify its costs." Furthermore, the costs do not fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons it is difficult to apply cost-benefit test in any particular case. According to Singh (2005), the major benefits of the financial reporting to the investors are the reduction of the likelihood that they will misallocate their capital. As far as costs are concerned he has classified them into three parts: The cost of developing and disseminating information, the cost of litigation attributable to informative disclosure, and the cost of competitive disadvantage attributable to disclosure.

2.5.2.4.3 Balance between Qualitative Characteristics

A trade-off between various qualitative characteristics is very much necessary.The relative importance of different characteristics varies from case to case. Generally the aim is to achieve an appropriate balance between the characteristics in order to achieve the objective of financial reporting

2.5.2.5 Concept of Disclosure

The concept of disclosure is of great significance to the accomplishment of the objectives of financial reporting. Financial reporting is the communication of financial information of an enterprise to the external world. Disclosure standards and practices

are influenced by legal systems, source of finance, political and economic environments, education level and culture. Capital market is the major motivating force to disclose decision-oriented information to different user groups, which is ultimately shape the nature of corporate disclosure. Disclosure in its annual report may be causes for obtain capital at a lower cost. It is pre- requisite for the growth of capital markets. Apart from stock market considerations, the following important considerations are also motivate the management of a company to disclose information voluntarily and not wait for mandatory requirements.

Political costs consideration: Fines, penalties, potential public hostility toward the companyare the examples of political costs. It is now recognized that political costs may play an important role in decisions relating to additional disclosure in the form of social and environmental information. Disclosure of environmental information can be considered to reassure the public or the regulating agencies that companies were concerned for community at large by protecting environment.

Users' needs consideration: Companies may disclose social information to meet the stakeholders' demand for such information. The argument is based on Users' Utility Model. Disclosure of additional information on a voluntary basis depends on the users' needs, and how these needs are perceived by management of companies.

Ideological goal consideration: It has been argued that companies would be motivated to disclose voluntarily additional information to serve their own political and ideological goals. Such disclosure would be guided by companies' agenda, ideologies and goals which are likely to be different for different companies even within the same industry. Consequently, disclosure of such information will vary from company to company.

Basic Problems of Disclosure: In disclosing information, business enterprises, particularly corporate entities, are confronted with the following basic problems:

(i) identification of users of information
(ii) identification information need
(iii) problem of determining quantum of information
(iv) mode of disclosure
(v) timing of disclosure

Disclosure being the transmission of accounting measurement to the users group, corporate entities views it as a major policy issue. As the disclosure of accounting

information is not costless, preparers of financial statement have to make judgments on the allocation of accounting information among various users groups. If the management answers to all the above points with the disclosures of facts and figures in the corporate financial report, it will serve the various groups. If there is failure to adequately respond to express information needs of different stakeholders, it will causes for the scope of negative sanctions of regulatory controls over corporate disclosure increases when users groups perceive that there are deficiencies on the part of companies in providing adequate disclosure.

2.5.2.5 Quality of Financial Reporting

Ideally, financial statements should reflect anaccurate picture of a company, its financial condition and performance. If the financial statements distort economic reality, capital will be deployed sub-optimally; resources will be misallocated; investors will pay a huge opportunity cost by investing in companies with unrealistic, inflated values and better investment opportunities may get bypassed. Regulations on financial reporting generally provides for penalties and other measures to deter accounting frauds. However, it may be pointed out that management has considerable discretion within the overall framework of generally accepted accounting principles. As results, there are scopes for management to "manipulate" the accounts. Such manipulations mainly relate to management of bottom-line (profit or loss) and commonly referred to an earnings management. For an investor or a security analyst it is important to recognize that many opportunities exist for management to affect the quality of financial statements. Hence, reported earnings may not best represent economic reality or the future operating potential of a firm.

2.5.2.6 Mode of Financial Reporting:

Despite the existence of different sources of information, the annual report is regarded as the most important source of information about a company's affairs. A typical corporate annual report usually contains a balance sheet, profit and loss account, cash flow and / funds flow statement, and directors' report. Besides, the details of information and additional information are provided in the schedules and notes on accounts, which form parts of financial statements. Annual reports often contain useful supplementary financial and statistical data as well as management comments. Many companies in India now include Management Discussion and Analysis (MD & A) report, corporate governance report, chairman's statement, historical summary, operating

positions, highlights of important data etc.

2.5.2.7 Indian Financial Reporting System

India is a federal state with unitary bias. This is perhaps why, unlike in the USA, there is no separate company law for any state in India. Apart from professional regulation, corporate financial reporting in India is governed primarily by the Companies Act, 2013, which is already discussed in the chapter 2.3. Another body that has a major influence in reshaping Indian financial reporting is the Securities and Exchange Board of India (SEBI). The reporting requirements that are imposed by the SEBI through its Guidelines and through the Listing Agreement are in addition to those prescribed under the Companies Act. The Companies Act and the SEBI requirements together provide the legal framework of corporate reporting in India.

2.5.3. Role of the SEBI

The Securities and Exchange Board of India (SEBI) is the regulatory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 provides for establishment of Securities and Exchange Board of India (SEBI) with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market and (c) Regulating the securities market.

Its regulatory jurisdiction extends over corporate in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI has been obligated to perform the aforesaid functions by such measures as it thinks fit. In particular, it has powers for

- Regulating the business in stock exchanges and any other securities markets
- Registering and regulating the working of stock brokers, sub-brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices
- Calling for information, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self - regulatory organizations, mutual funds and other persons associated with the securities market.

2.5.3.1 Norms of SEBI relating to information Disclosure in Annual Reports

SEBI has used its power to order changes in listing agreement and such changes are instrumental to bring about improvement in disclosure practices of listed companies in their annual reports. Listing agreement is the standard agreement between a company

seeking listing of its securities and the stock exchange where listing is sought. Any stock exchange has power to alter the clauses of listing agreement unilaterally, and companies listed with that exchange are bound to accept such changes to enjoy the facility of listing. Thus, whenever the SEBI suggests any change, it is incumbent on the listed companies to follow such a change. In effect, the SEBI has power to direct the listed companies to follow any changed disclosure requirements.SEBI has imposed a number of disclosures and other requirements through this route. Some important requirements are as follows:

- Dispatch of a copy of the complete & full annual report to the shareholders (Clause 32).
- Disclosure on the Y2K preparedness level (Clause 32).
- Disclosure of Cash Flow Statement (Clause 32).
- Disclosure of material developments and price sensitive information (Clause 36).
- Compliance with Takeover Code (Clause 40 B)
- Disclosure of interim unaudited financial result (Clause 41).
- Disclosure regarding listing fee payment status and the name and address of each stock exchange where the company's securities are listed (Clause 48 B).
- Corporate governance report (Clause 49).
- Compliance with Accounting Standards issued by the ICAI (Clause 50).

The process of the SEBI has resulted in a changed regime for imposition of financial disclosure requirements that is quick and does not require lengthy process of legislative changes. By virtue of the provisions contained the Listing Agreement (Clause 50), listed companies are now under legal compulsion to comply with all the accounting standards issued by the ICAI.

2.5.3.2 Principals Governing Disclosures

The Securities Exchange Board of India (SEBI), on September 2, 2015, issued SEBI (Listing and Disclosure) Regulations, 2015 (hereinafter referred to as 'Regulations') on listing of different segments of the capital market and disclosure norms in relation thereto. These regulations have been structured into one single document consolidating various types of securities listed on the stock exchanges. The latest set of

norms provides broad principles for periodic disclosures by listed entities, apart from incorporating corporate governance principles.

These regulations shall apply to the listed entity who has listed any of the following designated securities on recognized stock exchange(s):

a. Specified securities listed on main board or SME Exchange or Institutional trading platform;
b. Non-convertible debt securities, non-convertible redeemable preference Shares, perpetual debt instrument, perpetual non-cumulative preference Shares;
c. Indian depository receipts;
d. Securitized debt instruments;
e. Units issued by mutual funds;
f. Any other securities as may be specified by the Board.

The Disclosure aspect as in the framework of these Regulations has been discussed below in brief:The listed entities which have listed securities shall make disclosures and abide by certain obligations under these regulations, in accordance with the following principles:

i. Information shall be prepared and disclosed in accordance with applicable standards of accounting and financial disclosure.
ii. The listed entity shall implement the prescribed accounting standards in letter and spirit in the preparation of financial statements taking into consideration the interest of all stakeholders and shall also ensure that the annual audit is conducted by an independent, competent and qualified auditor.
iii. The listed entity shall refrain from misrepresentation and ensure that the information provided to recognised stock exchange(s) and investors is not misleading.
iv. The listed entity shall provide adequate and timely information to recognised stock exchange(s) and investors.
v. The listed entity shall ensure that disseminations made under provisions of these regulations and circulars made there under, are adequate, accurate, explicit, timely and presented in a simple language.

vi. Channels for disseminating information shall provide for equal, timely and cost efficient access to relevant information by investors.

vii. The listed entity shall abide by all the provisions of the applicable laws including the securities laws and also such other guidelines as may be issued from time to time by the Board and the recognized stock exchange(s) in this regard and as may be applicable.

viii. The listed entity shall make the specified disclosures and follow its obligations in letter and spirit taking into consideration the interest of all stakeholders.

ix. Filings, reports, statements, documents and information which are event based or are filed periodically shall contain relevant information.

x. Periodic filings, reports, statements, documents and information reports shall contain information that shall enable investors to track the performance of a listed entity over regular intervals of time and shall provide sufficient information to enable investors to assess the current status of a listed entity.

2.5.4 Corporate Governance:

In India the first attempt was made by the Confederation of Indian Industries (CII) to codify Corporate Governance. But the genesis of the provisions on Corporate Governance contained in clause 49 of the Listing Agreement is the Report of Kumar Mangalam Birla Committee. On 7th May 1999, the SEBI had set up a committee under the chairmanship of Sri Kumar Mangalam Birla to formulate the code of Corporate Governance. The SEBI in its meeting held on 25th January, 2000 accepted the recommendations made by the committee and suggested incorporation of certain matters in the Listing Agreement as clause 49. This clause addresses different aspects of corporate governance. The disclosure requirements contained under this clause are as under:

(a) Management Discussion and Analysis Report

Management Discussion and Analysis(MD & A) report is a very important document through which management of a company can express its views and opinions on various aspects of a company like performance, success or failure, future plan of the company, forward looking information, etc.

The MD&A complements and supplements the financial statements, but does not form part of the financial statements. The objective in preparing the MD&A should be

to improve the reporting company's overall financial disclosure by providing a balanced discussion of the results of operations and financial conditions. Although originally devised as a regulatory document to supplement financial statements, the MD&A report has the potential to be a foundational and integrative business reporting document that provides 'forward-looking information'.

The MD&A serves the admirable purpose of giving investors important disclosures about a company's operations. Although this section contains useful information, investors must heed caution, as the section is unaudited.By virtue of the provisions contained in clause 49 under the Listing Agreement, the company has to provide a MD & A report to the shareholders. This report may be presented *as part ofthe directors' report* or *as an addition thereto*. It should include discussion on the followingmatters within the limits set by the company's competitive position:

(i) Industry structure and developments.
(ii) Opportunities and threats.
(iii) Segment-wise or product-wise performance.
(iv) Outlook.
(v) Risks and concerns.
(vi) Internal control systems and their adequacy.
(vii) Discussion on financial performance with respect to operational performance.
(viii) Material developments in Human Resources/ Industrial Relations front, including number of people employed.

(b) Management's Report on Corporate Governance

The listed companies are required togive a detailed compliance report on corporate governance in the separate section on 'Corporate Governance' in their annual reports. The report must specifically highlight non-compliance of any mandatory requirements with reasons thereof and also the extent to whichnon-mandatory requirements have been adopted.

The company should obtain a certificate from the auditors of the company regarding the compliance with the conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report which is sent annually to all the shareholders of the company.

2.5.4. 1 Disclosure in Corporate Governance Report

The following disclosures shall be made in the section on the corporate governance of the annual report of the listed entities:

i. A brief statement on listed entity's philosophy on code of governance.
ii. Information, as prescribed in the Regulations, about the following:
    a. Board of directors,
    b. Audit committee,
    c. Nomination and Remuneration Committee,
    d. Remuneration of Directors,
    e. Stakeholders' grievance committee,
    f. General body meetings,
    g. Means of communication,
    h. General shareholder information,
iii. Other Disclosures:
    a. Disclosures on materially significant related party transactions that may have potential conflict with the interests of listed entity at large;
    b. Details of non-compliance by the listed entity, penalties imposed on the listed entity by stock exchange(s) or the board or any statutory authority, on any matter related to capital markets, during the last three years;
    c. Details of establishment of vigil mechanism, whistle blower policy, and affirmation that no personnel has been denied access to the audit committee;
    d. Details of compliance with mandatory requirements and adoption of the nonmandatory requirements;
    e. Web link where policy for determining 'material' subsidiaries is disclosed;
    f. Web link where policy on dealing with related party transactions;
    g. Disclosure of commodity price risks and commodity hedging activities.

Where there is any non-compliance of any requirement of corporate governance report, reasons thereof also needs to be disclosed.

2.5.4. 2 Disclosure of Events or Information

1. Every listed entity shall make disclosures of any events or information which, in the opinion of the board of directors of the listed company, is material. Events

specified in Para (A) of Part (A) of Schedule III of the Regulations are deemed to be material events and listed entity shall make disclosure of such events. The listed entity shall make disclosure of events specified in Para (B) of Part (A) of Schedule III, based on application of the guidelines for materiality, as specified.

2. The listed entity shall consider the following criteria for determination of materiality of events/ information:
    a. the omission of an event or information, which is likely to result in discontinuity or alteration of event or information already available publicly; or
    b. the omission of an event or information is likely to result in significant market reaction if the said omission came to light at a later date;
    c. In case where the criteria specified in sub-clauses a) and b) are not applicable, an event/information may be treated as being material if in the opinion of the Board of Directors of listed entity, the event / information is considered material.

The listed entity shall frame a policy for determination of materiality, based on criteria specified above, duly approved by its board of directors, which shall be disclosed on its website.

3. The board of directors of the listed entity shall authorize one or more Key Managerial Personnel for the purpose of determining materiality of an event or information and for the purpose of making disclosures to stock exchange(s) under this regulation and the contact details of such personnel shall be also disclosed to the stock exchange(s) and as well as on the listed entity's website.
4. The listed entity shall first disclose to stock exchange(s) of all events, as specified in Part A of Schedule III, or information as soon as reasonably possible and not later than 24 hours from the occurrence of event or information. In case the disclosure is made after 24 hours of occurrence of the event or information, the listed entity shall, along with such disclosures provide explanation for delay. Disclosure with respect to the outcome of board meeting shall be made within 30 minutes of the conclusion of such board meeting.

5. The listed entity shall, with respect to disclosures referred to in these regulations, make disclosures updating material developments on a regular basis, till such time the event is resolved/closed, with relevant explanations.

6. The listed entity shall disclose on its website all such events or information which has been disclosed to stock exchange(s) under this regulation, and such disclosures shall be hosted on the website of the listed entity for a minimum period of 5 years and thereafter as per the archival policy of the listed entity, as disclosed on its website.

2.5.5. Corporate Reporting Practices in India

There are few studies that deal with Indian practices of corporate financial reporting. The Institute of Chartered Accountants of India has made survey of corporate reporting practices in India from time to time. Many scholars are studied about the financial reporting in India. It is noticed from these studies that Indian corporate reporting practices are coping with changing needs of the economy and the society. Though, the compliance with statutory disclosure requirement is a general phenomenon, there are cases of non-compliance with mandatory disclosure requirements. It is the ultimate responsibility of the management to providing information to the. It may also be noted that there is a great amount of diversity in corporate reporting. The quality of information provided by the big companies has improved considerably and reports of some Indian companies are internationally competitive. The current reporting practices of Indian companies are discussed below.

2.5.5.1 Published Financial Statements

Indian companies are publishing their financial statements in the Annual report. Indian annual reports now include much more than the legal minimum requirements. Regarding elements of annual reports, the following are most common:

- Notice of annual general meeting
- Chairman's report*
- Summary of financial results*
- The financial highlights for a number of years*
- Director's report

- Management discussion & analysis
- Corporate governance report
- Auditor’s report on financial statements
- Balance sheet
- Profit and loss account
- Significant accounting policies
- Schedules and notes accounts
- Cash flow statement
- Supplementary statements
- C& AG’s Comments on Accounts (in case of Government Companies)
- Audited consolidated financial statements
- Information on human resources*
- Value added statement*
- Corporate social report*
- Environmental report*
- Information on Brand/ Intangibles*
- EVA® report*
- Business Responsibility Report*

The marked elements are provided voluntarily. Regarding last few items disclosure is limited to large companies only.

2.5.6 Role of Auditors

The audit of financial statements is a legal requirement. The audit provides an external and objective check on the measurement and disclosure aspects of corporate financial reporting. An auditor is appointed by the shareholders, but effectually his appointment is subject to will of management or promoter group. Nevertheless, the auditor is supposed to be independent of management and to serve the shareholders and other users of financial statements. Although, Management is responsible for the preparation of financial statement including the notes, the auditor through the auditor’s report states whether financial statements presents fairly, in all material respects the financial position, the results of operations and the cash flows for the accounting period. The auditor is responsible for seeing that the financial statements issued conform with generally accepted accounting principles. Thus, the auditor must agree that accounting

policies adopted by the management is appropriate and all estimates are reasonable. Any departure from generally accepted accounting principles (including non-compliance with the measurement and disclosure requirements of the accounting standards) would result in a qualified opinion. Auditor's report is an important accompaniment of financial statements. Because of boilerplate nature (ie. standard language) of these reports, there is tendency to skip over them while analyzing financial statements. However, such failure to give attention to the auditor's report may cause the user to miss significant information.

2.5.6.1 Functions performed by Chartered Accountants only

The law places certain conditions on the performance of certain functions. Where the law requires that a particular function be performed only by a certain professional, it should be so. Therefore in such cases and in those cases where the specialised knowledge of the professional would be very much crucial in performing the function, we find that the functions performed would be specific to the profession.

1. Under Sec 44 of the Income -Tax law every assesses with a gross receipts of ₹. 10 lakhs in the case of professionals and ₹. 40 Lakhs in the case of business concerns is compulsorily required to maintain accounts and get them audited by a CA.
2. CA's services are employed by the tax department for auditing complicated cases, having large revenue potential.
3. CA's services are employed by the Reserve Bank of India and the Comptroller and auditor general of India for conducting Statutory Audit of Banks every year.

2.5.5.2 Functions performed by all Professional Accountants

The three professional accounting courses of CA/CWA/CS which give an entry into the respective professions can be called professional accounting courses in general. The subjects that you study in all the three courses are similar/common to a certain/major extent. A CA's, concentration would be on accounting, taxation and auditing. A CWA/ICWA's concentration would be on Costing and Management Accounting. A CS's concentration would be on company law and related aspects.The General Functions that are capable of being performed by these professional accountants are:

Accounting

Writing up of accounts and the preparation of financial statements ranging from simple Book keeping to making complex financial analysis.

Audit

Satisfying the users of financial statements that the statements which represent the accounts of organisations present a true and fair view of the state of affairs and are based on appropriate accounting principles.

Cost Accounting

Ascertaining the cost of production/processes at different levels of operations in the manufacture of a product or rendering a service. Providing costing information for the guidance of management, introducing cost control methods and assisting managements in establishing appropriate sale prices.

Taxation

Since the tax laws are varied and complicated for a lay man to understand every one needs the services of a professional accountant for current and continuing tax information and getting general advice on taxes. Tax assessment is very closely linked with financial accounts. Therefore a professional accountant performs the functions of preparing returns for tax purposes, representing assessee's before Income-Tax authorities.

Special Company Work

Matters such as the formation of companies (registration work), designing the financial structure, liquidation etc the services of a professional accountant would be needed.

Shareholders representative - Company Directors

Working as a representative of the shareholders i.e. in the position of a director in the "Board of Directors" of the company. The professionals who hold senior positions in industry and commerce are best suited to this task. On account of their professional knowledge in one of the core functions i.e. accounting, they are capable of giving appropriate advices.

Secretarial Work

A secretary in addition to his regular secretarial work is an important link in the management chain. Small companies which may not need or are unable to afford the services of a full time secretary take the help of professional accountants for these. The

growth of company as a form of business organisation creates a large scope in this area.Almost every kind of organisation whose affairs are controlled by boards, councils and other corporate structures be it a co-operative , trust, society, association, federation, statutory authority, commission, board or the like finds it useful to utilize the services of the professional accountant for secretarial work.

Trustees - Executors

Professional accountants often are appointed as executors under a will or trust in order to carry on the administration of the estate or settlements. In such cases they work in tandem with legal practitioners. Solicitors or lawyers carrying out works of this kind usually take the help of professional accountants.

Management Accounting and consultancy

Professional accountants perform functions relating to management which have a direct accounting implication like formulation of policies, day to day control, performance evaluation, etc. They can assist business organisations in making the best use of the available resources in achieving their goals effectively.

Investigation - Share Valuation Work

Investigation is carried out to ascertain the financial position of business in connection with matters such as a new issue of share capital, the purchase or sale or financing of a business, reconstruction and amalgamations. Valuation of shares of public and private companies at the time of amalgamation or re-organisation and for the purpose of takeover bids and other acquisitions is being done by professional accountants.

Teaching/Training

The qualifications of the respective institutions are recognized at par with post graduate qualifications in commerce by many universities which enable them to take up a post as a lecturer in respective subjects where post graduation qualification is needed to be so appointed in the post.

Emerging areas

Other miscellaneous services and emerging new areas of work like (a) Work related to e - commerce in assessing the adequacy of the system (b) Risk management (c) Services as an arbitrator for the settling of disputes (d) Work connected with insolvency (e) measuring intellectual capital (f) Measurement of performance and system quality (g) Continuous assurance etc.

2.5.6 Code of Ethics for Chartered Accountant

Financial statements of an enterprise depict the wholesome financial situation of the enterprise for a particular period / at a particular date. The information in these statements are of vital importance for a large section of the society, which deals with that enterprise. It may be suppliers of material, customers, investors, Banks, Financial Institutions, Insurers, Government, Tax Authorities, employees, collaborators and even their competitors. Keeping in view the importance of these statements and the large section ofthe society who use these statements for taking many vital decisions, it is necessary that these statements are attested by some person who is expert in this field so that the objectivity, integrity, reliability and credibility of the information is assured to a large extent. This function of attestation is done by professional accountants, who are Chartered Accountants in our country. For the success of the profession of accountancy a self-imposed Code of Ethics is essential to command the respect and confidence of the general public. Chartered Accountants in the service of the affairs of others have responsibilities and obligations to those who rely on their work.

A client, before engaging the services of a professional requires to be assured, (i) that he has the required competence and (ii) that he is a person of character and integrity. As regards the first, evidence is available to the client in the form of a certificate that the Chartered Accountant has undergone the training and passed the appropriate examination in accountancy and as regards the second, he would have an assurance only if the professional body to which he belongs has adopted a code of professional ethics for its members.

The International Federation of Accountants (IFAC), in its guidelines on Professional Ethics for the Accountancy Profession, has stated:"Persons who pursue a vocation in which they offer their knowledge and skills in the service of the affairs of others have responsibilities and obligations to those who rely on their work. An essential pre-requisite for any group of such persons is the acceptance and observance of professional ethical standards regulating their relationship with clients, employers, employees, fellow members of the group and the public generally."IFAC in its Code of Ethics for Professional Accountants has also stated as under:

The Public Interest

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community and others who rely on the objectivity and integrity of professional accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on the accountancy profession. The public interest is defined as the collective wellbeing of the community of people and institutions the professional accountant serves.

A professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. The standards of the accountancy profession are heavily determined by the public interest, for example:

- Independent auditors help to maintain the integrity and efficiency of the financial statements presented to financial institutions in partial support for loans and to stockholders for obtaining capital;
- Financial executives serve in various financial management capacities in organizations and contribute to the efficient and effective use of the organization's resources;
- Internal auditors provide assurance about a sound internal control system which enhances the reliability of the external financial information of the employer;
- Tax experts help to establish confidence and efficiency in, and the fair application of, the tax system; and
- Management consultants have a responsibility towards the public interest in advocating sound management decision making.

Professional accountants have an important role in society. Investors, creditors, employers and other sections of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behaviour of professional accountants in

providingsuch services have an impact on the economic well-being of their community and country.

Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance. In formulating their national code of ethics, member bodies should therefore consider the public service and user expectations of the ethical standards of professional accountants and take their views into account. By doing so, any existing "expectation gap" between the standards expected and those prescribed can be addressed or explained.

Objectives

The Code recognizes that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement set out above. These objectives require four basic needs to be met:

- **Credibility:**In the whole of society there is a need for credibility in information and information systems.
- **Professionalism:**There is a need for individuals who can be clearly identified by clients, employers and other interested parties as professional persons in the accountancy field.
- **Quality of Services:**There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.
- **Confidence:** Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.

Fundamental Principles

In order to achieve the objectives of the Accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles are:

- **Integrity:**A professional accountant should be straightforward and honest in performing professional services.
- **Objectivity:**A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.
- **Professional Competence and Due Care:** A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.
- **Confidentiality:**A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.
- **Professional Behaviour:** A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession. The obligation to refrain from any conduct which might bring discredit to the profession requires IFAC member bodies to consider, when developing ethical requirements, the responsibilities of a professional accountant to clients, third parties, other members of the accountancy profession, staff, employers and the general public.
- **Technical Standards:** A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer in-so-far as they are compatible with the

requirements of integrity, objectivity and in the case of professional accountants in public practice, independence. In addition they should confirm with the technical and professional standards promulgated by: (i) IFAC (e.g. International Standards on Auditing), (ii) International Accounting Standards Board, (iii) The Member's professional body or other regulatory body and (iv) Relevant legislation.

- **Independence:** When in public practice, an accountant should both be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

The over-riding motto has been 'pride of service in preference to personal gain'. A code of professional conduct may have the force of law, as is the case in this country in some matters, as well as the result of discipline and conventions voluntarily established by the members, any breach whereof would result in the person being disentitled to continue as a member of the professional body. In any event, it has a great deal of practical value in so far as it proclaims to the public that the members of the profession will discharge their duties and responsibilities, having regard to the public interest. This, in turn, will give an assurance to the public that in the event of a member straying away from the path of duty, he would be suitably dealt with by the professional body.

"Other Misconduct"

In this background, the Chartered Accountants Act, 1949 (as amended up to date), was formulated to regulate the profession of Chartered Accountancy. This Act is being administered through the Institute of Chartered Accountants of India; which functions and discharges its duty through a 'Council'. To ensure discipline in the profession, The Chartered Accountants Act along with its schedules sets out different forms of behaviour, which constitute misconduct under the law. The definition of misconduct in the Act is only an inclusive one and is not exhaustive. Over and above this, the council of the Institution (ICAI) has also been given powers under the law to enquire into the conduct of any member of the Institute other than those specified in the Act, which may in the view of the COUNCIL be not desirable and/or expected of a Chartered Accountant. This kind of misconduct is known as 'other misconduct'. The 'other misconduct' may not necessarily arise out of professional work. With a view to

bring harmony in presentation of the financial statements and an identical treatment in a particular situation, the ICAI has brought out various Statements, Auditing and Assurance Standards, Accounting Standards and Guidance Notes, which are mandatory for a practicing Chartered Accountant to be adhered to while discharging his professional duty of attestation of financial statements. These sets of documents necessitate that financial statements are depicted in a definite manner, and give the required information in the desired manner, which are professionally verified by applying scientific audit techniques to ensure material correctness to a large extent. The objectivity and integrity of the financial statements attested by a Chartered Accountant following these sets of documents are of a very high degree, and which enhance the credibility and reliability of these statements to the user. A Chartered Accountant, who does not follow these sets of documents in discharging his professional duty of attestation, is guilty of professional misconduct, and thereby liable for disciplinary action and punishment under the Act, which may be;

(i) Reprimanding the member or

(ii) Removing his name from the Register of members for such period not exceeding five years, or

(iii) Forwarding the case to the High Court with its recommendations where the council opines for removal of name for a period exceeding five years, or

(iv) If the misconduct is of a nature, which as per the Chartered Accountants Act requires action by the High Court, reference to the High Court with recommendations of the council.

The procedure of enquiry in respect of disciplinary action against a Chartered Accountant is not only lengthy but rigorous also. Barring a few exceptions, the Chartered Accountant, who has to face action would feel so humiliated that his enthusiasm and working capacity comes to the lowest level. Removal of name as a punishment further nails him with a severe economic blow.

2.5.8 Self Assessment Questions

1. Explain financial reporting and disclosure practices in India.
2. Describe the Norms of SEBI relating to information Disclosure in Annual Reports.
3. Explain the Professional Chartered Accountants' Functions and Services.
4. Discuss the code of conduct and professional ethics of the Chartered Accountants.

Lesson 3.1 Valuation of Goodwill

Learning Objectives

After reading this lesson you should be able

- Know the meaning, nature, and types of goodwill
- know the need for valuation of goodwill
- Identify the factors affecting the value of goodwill
- Describe the various methods of valuation of goodwill

3.1.1 Introduction

Goodwill may be explained as the aggregate of those intangible attributes of a business which contribute to its superior earning capacity over a normal return on investment. In short goodwill refers to measure of the capacity of a business to earn above the normal profits. It attracts more customers and increases the earning capacity of the firm.

3.1.2 Meaning of Goodwill

Goodwill is the valuable asset for the profitable business otherwise it valueless one. Some of the definitions of goodwill as follow:

"Goodwill is a thing easy to describe, but very difficult to define. It is the benefit and advantage of good name, reputation and connection of a business. It is the attractive force which brings in more customers. It is one thing which distinguishes an old established business from a new business at its first start. Goodwill is composed of a variety of elements. It differ in its composition in different businesses in the same trade,"- Lord Macnaughton.

"When a man prays for goodwill, he payes for something which places him in the position of being able to earn more money than he would be able to do by his own unaided efforts."- Dicksee

"The element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books" – Walton.

"Goodwill is nothing more than the probability that the old customers will resort to the old lance" – Lord Eldon.

According to the Institute of Chartered Accountants of India, goodwill is "an intangible asset arising from business connections or trade name or reputation of an enterprise."

The above definitions reveal that the goodwill is thus the extra saleable value attached to a prosperous business beyond the intrinsic value of net assets. Though, goodwill is an intangible asset, the existence of it can be felt through extra earning power. It is ranked as real assets.

3.1.3 Features of Goodwill

The special features of goodwill as follows:

i. It can be sold only with the entire business or it cannot be sold in part in isolation.

ii. It has the value only when it is transferred from one person to another.

iii. It is nonphysical varies over and above the physical assets.

iv. It cannot have an exact cost and it time to time it will fluctuate.

v. Its value based on the judgement of the valuer.

3.1.4 Nature of Goodwill

Goodwill has been said to be the attractive force which brings in customers. Hence to determine the nature of the Goodwill in any one given case, it is necessary to consider the type of business and the type of customers. The following are the principal classes of Goodwill.

a) **DogGoodwill**: Dogs are attached to the persons. Such customers lead to *personal goodwill* which is not transferable.
b) **Cat Goodwill**: The cat stays in the old home although the person who has kept the home leaves. Such customers give rise to *locality goodwill*.The value of cat goodwill always maximum one.
c) **Rat Goodwill**: The characteristic of a rat is that it moves from place to place. The rat has no attachments and is purely casual. The customer has attachment neither to the person nor to the place.It is known as *fugitive goodwill*. Such goodwill is valueless.
d) **Rabbit Goodwill**: The rabbit is attracted by mere propinquity. He comes because he happens to live close by and it would be more troublesome to go elsewhere.

3.1.5 Types of Goodwill

Goodwill is generally of two types, viz. purchased goodwill and non-purchased or inherent goodwill.

3.1.6 Need for valuation of Goodwill

Circumstances necessitating ascertainment of goodwill are:

In the case partnership firm

1. When there is a change in profit sharing ratio.
2. When a partner is admitted.
3. When a partner has died or retired.
4. When two partnership firms are amalgamated.
5. When a firm is sold to a company.

In the case of a Company

a. When amalgamation and absorption taken place.
b. When sales or purchase take place.
c. When shares are to be acquired by a holding company.
d. When value of share is not quoted in stock Exchange and shares are to be valued for taxation purposes.

3.1.7. Factors affecting Goodwill

The value of goodwill depends upon the conditions of each case. The main factors affecting the value of goodwill are as follows:

1. **Profitability:**
   Profitability of a firm is most important consideration for computation of goodwill. It refers to the profit which the firm is expected to earn in future. Many factors contribute to determine the profitability of the firm they are as follows:
   (a) Nature of Goods. Profits depend upon nature of goods. If business deals in articles of daily use, profits are likely to be constant. If more steady or constant profits are, the more is goodwill or vice versa.
   (b) Monopolised Business. A monopolised business will have more goodwill as compared to a business in which many rivals can enter the business.
   (c) Trade Name.
   (d) Risk Involved. Greater the risks involved, the higher the profits are.
   (e) Favourable Location and Site.
   (f) Possession of Trademarks, Patents and Copyrights.
   (g) Access to Supplies.
   (h) Skill of Management.

(i) Possession of Exceptional Contracts.

(j) Future Competition.

(k) Money Market Conditions.

(l) Stable PoliticalConditions.

(m) Government Industrial Policy.

(n) Profit Trends.

(o) Capital Required. If two business units earn the same profit with different amounts of capital, the business unit with lesser amount requirement will enjoy more goodwill.

2. **Normal rate of return**

Normal rate of return means the rate of return that will satisfy ordinary inverts in the industry concerned. It is differ from one industry to another. It comprises of three components:

a. Return at zero risk level. It refers to the expected rate of return of a project involves no risk either business or financial.

b. Premium for business risk. Business risk refers to the variability in operating profits due to change in sales. In such case, the investor expected more return from the investment.

c. Premium for financial risk. Financial risk arises due to the capital structure or debt equity mix of a firm. The higher debt content in the capital structure is more risk compared with low debt content firm.

3. **Capital employed**

The capital employed is the factor considered for the base for computation of the normal return on investment. It there is any change, which will affect the value of goodwill.

3.1.8 Accounting Treatment

Following are the methods of accounting for goodwill:

(a) Carry it as an asset and write it off over a period of years through the Profit and Loss Account.

(b) Eliminate it against reserves immediately

(c) Retain it an asset with no write-off unless a permanent reduction in value become evident.

(d) Write it off against profits immediately.

(e) Show it as a deductionfrom shareholders’ funds which may be amortized or carried forward indefinitely.

3.1.9 Methods of Evaluating Goodwill

The following are the methods of evaluating goodwill:

1. Average Profit Method
2. Super Profit Method
3. Capitalization Method
4. Annuity Method

3.1.9.1Average Profit Method

In this method, this goodwill is valued on the basis of an agreed number of years’ purchase of the averageprofits. The following factors are to be considered for computation of average profit:

1. Non-operating profit or loss to be excluded.
2. The loss, if any, in any year to be deducted.
3. Deduct such incomes or special incomes which may not be continued in future.
4. Past special types of expenses, which will not incur in future, are added.
5. Provision may be made for managerial remuneration.
6. Depreciation on fixed asset should be provided.

After adjustment the computed average profit is multiplied by a number as agreed. At the time of calculating average profit, precaution must be taken in respect of any abnormal items of profit or loss which may affect future profit. It should be mentioned that average profit may be based on simple average or weighted average.The product will be the value of goodwill.

$$\text{Average Profit} = \frac{\text{Total Profits for all the years}}{\text{Number of Years}}$$

Value of Goodwill = Average Profit x Years of Purchases

Illustration: 1

Mathanmohan and company decided to purchase a business for ₹1,80,000.Its profit for the last 4years are 2011-12 ₹40,000:2012-13 ₹50,000:2013-14 ₹56,000 and 2014-15 ₹68,000. The business was looked after by the management. Remuneration from alternative employment, if not engaged in the business, for the management comes to ₹3,500p.a.

Find out the amount of goodwill if it is valued on the basis of three years' purchase of the average net profit for the last four years.

Salutation:

		Profits ₹
2011-12		40,000
2012-13		50,000
2013-14		56,000
2014-15		68,000
Total of 4 years Profit:		2,14,000
Average Profit = 2,14,000/4	=	53,500
Less Management Remuneration	=	3,500
Adjusted Profit		50,000

Value of goodwill = 50,000 x 3 = ₹1,50,000

3.1.9.2 Super Profit Method

Super profit refers to that average profit which is earned by a business in excess of normal earnings. Really speaking the super profit is the difference between actual average profit and normal profit. That is, the term super profit means the profit over and above the normal profit. Or

Super Profit = Average Profit (Adjusted) – Normal Profit

Value of Goodwill = Super Profit x Years of Purchases

An assumption is made regarding the percentage of profit earned on a certain investment of capital in similar industries. This is considered as the normal expected profit in similar concerns.

This normal profit is compared with the actual profit. When the actual profit is more, there will be goodwill. To arrive at the value of goodwill, the super profit is multiplied by the number of years.

Illustration: 2

Average capital employed in X Ltd. is ₹30,00,000 whereas net trading profits before tax for the last three years have been ₹14,60,000, ₹14,45,000 and ₹15,20,000. In these three years, the managing director was paid a salary of ₹5,000 p.m. But now he would be paid a salary of ₹7,500 per month. Normal rate of

return expected in the industry in which X Ltd. is engaged is 20%. Rate of tax is 50%. Calculate goodwill on the basis of two years' purchase of the super profits.

Solution:

Total trading profits for the last three years = ₹14,60,000 + ₹14,45,000 + ₹. 15,20,000 = ₹44,25,000

	₹
Average annual trading profits = Rs. 44,25,000 ÷ 3	14,75,000
Less : Additional salary to managing director = (₹7,500 - ₹ 5,000) x 12	30,000
	14,45,000
Less : Income tax @ 50%	7,22,500
Expected profits	7,22,500

Normal profits = 20% of ₹30,00,000 = ₹6,00,000

Super profits = ₹7,22,500 - ₹6,00, 000 = ₹1,22,500

Goodwill on the basis of two years' purchase of super profits = ₹1,22,500 x 2

= ₹ 2,45,000

3.1.9.3 Capitalization of Profit Method

There are two methods under this:

(a) Capitalization of Super Profit

Under this method, it is estimated as to how much capital will be required to earn super profit at normal rate of profit. This capitalized value of super profit is treated as goodwill.

(b) Capitalisation of average profit

Under this method the average annual profit is to be ascertained after providing for reasonable management remuneration. This profit should be capitalized at the rate of reasonable return to find out the total value of the business. Now the value of goodwill will be the total value of the business minus its net assets. If, however, the net assets are greater, there will be no goodwill but bad will.

$$\text{Capitalised Value of Profit} = \frac{\text{Profit (Adjusted)}}{\text{Normal Rate of Return}} \times 100$$

Value of Goodwill =Capitalised Value of Profit – Net Tangible Assets

Illustration:3

The net profits of a company, after providing for taxation, for the past five year are ₹42,000;₹47,000;₹45,000; ₹39,000 and ₹. 47,000. The capital employed in the business is ₹4,00,000 on which a reasonable rate of return of 10% is expected. Calculate the goodwill under (a) Capitalisation of average Profit Method and (b) Capitalisation of Super Profit Method.

Solution:

(a) Average Profit = Total profit of 5 years/ 5

= (₹42,0000 + ₹47,000 + ₹45,000 +₹39,000 + ₹47,000)/ 5

= ₹.2,20,000 / 5
= ₹44,000

Capitalised value of the business at 10% = $\frac{₹44,000 \times 100}{10}$ = ₹4,40,000

Less: Capital employed (given)	₹4,00,000
Value of goodwill:	40,000

(b)Average Profit (as above)	₹44,000
Less: normal return on capital employed	
(At 10% on Rs 4,00,000)	₹ 40,000
Super Profit	₹4,000

Capital value of super profit = $\frac{4,000 \times 100}{10}$ = ₹ 40,000

3.1.9.4 Annuity Method

This method is based on the logic that the purchaser should pay now for goodwill only the present value of super profits calculated at a proper rate o interest. In other words, goodwill in case of this method is the discounted value of the total amount calculated as per purchase of super profit method.

The value of goodwill in case of this method is ascertained as follows:

Average Annual Super Profit × Annuity Rate

Illustration:4

Calculate the value of Goodwill for thefollowing data on the basis of aunity method:

Average annual super profit	₹5,000
Rate of interest	10%

Goodwill is to valued at 3 year purchase of the average annual super profit

Solution:

In case goodwill is to be valued at 3 years' purchase of the average annual super profit reference will have to be made to the annuity table for finding out the present value of one rupee paid annually for 3 years at 10% interest. Reference to annuity table shows that ₹2.48685 is the present value of an annuity of ₹1 for three years. The value of goodwill will, therefore, be ascertained as follows:

₹ 5,000 × 2.48685 = ₹ 12,434 or (say) ₹ 12,500.

Illustration:5

Balance Sheet of Mr. X as as on 31st March 2014 was as under:

Capital	2,50,000	Land	1,80,000
Creditors	80,000	Machinery	1,10,000
Bills Payable	20,000	Furniture	2,000
		Stock	8,000
		Cash at Bank	50,000
	3,50,000		3,50,000

The profit of the business for the five years ending 31st March 2014 are:

	₹
31st March 2010	40,000
31st March 2011	42,000
31st March 2012	45,000
31st March 2013	50,000
31st March 2014	53,000

The assets are revealed as under:

	₹
Land	1,94,000
Machinery	1,18,000
Furniture	1,000

The reasonable return on capital invested is 10% p.a.

Assume that normal management remuneration is ₹ 6,000.

Find out goodwill by capitalization method.

Solution:

Average profit = (Total Profits of 5 years)/5
= 2,30,000 / 5 = 46,000
Less: Remuneration = 6,000
Average Profit 40,000

Calculation of normal capital by capitalisation of average profit
= (40,000 x 100)/10 = ₹4,00,000

		₹
Land		1,94,000
Machinery		1,18,000
Furniture		1,000
Stock		8,000
Cash		50,000
Total Assets		3,71,000
Less: Liabilities		
Creditors	80,000	
B/P	20,000	1,00,000
Net assets (capital Employed)		2,71,000

Good will = Normal Capital – Actual Capital Employed

= ₹4,00,000 – ₹2,71,000 = ₹1,29,000

Capitalization of super profit:

Average Profit	₹ 40,000
Less: Normal Profit: 10% on ₹ 2,71,000	₹ 27,100
	12,900

Goodwill = ₹12,900 x 100/10 = 1,29,000

Illustration:6

Ram runs a chemist shop. His net assets on March 31, 2014 amount to ₹20,00,000. After paying a rent of ₹20,000 a year and salary of ₹20,000 to the chemist, he earns a profit of ₹1,50,000. His landlord, who happens to be an expert chemist, is interested in purchasing the shop 12% is considered to be a reasonable return on capital employed. What can Ram expect as payment for goodwill?

Solution:

	₹
Profit earned by Ram	1,50,000
Add: Rent, no more to be paid	20,000
Add: Chemist salary, no more to be paid	20,000
	1,90,000
Less: Reasonable remuneration for the new propriater assumed	25,000
adjusted profit:	1,65,000
Capital employed amounted to:	20,00,000
Add: Value of buildings, now form part of the capital (assume)	2,00,000
	22,00,000
Normal Profit @ 12% on ₹ 22,00,000	2,64,000
Adjusted profit	₹ 1,65,000
Less: Normal Profit	₹ 2,64,000
	NIL

Since, there is no super profit, there will be no goodwill.

Illustration:7

The following is the Balance-Sheet of Quality Traders Ltd., as at 31st March 2015:

BALANCE SHEET

Liabilities	₹	*Assets*	₹
Share capital	3,28,000	Fixed assets	1,80,000
Reserve	80,000	Current assets	2,44,080
Creditors	76,080	Investment in shares	60,000
	4,84,080		4,84,080

The following net profits were earned which included a fixed income from investment of ₹ 4,000 p.a:

Year ended 31st March, 2012	₹64,000
Year ended 31st March, 2013	72,000
Year ended 31st March, 2014	86,000
Year ended 31st March, 2015	90,000

Standard rate of return on capital employed in such type of business is 8%.

Compute the amount of goodwill of the above business at three years* purchase of the average super profits for four years assuming that each year's profit was fully distributed as dividend among the shareholders.

Solution

Average profit.

Since the profits are showing increasing trend, a weighted average is preferable.

Year	*Operating Profits* ₹	*Weight*	*Product* ₹
Year ended 31st March, 2012	60,000	1	60,000
Year ended 31st March, 2013	68,000	1.5	1,02,000
Year ended 31st March, 2014	82,000	2	1,64,000
Year ended 31st March, 2015	86,000	2.5	2,15,000
		7	5,41,000
Average profit		(A)	77,286
Capital employed: Fixed assets			1,80,000
Current assets			2,44,080
			4,24,080
Less: Sundry creditors			76,080
			3,48,000
Add: ½ of the Average profit			38,643
Average capital employed			3,86,643
Return on capital employed @ 8%		(B)	30,931
Super profits (A)-(B)			46,355
Goodwill at 3 years' purchase			1,39,065

Illustration:8

The Balance Sheet of Toy Gun Manufacturing Co. Ltd. discloses the following financial position as at 31st March, 2013.

Liabilities	₹	*Assets*		₹
Paid-up capital:		Goodwill at cost		30,000
30,000 shares of ₹ 10 each		Land and buildings at cost		
fully paid	3,00,000	(*Less:* Depreciation)		1,75,000
Capital reserve	60,000	Plant and machinery at cost		
Sundry creditors	71,000	(*Less:* Depreciation)		90,000
Provision for taxation	55,000	Stock at cost		1,15,000
Profit and loss A/c	26,000	Book debts	98,000	
		Less: Provision for		
		doubtful debts	3,000	95,000
		Cash at bank		7,000
	5,12,000			**5,12,000**

You are asked to value the goodwill of Toy Gun Manufacturing Co. Ltd. for which purpose the following information is supplied:

a) Adequate provision has been made in the accounts for income-tax and depreciation.
b) Rate of income-tax may be taken at 50%.
c) The average rate of dividend declared by the company for the past five-years was 15 per cent.
d) The reasonable return on capital invested in the class of business done by the company is 12 per cent.

Solution

VALUATION OF GOODWILL

1. Super Profit Method	
Capital employed:	₹
Tangible assets:	
Land and buildings	1,75,000
Plant and machinery	90,000
Stock	1,15,000
Book debts	95,000
Cash at bank	7,000
	4,82,000

Less: Sundry creditors	71,000	
Provision for taxation	55,000	1,26,000
Capital employed		3,56,000
Normal profit @ 12 per cent		42,720
"Actual profit after tax		55,000
Super profit (₹55,000 - ₹ 42,720)		12,280
Goodwill at say 4 years' purchase		49,120
2. Capitalization of Profits Method		₹.
Total value of business	55,000 × 100 ÷ 12	4,58,333
Less: Net tangible assets (as above)		3,56,000
Goodwill		1,02,333

*Profit during the year is assumed to be equal to the Provision for Taxation since the rate of income-tax is 50 per cent. Tax figure of ₹ 26,000 in the Profit and Loss Account seems to be only the balance left in this account after payment of dividend.

3.1.10 Self Test Questions

Theory

1. What are the different methods of employed for valuation of goodwill?
2. Explain with an illustration the significance of the capitalisation of profit method?
3. Define goodwill and point out its principles of calculation?
4. What is the importance of goodwill?
5. Define goodwill. Is it real or fictitious?

Problems

1. Find out goodwill by capitalization method from the following information: normal rate of return 10%; Profit for the last three years are ₹.30,000; ₹. 40,000 and ₹.50,000. Non recurring income of ₹. 3,000 is included in the above mention profit of ₹., 30,000. Capital employed is ₹.3,00,000.

2. The following information is given (a) Average capital employed ₹1,00,000, (b) Present value of the annuity of ₹1 for 5 years at 10% is ₹3.78, (c) Normal rate of profit is 10% (d) Net profits for five years are: I year ₹ 15,000; II year ₹16,000; III year ₹ 17,000 IV year ₹ 18,000 and V year ₹20,000.

   Profits included non recurring profit on an average basis of ₹1,500 out of which ₹300 had the recurring tendency. Remuneration of proprietor is ₹ 800 p. a which

is not charged in profit and loss. Find out goodwill (a) as per 5 years' purchases of super profit, (b) as per annuity method (c) as per capitalization of profit method.

3. The following particulars are available in respect of the business carried on by a traders:

1) Profits earned : 2011-12₹ 50,000; 2012-13₹60,000: 2013-14₹55,000
2) Normal Rate of profit 10%
3) Capital Employed ₹.3,00,000
4) present value of an annuity of one rupee for five years at 10% ₹ 3.78
5) The profits included non- recurring profits on an average basis of ₹.4,000 out of which it was deemed that even non- recurring profits had a tendency of appearing at the rate of ₹ 1,000 p.a

You are required to calculate Goodwill:

(a) As per five years purchase of super profit:

(b) As per capitalization of super profit method

(c) As per annuity method

4. Following information are available about the business of Sudhir Ltd.

(i) Profits: in 2002 ₹. 40,000; in 2003 ₹.50,000; in 2004 ₹.. 60,000.

(ii) Non-recurring income of ₹4,000 is included in the profit of 2003.

(iii) Profits of 2002 have been reduced by ₹.6,000 because goods were destroyed by fire.

(iv) Goods have not been insured but it is thought to insure them in future. The insurance premium is estimated at ₹.4000 per year.

(v) Reasonable remuneration of the proprietor of business is ₹.6,000 per year, but it has not been taken into account for calculation of above mentioned profits.

(vi) Profit of 2004 included ₹.5,000 income on investment. Calculate Goodwill on the basis of two years purchase of the average profit of last three years.

5. Ascertain the value of Goodwill of Pai and Company, carrying on business as retail traders from the following information:

Balance sheet as on 31st March 2012

	₹.		₹.
Paid up Capital:		Goodwill	25,000
2,5000 shares of Rs 100		Land & Building (as cost)	1,10,000
each	2,50,000	Plant (at cost)	1,00,000
Profit and loss A/c	56,650	Stock at cost	1,50,000
Bank over draft	58,350	Book debts	90,000
Sundry creditors	90,500		
Provision for taxation	19,500		
	4,75,000		4,75,000

The company commenced operation in 2010-11 with a paid up capital as aforesaid of ₹ 2,50,000. The profits earned, before providing for taxation, have been as follows:

2010-11₹ 61,000 2011-12₹ 64,000 2012-13₹ 71,500

2013-14₹ 78,000 2014-15₹ 85,000

You may assume that income tax at the rate of 50% has been payable on these profits. The average dividend paid by the company for the four years is 10% which is taken as reasonable return expected on the capital invested in the business.

6. The Balance sheet of Ram Ltd as on 31st March 2012

Liabilities	₹	Assets	₹
8% 5,000 shares of ₹10 each	50,000	Goodwill	10,000
10,000 shares of ₹ 10 each	1,00,000	Fixed Assets	1,80,000
Reserves (including provisions for taxation ₹10,000)	1,00,000	Investments (5% Govt. loan)	20,000
		Current Assets	1,00,000
8% Debentures	50,000	Preliminary Expenses	10,000
Creditors	25,000	Discount on 8% Debentures	5,000
	3,25,000		3,25,000

The average profit of the company (after deducting interest on debentures and taxes) is ₹31,000. The market value of machinery included in fixed assets is ₹ 5,000 more. Expected rate of return is 10%. Evaluate the goodwill of the company at five times of the super profits.

7. The following is the balance sheet of Krishna Ltd as on 31st March 2014

Liabilities	₹	Assets	₹
Paid up Capital		Land and Building	7.80.000
12,000 shares of ₹100 each	12,00,000	Plant and machinery	3,00,000
General Reserves	1,60,000	Sundry Debtors	2,20,000
Profit and Loss A/c	1,00,000	Bills receivables	60,000
Sundry Creditors	80,000	Stock in trade	1,20,000
Bills payable	40,000	Goodwill	40,000
		Government Securities at 10%	60,000
	15,80,000		15,80,000

Company earned net profits for the past four years as follows:

2010 – 11 - ₹ 1, 00,000

2011 – 12 - ₹ 2, 00,000

2012 – 13 - ₹ 3, 00,000

2013 – 14 - ₹ 4, 00,000

The value of Goodwill should be computed at three years purchase of the average super profit for the four years.

Lesson 3.2 Valuation of Shares

Learning Objectives

After reading this lesson you should be able to

- know the need for valuation of share
- Identify the factors affecting the value of share
- Describe the various methods of valuation of share
- Compute the value of share

3.2.1 Introduction

A share represents an interest in a company. The term “value of share” has different meaning. The “Face value” of a share specified in the memorandum of association of the Joint Stock Company, which is fixed in nature. The listed company’s shares are quoted in stock exchange at market price known as “Market value”, which is determined by market forces of demand and supply. The shareholders are interested in dividend and the realisable value of their holdings. The value of a share of a company may be valued in number of ways. On the basis of the reasons this may be vary. The valuation of shares is not only meant of the public limited company but also for the private company as and when need raised.

3.2.2 Need for Valuation

Valuation of shares assumes significance in the following cases:

1. Amalgamation or absorption of companies
2. Conversion of shares of one class into another
3. Purchase and sale of controlling shares
4. Shares as security for loans and advances
5. Assessment of estate duty, wealth tax etc.
6. Unquoted shares in the exchange
7. To satisfy dissentient shareholders
8. Nationalisation of companies
9. To satisfy dissentient shareholders
10. In case of trust finance or investment trust companies

3.2.3 Factors affecting value of shares

The factors affecting value of shares are similar to those factors which affect the value of goodwill. They are as follows:

1. Nature of the company's business
2. Percentage of dividend declared on the shares
3. Demand and supply of shares
4. Company's earnings capacity
5. Price level changes
6. General economic conditions
7. Restrictions on investment
8. Net tangible asset of company
9. Nature of competition and market share
10. Financial, Political and other factors affecting the business
11. Type of management
12. Goodwill of company
13. Capacity of director

3.2.4 Methods of Valuation of Shares

The share can be valued either as an interest in the net assets of the company or as an entitlement to a share of future profits. In this view, the following are the methods for valuation of shares.

1. Net Asset Method (Intrinsic value)
2. Yield Method
3. Earning Capacity

3.2.4.1 Net Asset Method

This is also known as Balance Sheet Method or Intrinsic Method or Break-up Value Method or Valuation of Equity basis or Assets Baking Method. Here the emphasis is on the safety of investment as the investors always need safety for their investments. In this method, the value of the net assets of the company against each shares are t be arrived. The following points may be become in mind:

1) The fixed assets of the company should be revalued at their net realisable values.

2) Floating assets are to be taken at market value.
3) All fictitious assets, such as Preliminary Expenses, Accumulated Losses etc. are to eliminated.
4) The goodwill will be ascertained on the appropriate basis.
5) Provision for depreciation, bad debts provision etc. must be considered.
6) Find out the external liabilities of the company payable to outsiders including contingent liabilities.
7) All unrecorded assets and liabilities are to be taken into consideration.

Thus the value of net asset is:

Total of realisable value of assets – Total of external liabilities = Net Assets (Intrinsic value of asset)

Value of equity share = Net assets – Preference share capital

$$\text{Value of equity share} = \frac{\text{Net assets – Preference share capital}}{\text{Number of Equity Shares}}$$

Illustration: 1

From the following information compute the 'Intrinsic Value' of an Equity share of Joy Ltd.

Balance Sheet as at 31 .3. 2014.

Liabilities	₹	Assets	₹
2,000 Equity shares of ₹ 100 each, fully paid-up	2,00,000	Land & Building	2,00,000
		Plant & Machinery	80,000
1000, 6% Preference shares of ₹100 each, fully paid	1,00,000	Sundry Debtors	55,000
		Stock	70,000
Reserve & Surplus	25,000	Cash at Bank	25,000
1000, 5% Debentures of ₹ 100 each	1,00,000	Investment in 5% Govt. Securities	10,000
Sundry Creditors	10,000	Cash in hand	10,000
		Preliminary Expenses	5,000
	4,55,000		4,55,000

i. Fair return on capital employed in this type of business is around 10% p.a.

ii. Goodwill is to be taken at 5 'years' purchase value of super profit.

iii. Average of the profits (after deduction of Preliminary expenses) for the last seven years is ₹43,000. Preliminary expenses to the extent of ₹ 1,000 have been written-off every year for the last seven years. Profit is more or less stable over years and the same trend is expected to be maintained in the near future. Ignore tax.

SOLUTION:

Computation of Goodwill

		₹.
Capital Employed :		
Land & Building		2,00,000
Plant & Machinery		80,000
Sundry Debtors		55,000
Stock		70,000
Cash at Bank		25,000
Cash in hand		10,000
		4,40,000
Less: Liabilities:		
5% Debentures	1,00,000	
Creditors	10,000	1,10,000
Capital Employed:		3,30,000

Normal Profit =₹3,30,000 x 10/100 = ₹ 33,000

Super Profit

	₹
Average Profit	43,000
Less: Non-trading income	
Interest on Investment@ 5% on Rs. 10,000	500
	42,500

Super Profit = Average Profit – Normal Profit = ₹42,500 – ₹33,000 = ₹9,500

Value of Goodwill = ₹ 9,500 x 5 = ₹ 47,500

Valuation of Shares:

	₹
Total Assets (as above)	3,40,000
Add: Investment	10,000
Add: Goodwill	47,500
	3,97,500

Less: Liabilities (as above)	1,10,000
	2,87,500
Less: Preference Share Capital	1,00,000
Funds available to equity shareholders	2,87,500

⇨ Intrinsic value a Equity Share = $\frac{₹2,87,500}{2,000}$ = ₹143.75

Illustration:2

The following is the balance sheet of Shan Company Ltd. as on March 31, 2014.

Liabilities	₹	Assets	₹
3,000 Equity shares of ₹100 each	3,00,000	Cash in hand	2,000
		Cash at Bank	20,000
1,500, 8% Preference share Capital of ₹ 100 each	1,50,000	Sundry Debtors	80,000
		Stock in trade	1,40,000
General Reserve	40,000	Land & Building	2,05,000
Profit & Loss A/c	10,000	Furniture	30,000
Bank Loan	50,000	Goodwill	70,000
Sundry Creditors	15,000	Discount on Shares	18,000
	5,65,000		5,65,000

The value of assets is assessed as follows:

1. Furniture to be depreciated at 10%
2. Value of stock-in-trade, land and building and goodwill is estimated at ₹ 1,20,000, ₹2,50,000 and ₹ 80,000 respectively.
3. Debtors are expected to realise 80% of book value.

Find out the value of equity shares.

SOLUTION:

Reserved Value of Reliable Assets:	₹
Cash in hand	2,000
Cash at Bank	20,000
Sundry Debtors	64,000
Stock in trade	1,20,000
Land & Building	2,05,000
Furniture	27,000
Goodwill	80,000

		5,63,000
Less: Liabilities:		
Bank Loan	50,000	
Sundry Creditors	15,000	65,000
Net Assets		4,98,000
Less Preference Share Capital		1,50,000
Assets backed by Equity Share Capital		3,48,000

No. of equity shares is 3,000

Intrinsic value of each equity share is $\frac{3,48,000}{3,000} = ₹\ 116$

Illustration:3

The following is summarised Balance Sheet of Mathi Co. Ltd. as on 31.03.2014.

Liabilities	₹	Assets	₹
Authorised, Issued, Subscribed		Goodwill	5,000
Capital:		Land & Building	1,05,000
1,000 Equity shares of		Machinery	55,000
₹.100 each fully paid	1,00,000	Stock (at cost)	45,000
1,000 Redeemable Pref. Shares		Sundry Debtors	20,000
of ₹100 each fully paid	1,00,000	Cash in hand	5,000
General Reserve	15,000	Cash at Bank	1,15,000
Dividend Equalisation Reserve	5,000	Investment in National	
Employees' Compensation Fund	5,000	Plan certificate	5,000
(represented by Investment in		Preliminary Expenses	5,000
securities)			
Provision for Taxation	5,000		
Employees' Saving Account	10,000		
Sundry Creditors	20,000		
Profit & Loss A/c	1,00,000		
	3,60,000		3,60,000

On 1.4.2014, all the Preference shares were redeemed at a premium of ₹10 per share out of profits otherwise available for dividends.

You are asked to ascertain the intrinsic value of each of the Equity shares by Assets Banking Method, on the Balance Sheet immediately after redemption of preference shares.

Take into account the following information:

i. Goodwill to be taken at ₹50,000
ii. 10% of Sundry are bad;
iii. A claim for compensation to an employee has been admitted on 1.4.2014, for ₹ 1,000;
iv. All the other assets are taken at their book values as shown in the above Balance Sheet.

SOLUTION:

		₹
Net Assets:		
Goodwill		50,000
Land & Building		1,05,000
Machinery		55,000
Stock		45,000
Sundry Debtors (₹ 20,000 – ₹ 2,000)		18,000
Investment		5,000
Cash in hand		5,000
Cash in Bank		5,000
(₹ 1,15,000 – ₹ 1,10,000 for payment Pref. Shareholders with premium)		2,88,000
Less: Current Liabilities:		
Employees' Savings Account	10,000	
Sundry Creditors	20,000	
Employees' Compensation Claim	1,000	
Provision for Taxation	5,000	36,000
Funds available for Equity shareholders		2,52,000

⇨ Intrinsic value of each Equity Share = $\frac{₹\ 2,52,000}{1,000}$ = **₹ 252**

Illustration:4

The following sheet of ABC Ltd. as at 31st March 2014 was as follows:

	₹		₹
Equity shares (₹ 10)	5,00,000	Goodwill	1,00,000
General Reserve	2,50,000	Equipment at cost	9,00,000
Profit & Loss A/c	1,00,000	Stock	3,50,000
12% Debentures	3,00,000	Debtors	1,50,000
			75,000

Provisions for Depreciation	1,50,000	Bank	
on equipment	40,000	Advertisement	25,000
Staff Welfare Fund	75,000	Suspense Account	
Proposed Dividend	1,85,000		
Sundry Creditors	16,00,000		16,00,000

You are required to calculate the value of each equity share under assets basis.

The following further information is available:

i. A fair after-tax return on capital employed for this type of business is 18%.
ii. Equipment is to be revealed at ₹8,00,000.
iii. Stocks are consider to have a net realisable value of ₹ 3,30,000.
iv. Goodwill in this type of business is normally valued at years' super profits.
v. Included in the debtors is a balance of ₹ 10,000 which may prove irrecoverable.
vi. Profits for the last three years (before interest and taxes) are: 2013-14 – ₹ 5,40,000;
vii. Company profits are taxed at 40 per cent.

SOLUTION:

Computation of Goodwill

	₹	₹
Capital Employed:		
Equipment	8,00,000	
Stock	3,30,000	
Debtors, Less Provision (₹1,50,000 – ₹ 10,000)	1,40,000	
Bank	75,000	13,45,000
Less: Current Liabilities		
Sundry Creditors	1,85,000	
Proposed Dividend	75,000	2,60,000
		10,85,000
Normal profit @ 18% on Rs 10,85,000	=	₹1,95,300

Average Profit = (₹ 5,10,000+ ₹ 5,10,,000 + ₹ 5,50,000)/ 3	=	₹. 5,23,333
Less: Income-Tax @ 40%		2,09,333
Average Profit (after tax)		3,14,000

Super Profit = Average Profit – Normal Profit= ₹. 3,41,000 – ₹1,95,300

= ₹1,18,700

Value of Goodwill = ₹. 1,18,700 x 3 = ₹. 3,56,100

Computation of Net Asset	₹
Net Assets (calculated as above)	10,85,000
Add: Goodwill	3,56,100

	14,41,100
Less: 12% Debentures	3,00,000
Funds available for equity shareholders	11,41,100

$$\text{Intrinsic Value of each equity share} = \frac{\text{Funds available for equity shareholders}}{\text{Total number of equity shares}}$$

$$= \frac{\text{Rs. } 11,41,100}{50,000} = ₹.\ 24.32$$

Intrinsic value each equity share (Cum-Dividend)

= 22.82 + ₹. 1.50 (i.e. ₹ 75,000 / 50,000 shares) = ₹ 24.32

Note:

1. Staff Welfare Fund is not a current liability, it is an appropriation of profit.
2. Advertisement Suspense account is a fictitious asset and hence exclude.
3. Debenture Interest is not added with average profit since it has been assumed as part of capital employed and it is engaged in the business for long period of time.
4. Profit for 2013-14 — 5,40,000

Profit for 2013-14	5,40,000
Less; Value of stock reduced (₹ 3,50,000 – ₹. 3,30,000)	20,000
	5,20,000
Less: Provision for Bad Debts	10,000
	5,10,000

3.2.4.2Yield Method

Under the yield method, yield expected by the investors on their investment have considered. The yield denotes the possible return that an investor may get out of his holdings viz. dividend, bonus shares and right issue. If the return is more, the price of share is also more. The following formula is used to calculate the value of a share.

Calculation of Expected Return:

$$\text{Expected Return} = \frac{\text{Expected Profits}}{\text{Equity Capitals}}$$

Calculation of Yield value of Shares:

$$\text{Value of Share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid up value of shares}$$

Illustration:5

On the 31st March 2014, the Balance Sheet of Srivatsan Limited Company disclosed the following positions:

Liabilities	₹	Assets	₹
Issued Capital in shares of		Fixed Assets	5,00,000
₹10 each	40,00,000	Current Assets	2,00,000

Reserve	90,000	Goodwill	40,000
Profit & Loss	20,000		
5% Debentures	1,00,000		
Current Liabilities	1,30,000		
	7,40,000		7,40,000

On 31st March 2014the fixed assets were independently valued at ₹ 3,50,000 and the goodwill at ₹ 50,000. The net profits for the three years were:

2011-12 ₹ 51,600; 2012-13 ₹ 52,000 and 2013-14 ₹ 51,650 of which 20% was placed to reserve account and this proportion being considered reasonable in the industry in which the company is engaged and where a fair investment return may be taken at 10%. Compute the value of the company's sahre by (a) the assets method and (b) the yield method.

SOLUTION:

(a) Value of shares according to the Assets method:₹

Current Assets as per Balance Sheet		2,00,000
Revalued fixed Assets		3,50,000
Revalued goodwill		50,000
		6,00,000
Less: Liabilities: 5% Debentures	1,00,000	
Current Liabilities	1,30,000	2,30,000
Net Assets		3,70,000

$$\text{Intrinsic value per share} = \frac{\text{Net Assets}}{\text{No. of Equity shares}}$$

$$= \frac{3,70,000}{40,000} = ₹\ 9.25$$

(b) Value of shares according to Yield Method

Calculation of average expected future profits:

Profit for 2011-12	₹ 51,000
Profit for 2012-13	₹ 52,000
Profit for 2013-14	₹ 51,650
	1,55,250

Average Profit = 1,55,250/3	=	₹ 51,750
Less: 20% transferred to Reserve	=	10,350
Average Profit after reserve		41,400

Calculation of Expected Return = (Expected Profits x 100) / Equity Capital

= (41,400 x 100)/ 4,00,000 = 10.35%

$$\text{Calculation of Yield value of share} = \frac{\text{Expected Rate x Paid up value of share}}{\text{Normal Rate}}$$

$$= \frac{10.35}{10} \times 10 = ₹\ 10.35$$

Illustration:6

From the following information, find out the value of each share:

Balance Sheet of Ramgopal Company Ltd.

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets:	
20,000 Equity shares of			
₹10 each	2,00,000	Goodwill	1,90,000
Reserve & Surplus:		Investment	3,00,000
Reserve	2,50,000	Current Assets, Loans &	
Profit & Loss A/c	30,000	Advances:	
Unsecured Loans	80,000	(a) Current Assets	50,000
Current Liabilities	20,000	(b) Loans & Advances	30,000
		Misc. Expenditure	10,000
	5,80,000		5,80,000

For the purpose of valuation of shares goodwill shall be taken at two years' purchase of the average profit of the last five years. The profits for the last five years are: ₹ 60,000; ₹70,000; ₹ 40,000; ₹ 50,000 and ₹ 50,000.

SOLUTION:

Total Profits = ₹ 60,000 + ₹. 40,000 + ₹ 50,000 + ₹. 50,000 = ₹. 2,70,000

			₹
Average Profits	= (2,70,000)/ 5		= 54,000
Goodwill	= 54,000 x 2		= 1,08,000
Investments			= 3,00,000
Current Assets		50,000	
Loans & Advances		30,000	80,000
			4,88,000

Less: Unsecured Loans	80,000	
Current Liabilities	20,000	1,00,000
		3,88,000

$$\text{Value of one equity share} = \frac{3,88,000}{20,000} = ₹.19.40$$

Alternative Method

	₹
Capital	2,00,000
Add: Reserves	2,50,000
Add: Profit	30,000
	4,80,000
Less: Reduction in value of goodwill & Misc. Expenditure	92,000
	3,88,000

$$\text{Value of one equity share} = \frac{3,88,000}{20,000} = ₹. 19.40$$

	₹
@ Goodwill as per Balance Sheet	1,90,000
	1,08,000
Revalued amount of goodwill	82,000
	10,000
Misc. Expenditure	92,000

3.2.4.3 Valuation of Right Shares

According to Sec. 81 of the Companies Act, 1956, a company, if it so desires, can increase its share capital by issuing new shares. In that case, the existing shareholders must be given the priority of purchasing those shares according to their paid-up value. Since the existing shareholders have got such right to purchase the newly issued shares, they are called *Right Shares.*

In order to make a proper valuation of right relating to right shares, the market value of the old holdings and the total issue price of new holdings must be added and the same must be divided by the total number of new and old holdings. Value of right will be the difference between the result that is obtained and market value of shares. Hence,

$$\text{Value of Right} = \frac{\text{Number of Right Shares}}{\text{Total Holdings (i.e. holdings = Old + New)}} \times (\text{Market Value} - \text{Issue Price})$$

Illustration:7

The face value of the equity share of a company is ₹ 10 and the current market price ₹ 17. The company issues “Right” shares at the rate of 3 Equity shares for every 5

existing Equity shares held, the : “Right” shares being priced at ₹13. Calculate the value of “Right”

Solution:

$$\text{Value of Right} = \frac{\text{No. of Right Shares}}{\text{Total Shares (old + new holdings)}} \times (\text{Market Value} - \text{Issue Price})$$

Value of Right = 3 / (5 + 3) x (₹ 17 – ₹13)

= 3/8 x ₹ 4 = ₹ **1.50**

Alternatively

Market value of 5 existing holdings = ₹ 17x 5 = ₹ 85

Add: Issue price of 3 new holdings = ₹ 13 x 3 = ₹ 39

Value of holding = ₹124

Value of each share = ₹124/8 = ₹15.50

Value of Right = ₹ 17.00 – ₹. 15.50 = **₹. 1.50**

Illustration:8

The following is the balance sheet of X co. Ltd. as on 31.3.2014

Liabilities	₹	Assets	₹
Share Capital:		Goodwill	50,000
Equity shares of ₹. 10 each	1,00,000	Building	1,50,000
12% Pref. Shares of ₹ 100 each	1,00,000	Plant	1,00,000
General Reserve	60,000	Investment in 10% stock	
Profit & Loss A/c	40,000	(Market value of 52,000;	
15% Debentures	1,00,000	Normal value ₹50,000)	48,000
Creditors	80,000	Stock	60,000
		Debtors	40,000
		Cash	10,000
		Preliminary Expenses	22,000
	4,80,000		4,80,000

According the value of each equity share under Fair Value Method on the basis of the information given below:

Assets are revalued as follows:

Building ₹. 3,20,000

Plant ₹. 1,80,000

Stock ₹ 45,000 and

Debtors ₹. 36,000

Average profit of the company is ₹1,20,000 and 12(1/2)% of profit in transferred to general reserve. Rate of taxation being 50%. Normal dividend expected on equity shares is 8% whereas fair return on capital employed is 10%. Goodwill may be valued at 3 year's purchase of super profit.

Solution:

Computation of Goodwill

	₹
Total Net Assets	
Building	3,20,000
Plant	1,80,000
Stock	45,000
Debtors	36,000
Cash	10,000
	5,91,000
Less: Current Liabilities	
Creditors	80,000
Capital Employed	5,11,000

⇨ Normal Profit ₹. 51,100 [i.e. ₹. 5,11,000 x 10/100]

Actual Profit

		₹.
Average Profit		1,20,000
Less: Non-trading Income		
(i.e. income from investment)	@ 10% on ₹. 50,000	5,000
		1,15,000
Add: Debenture Interest		15,000
		1,30,000
Less: Pref. Dividend		12,000
		1,18,000
Less: Taxation @ 50%		59,000
		59,000
Less: Transfer to Reserve @12(1/2) %		7,375
		51,625

Super Profit = Actual Profit – Normal Profit

= ₹. 51,625 – ₹ 51,100

= ₹. 525

Value of goodwill = ₹ 525 x 3 = ₹.1,575 or ₹.1,600

Valuation of Shares

Asset-Backing Method

	₹
Sundry Assets (as above)	5,11,000
Add: Investments	48,000
Add: Goodwill	1,600
Funds available for Equity shareholders	5,60,000

Intrinsic value of share = $\frac{₹\ 5,60,600}{10,000}$ = **₹. 56.06**

Yield-basis

Value of share = $\frac{\text{Rate of Dividend}}{\text{Normal Rate of return}}$ x Paid up value of each share

= 8/10 x Rs.10 = **₹ 8**

Fair Value

Fair Value = (Insurance value + yield Basis)/2

= (₹ 56.66 + ₹. 8.00)/2 = ₹ **32.03**

Illustration:9 From the following particulars calculate the value of share of Z Ltd., on yield basis:

Balance Sheet of Z Ltd., *as on 31st March, 2014*

Liabilities	₹	*Assets*	₹
8,000 Equity shares of Rs.100 each	8,00,000	Land & Building	5,00,000
4,000 10% Preference shares of		Plant & Machinery	6,00,000
₹ 100 each	4.00,000	Patents	2,00,000
6% Debentures	2.00,000	Sundry debtors	3,00,000
Reserves	4.00,000	Work-in-progress and stock	5,00,000
Sundry creditors	4.00,000	Cash at bank	1,00,000
	22,00,00		**22,00,000**

Land and building to be valued at ₹ 9,00,000. The company's earnings were as follows:

Year	*Profit (loss) before tax (₹)*	*Tax (₹)*
2009-10	3,00,000	80,000
2010-11	4,00,000	1,60,000
2011-12	(1,00,000)	40,000 (Strike)
2012-13	5,00,000	2,30,000
2013-14	5,50,000	3,00,000

The company paid managerial remuneration of ₹ 60,000 per annum but it will become ₹ 1,00,000 in future. There has been no change in capital employed. The company paid dividend of ₹ 9 per share and it will maintain the same in future. The company proposes to build up a plant rehabilitation reserve. Dividend rate in this type of company is fluctuating and the asset backing of an equity share is about 1*1/2*times. The equity shares with an average dividend of 8% sell at par.

Solution

(*i*)Computation of average maintainable profits:

Year	*Profits* ₹	**Weight**	*Product* ₹
2009-10	3,00,000	1	3,00,000
2010-11	4,00,000	2	8,00,000
2011-12	—	—	—
2012-13	5,00,000	3	15,00,000
2013-14	5,50,000	4	22,00,000
		10	48,00,000

Weighted average profits: ₹ 48,00,000 ÷ 10 = ₹ 4,80,00

Notes:

(a) Since the profits are showing a definite trend, weights have been given. (b) The loss of the year 2005 has not been considered since it is an abnormal year.

(*ii*)Computation of profits available for dividend:

	₹
Weighted average profits	4,80,000
Less: Increase in managerial remuneration	40,000
	4,40,000
Less: Tax (50% assumed)	2,20,000
Profit available for distribution	2,20,000
Less: Rehabilitation reserve (15% assumed)	33,000
	1,87,000
Less: Dividend on preference shares	36,000
Profit available for distribution to equity shareholders	1,51,000

(*ii*)Asset backing per equity share:

Total Assets as per Balance Sheet		22,00,000
Add: Increase in value of land & building		4,00,000
		26,00,000
Less: Sundry creditors	4,00,000	
6% Debentures	2,00,000	
9% Pref. capital	4,00,000	10,00,000
Net Asset available for equity Shareholders		16,00,000
Equity Share Capital		8,00,000
Asset backing		2 Times

(*iv*)Dividend rate:

Normal dividend rate		8.0%
Less: For higher dividend rate (9%) and stability	(say)	0.5%
Less: For higher asset backing (2 times as compared to 1.5)	(say)	0.5%

(*v*) Capitalization factor: 100 ÷ 7 = 14.286

(*vi*)Value of an equity share:

$$\frac{\text{Profit available for equity shareholders x Capitalization factor}}{\text{No. of equity shares}} = \frac{1,51,000 \times 14.286}{8,000}$$

=₹ 264.64 or say ₹ 270

Illustration: 10

Balance Sheet of Diamond Ltd.*as on 30.3.2015*

Liabilities	₹	*Assets*	₹
Share Capital:		Land and buildings	1,10,000
2,000 shares of ₹ 100	2,00,000	Plant and machinery	1,30,000
General reserve	40,000	Patents and trade marks	20,000
Profit and loss account	32,000	Stock	48,000
Sundry creditors	1,28,000	Debtors	88,000
Income-tax	60,000	Bank balance	52,000
		Preliminary expenses	12,000
	4,60,000		**4,60,000**

The expert valuer valued the land and buildings at ₹ 2,40,000; goodwill at ₹ 1,60,000; and plant and machinery at ₹ 1,20,000. Out of the total debtors, it is found that debtors of ₹ 8,000 are bad. The profits of the company have been as follows:

	₹
2012-13	80,000
2013-14	90,000
2014-15	1,06,000

The company follows the practice of transferring 25% of profits to general reserve. Similar type of companies earn at 10% of the value of their shares. Ascertain the value of the company's shares under: (*i*) intrinsic value method; (*ii*) yield value method; and (*iii*) fair value method. Ignore taxation.

Solution

VALUATION OF SHARES OF DIAMOND LTD.

(*i*) Intrinsic Value Method:	**₹.**
Assets:	
Land & buildings	2,40,000
Goodwill	1,60,00
Plant & machinery	1,20,000
Patents and trade marks	20,000
Stock	48,000
Debtors *less* bad debts	80,000
Bank balance	52,000
	7,20,000
Less: Liabilities:	
Sundry creditors	1,28,000
Net assets	5,92,000

$$\text{Intrinsic value of shares (each share)} = \frac{\text{Net Assets}}{\text{No. of shares}} = \frac{₹\ 5,92,000}{2,000} = ₹\ 296$$

(*ii*)Yield Value Method:	**₹**
Total profit of last three years	2,76,000
Less: Bad debts	8,000
	2,68,000
Average profit = 2,68,000 4-3	89,333
Add: Decrease in depreciation on plant & mach. (say @ 5% on ₹ 10,000)	1,500
	90,833
Less: Increase in depreciation on Land & Bldg. (say @ 10% on ₹ 1,30,000)	13,000
Average profit	77,833
Less: Transfer to reserve (@ 25% of ₹ 77,833)	19,458
Profit available for Dividend	58,375

$$\text{Rate of Dividend} = ₹.\ \frac{58,375}{2,00,000} \times 100 = 29.187\%$$

Yield Value of each share

$$= \frac{\text{Possible rate of dividend}}{\text{Normal rate of return}} = \text{Paid up value of share} = \frac{296.187}{10} = 100 = \text{Rs.}\ 291.87$$

(*iii*)Fair Value Method:

$$\text{Fair Value of Share} = \frac{\text{Instrinsic value} + \text{Yield value}}{2} = \frac{296 + 291.87}{2} = \text{Rs.}\ 293.93$$

3.2.4.4 Earning Capacity

Under this method of valuation of shares are made on the basis of the disposable profit of the company. The profit is found out be deducting reserves and taxes from the net profit of the company. The profits earned by the company are compared with the amount of capital employed in the business and rate of earning is found out in the following manner:

$$\frac{\text{Profit earned}}{\text{Capital employed}} \times 100 = \text{Rate of earning}$$

Illustration:11

Shri Das holds 5,000 Enquiry Shares in Hindustan Ltd., the nominal and paid up capital of which consists of:

i. 20,000 Enquiry Shares of ₹ 1 each.
ii. 10,000 5 per cent Preference Shares of ₹.1 each.

Note: The preference shares do not participate further in the profits.

It is ascertained:

a) The normal annual net profit of such a company is ₹.5,000; and
b) The normal return by way of dividend on the paid of Equity Share Capital for the type of business carried out by the company is 8 per cent.

Shri Das requires you to value his share-holding based upon the above figures

Solution:

	₹
Annual Net Profit	5,000
Less: Preference share dividend @ 5% on Rs. 10,000	500
Profit available for equity dividend	4,500

Profits of ₹ 4,500 capitalised at 8% $= \frac{4,500 \times 100}{8}$ =₹ 56,250

Earning capacity value of each equity share $= \frac{56,250}{20,000}$ = ₹ 2.81

Hence, the value of 5,000 share held by Sri das =5,000 x ₹2.81 = ₹ 14,050

ALTERNATIVELY:

Expect rate of return = (4,500 /20,000) x 100 =22.5%
Norma Return = 8%

Value of each equity share $= \frac{\text{Expected rate of return}}{\text{Normal return}} \times$ paid up value of share

= (22.5/8)x 1 = ₹ 2.81

Illustration: 12

The following is the balance sheet of B company Ltd.as on March 31, 2014

Liabilities	₹	Assets	₹
6,000 Equity share of ₹100 each	6,00,000	Cash	50,000
500 6% Debenture of ₹ 100 each	5,00,000	Cash at bank	80,000
General Reserve	70,000	Sundry Debtors	1,20,000
Profit and Loss account	20,000	Stock	1.00,000
Sundry creditors	30,000	Land and Building	4,10,000
Other Liabilities	10,000	Furniture	60,000
		Goodwill	70,000
		Plant and machinery	3,40,000
	12,30,000		12,30,000

All the assets were independently valued at ₹13,80,000.The company earned net profits for the last five years as follows: ₹ 80,000,₹ 84,000,₹ 92,000, 88,000 and ₹ 96,000. It was decided to set aside 15% of the profits towards General reserve. This proportion was considered reasonable in the industry in which the company was engaged and where a fair investment return may be taken at 10%.Find out the value of equity share of the company by Assets Valuation Method and Yield Valuation Method.

SOLUTION:

(a) Assets Valuation Method:

	₹	₹
Value of Total Assets		13,80,000
Less: Liabilities:		
Sundry Creditors	30,000	
Other Liabilities	10,000	40,000
		13,40,000

Net Assets:		13,40,000
Less: Debentures		5,00,000
		8,40,000
No. of Equity Shares		6,000
Value per share =	8,40,000/6000	= ₹. 140

(a) Yield valuation method:

Net profits for five years =₹ 80,000 + ₹ 84,000 + ₹ 92,000 + 88,000 +₹ 96,000

= ₹ 4,40,000

Average net profits for five years = 4,40,000/5	88,000
Average net profit	88,000
Less: 15% transferred to Reserve	13,200
	74,800

Capital Yielding at 10%

74,800 x 10/6000 = 7,48,000/600 = ₹124.66

Value per equity share = ₹ 124.66

3.1.7 Self Test Question

Theory

1. State the need for computation of value of the shares.
2. What are the factors that influence valuation of shares?
3. What are the methods employed for the valuation of shares?

Problems

1. Mr. Sharewallah holds 12,000 equity shares in Bharti Ltd., the nominal and paid up capital of which consists of :

i. 40,000 equity share of ₹ 1 each

ii. 10,000 8% preference share of ₹ 1 each.

Note: The preference shares do not participate further in profits.

It is ascertained

(a) The normal annual net profit of such a company is ₹ 12,000; and

(b) The normal return by way of dividend on this paid up value of equity share capital for the type of business carried out by the company is 15%.

Mr. Sharewallah requires you to value his share holding based upon the above figures.

2. The following is the summarized balance sheet of Victory Machines Ltd as on 31st March, 2014

Liabilities		₹	Assets	₹
Share capital			Freehold property	1,20,000
30,000 Equity shares of ₹ 10 each		3,00,000	Plant	50,000
			Stock	3,10,000
Reserves and Surplus:			Debtors	2,03,000
General	1,20,000		Bank	1,17,000
Capital	40,000		Cash	1,700
Profit and loss	1,20,000	2,80,000		
Current liabilities & Provisions:				
Creditors	93,700			
I.T. Payable	11,500			
Proposed Dividend	34,500			
Provision for taxation	82,000	2,21,000		
		8,01,700		8,01,700

Net profit (before taxation) for the past three years ending:

31st March, 2012 ₹. 1,38,000

31st March, 2013 ₹. 1,83,000

31st March, 2014 ₹. 1,97,000

Freehold property was valued early in 2014 at ₹. 1,60,000

Average yield in this type of business is 15% on capital employed.

You are required to find out the value of each equity share on the basis of above mentioned facts.

3. It is provided in the Articles of Association that at the death of a shareholder his shares will be purchased by the remaining shareholders at a price to be settled on the basis of the last balance sheet. It is further provided that goodwill shall be valued on the basis of three years purchase of the average annual profits for the last five years.

Liabilities	₹	Assets	₹
20,000 Equity shares of ₹ 10		Goodwill	2,00,000
each	2,00,000	Investment at cost	
General Reserves	2,00,000	(market value	3,00,000
Workmen's saving fund	2,00,000	₹.2,50,000)	5,00,000
Employees provident fund	1,00,000	Stock at cost	4,00,000
Creditors	6,00,000	Debtors	70,000
Profit and loss account	1,70,000	Bank balances	
	14,70,000		14,70,000

The profits for the last five years were ₹. 15,000, Rs. 20,000, ₹. 25,000, ₹. 30,000 and ₹ 35,000. You are required to calculate the price to the paid for each share.

4. The following is the Balance sheet of A Ltd. as onMarch 31, 2014:

Liabilities	₹	Assets	₹
Share Capital:		Land and Building	30,000
10,000 shares of ₹ 5 each	50,000	Plant and Machinery	30,000
General Reserves	15,000	Trade Marks	5,000
Taxation Reserves	10,000	Stock	12,000
Workmen's saving account	7,500	Debtors	20,000
Creditors	24,500	Cash at Bank	15,000
Profit and loss account	8,000	Preliminary Expenses	3,000
	1,15,000		1,15,000

The land and Building have been valued at ₹. 65,000 and the Plant and machinery is worth ₹. 25,000. Debtors to the extent of ₹ 2,000 are to be considered as bad. The profits of the company for the last three years have been follows:

2011-12 ₹ 22,000; 2012-13 ₹ 23,000; and 2013-14 ₹ 26,000.

It is the company practice to transfer 25% of profits to Reserves. Ignoring taxation, find out the value of the share. Similar companies give a yield of 10% on the market value of their shares. Goodwill may be taken to be of the value of ₹40,000.

5. The following is the Balance sheet of Jothi Ltd. as at 31st March 2012.

Liabilities	₹	Assets	₹
Share Capital:		Fixed Account	4,00,000
6% preference share of ₹10		Investment (non trading)	50,000
each	60,000	Current Assets	2,00,000
30,000 Equity shares of ₹ 10		Preliminary Expenses	10,000
each	3,00,000		
General Reserve	50,000		

Profit and Loss a/c	40,000		
5% Debentures	1,00,000		
Sundry Creditors	60,000		
Bills Payable	30,000		
	6,60,000		6,60,000

Average profit (annually) including ₹ 5,000 non- trading income is ₹ 50,000. Goodwill is to be valued at 3 years' purchases of super profit. Normal return on capital employed is 10%. Calculate the fair value of each equity share.

6. The following is the summarized balance sheet of Sun Limited as at 31st March, 2014:

Liabilities	₹	Assets	₹
50,000 Equity shares of ₹ 10 each	5,00,000	Goodwill	3,00,000
		Land and Building	1,20,000
General Reserves	4,00,000	Plant and machinery	68,000
Profit and loss A/c	20,000	Furniture	12,000
6% Debentures	2,00,000	Investments	1,85,000
Loan from state bank	60,000	Stock	1,40,000
Sundry Creditors		Debtors 3,65,000	
		Less: provision 2,000	3,63,000
		Cash and Bank balances	62,000
		Preliminary Expenses	10,000
	12,60,000		12,60,000

Calculate the value of each equity share on the net assets or realization basis.

7. Following is the balance sheet of Kannan Ltd company.

Liabilities	₹	Assets	₹
Share Capital		Land and Building	13,99,000
8,800 shares of ₹ 250 each		Plant and machinery	20,58,000
fully paid	22,00,000	Stock (market price)	26,00,000
Reserve Fund	8,24,000	Preliminary Expenses	25,000
Employees' savings A/c	2,27,000	Book debts	3,35,000
Workmen's Security	54,000	Investments (market price)	
Deposit	4,63,000	Bank	17,00,000
Depreciation Fund A/c	38,86,000		31,49,000
Creditors	36,12,000		
Profit and loss A/c			
	1,12,66,000		1,12,66,000

Depreciation Fund is more than reasonable depreciation by ₹ 54,000. Find out Intrinsic value of the share.

Lesson 4.1 Alteration of Share Capital and Internal Reconstruction

Learning Objectives

After reading this lesson you should be able to

- know the need for reconstruction of a company
- differentiate between internal and external reconstruction
- describe the different modes of internal reconstruction
- understand the accounting treatment required in connection with internal reconstruction

4.1.1 Introduction

Reconstructionmeans rebuilding something in different forms. Reconstruction of a Company refers the reorganizing the capital structure of a company including the reduction of claims of both the shareholders and the creditors against the company. It is necessary n account of bad financial position of a company. It may be “external” as well as “internal”

External Reconstruction refers to formation of a new company by take over the business of an existing company which is in a bad financial position. The vendor company goes into liquidation after selling its business to the new company.

Internal Reconstruction permits the existing Company to be continued with the capital of the company is reorganised to infuse new life in the company. It includes both alteration of share capital and reduction of capital.

4.1.2 Alteration of Share Capital

The company alters its share capital in any one of the following ways[94(1)]:

1. Increase its share capital by issue of new shares.
2. Consolidation of the whole or part of its share capital into shares of smaller amount.
3. Sub-division of the whole or part of its share capital into shares of smaller amount.
4. Conversion of fully paid shares into stocks or vice versa.
5. Cancellation of unissued shares.

A Company can make these alterationsby the company by passing an ordinary resolution at a general meeting, if it is authorized by its Articles of Association to do so.

Such alteration does not require any confirmation of the court [94(2)]. However, within 30 days of the alteration i.e. passing of the resolution of alteration, the company must give notice of such alteration to the Registrar of Companies who makes necessary alteration in Company's Memorandum or Articles of Association (Sec. 95).

4.1.2.1 Accounting Entries

Accountings in respect of alteration of share capital, explained above, are as follows:

1. **Increase of share capital**
   This is similar to fresh issue of share capital.
2. **Consolidation of shares**
   Consolidation of shares means conversation of shares of smaller denominations into shares of large denominations. Thus, the number of shares of stands reduced, face value of shares increases but the total share capital remains the same.

Example: A company has a share capital of Rs. 1,00,000 divided into shares of Rs. 10 each. Now the company deducts to convert the shares to the face value of Rs. 100 each. The entry will be:

	₹	₹.
Share capital account (Rs.10) Dr.	1,00,000	
To share capital A/c (Rs. 100)		1,00,000
(Being conversion of 10,000 shares of Rs. 10 each into 1,000 shares of Rs. 100 each)		

3. **Sub-Division of shares**
   This is just opposite to the above. Here, the shares of large denominations are concerned into shares of smaller denomination. Thus, the number of shares stands increased, face value of shares decreases but the total share capital remains the same.

   Example: A company has a share capital of Rs. 1,00,000 divided into shares of Rs. 100 each. Now the company decided to convert the shares to the face value of Rs. 10 each. The entry will be:

	₹	₹
Share capital account (Rs.100) Dr.	1,00,000	
To share capital A/c (Rs. 10)		1,00,000
(Being conversion of 1,000 shares of Rs. 100 each into 10,000 shares of Rs. 10 each)		

4. **Conversion of shares into stock**
   A company can convert all or any of its fully paid up shares into stock and reconvert that stock into fully paid up shares of any denominations.

   Example: A company has share capital of Rs. 1,00,000 divided into 10,000 shares. These shares are converted into stock. The entry will be:

Particulars		₹	₹
Share capital account (Rs.10) To share stock A/c (Being conversion of shares into stock)	Dr.	1,00,000	1,00,000

5. **Cancellation of Unissued shares**
   The authorised share capital of a company can be reduced by cancelling unissued shares. When the company cancels its unissued shares, it meet not require any journal entry.

4.1.3 Reeducation of Share Capital

As a matter of fact, the reduction of share capital is unlawful except when it is sanctioned by the court. The share capital of a company is the only security on which the creditors rely. The reduction of capital reduces the funds out of which the creditors are to be paid. Therefore, because of this reason, the power of the company to reduce its capital is closely guarded by the companies act (Sec. 100 to 105). The relevant provisions, relating to capital reduction from the point of view of accounting, are given below:

1) The articles of association of the company permits such reduction.
2) The company passes a special resolution for reducing its share capital.
3) The company has to obtain the confirmation of the court in respect of such reduction.

Any reduction of capital reduces the security of the creditors. Therefore, in order to get the confirmation of Court, Company has to file a scheme of reconstruction. The court passes the order of confirmation on such items and conditions as it may think fit only after the consent may require the company to add at the end of its name the word "and reduced" for a specified time. Court may also order the publication of the reasons which led the company to reduce the share capital.

The sanction of the court is not required for the following:
Reduction of capital under Section 100 must be distinguished from the following:

1) Cancellation of shares which have not been taken or agreed to be taken by any person.
2) Forfeiture of shares for non-payment of any call or calls.
3) Redemption of preference shares under section80.

A company may reduce its capital for many reasons: (a) the company is over-capitalised, therefore, a part of the capital may be returned, (b) a part of the capital might have been lost as a result of continued unfavourable trading results, (c) reduction of the paid up capital when it is not represented by available assets, etc.

4.1.3.1 Accounting entries

Accounting entries to be passed in respect of reduction of share capital are as follows:

1. When the liability on any share in respect of uncalled capital is being reduced, no entry is usually required.

For instance, a share of Rs 10 on which Rs 6 has been paid up, now being reduced to a fully paid share of Rs.6 and no entry is needed. However, if it is desired, it will be as follows:

Share capital account (₹10) Dr. To share capital A/c (₹6)		6 (paid up amount) 6

2. Where any paid up share capital is being reduced without reducing the liability on the shares, there is journal entry.

For instance, a share of ₹10 on which Rs.6 has been paid up is being reduced to a share of Rs. 10, Rs. 4 paid up, the entry is:

Share capital account Dr. To capital Reduction A/c	2	 2

3. Where any paid up share capital is being reduced the liability on the shares, for instance, a share of Rs. 10 on which Rs. 6 has been paid up being reduced to fully paid share of Rs. 10, Rs. 4 paid, the entry is:

Share capital account (₹10) Dr. To share capital account (₹4) To capital Reduction A/c	6	 4 2

4. Where any paid up share capital is being refunded to shareholders without reducing the liability on shares, for instance, a share of Rs. 10 on which Rs.6 has been paid up is held by a shareholder Rs 2 out of the paid up amount is being refunded to him although the face value of the share remains unaltered, the entry is:

(a)	Share capital account Dr. To shareholder's account	2	 2
(b)	ShareholderA/c Dr. To Bank A/c	2	 2

Usually, reduction in capital is made under the following circumstances:

1. To write off lost capital: When there are fictitious assets like Preliminary expenses, Discount on issue of shares or Debentures, Profit & Loss Account (Dr. balance) etc. then Capital is equal to these is regarded as lost Capital. In order to write off these fictitious assets, a portion of Capital is reduced.
2. To write off past years' losses" when there are accumulation of revenue losses as a result of series of bad trading years' unsound investments, a portion of the capital of the company might have been lost. To write off these accumulated losses, capital is reduced.

***Illustration*: 1**

A company has a paid up capital of ₹6,40,000 divided into 80,000 equity shares of ₹10 each ₹8 per share paid up. The Profit & Loss account shows a credit balance of ₹2,80,000.

SOLUTION:

	Journal	Dr.	Cr.
		₹	₹
	Share capital A/c Dr. To Shareholders A/c (Being the amount to be repaid to shareholders on reduction of paid-up-capital)	1,60,000	1,60,000
	Shareholders A/c Dr. To Bank A/c (Being the amount paid off)	1,60,000	1,60,000
	Profit & Loss A/c Dr. To General Reserve A/c (Being transfer on repayment of share capital)	1,60,000	1,60,000

Note: This transfer (General Reserve) is not to meet any requirements of law but is made as a matter of financial prudence so that the working capital is not depleted as a result of repayment of capital.

4.1.3.2 Disposal of Capital Reduction Account

The capital reduction account is a temporary account opened in order to carry out the internal reconstruction. When the scheme is carried out, the account is closed. The capital reduction account represents the sacrifice made by the shareholders, debentureholders, creditors etc. This sacrificed amount is credited to this account. The appreciation in the value of assets is also credited to this account. The amount available is used to write off accumulated losses, intangible assets, over-valuation of assets, etc. If there is any balance in this account, it will be transferred to capital reserve account. The various journal entries are as follows:

1. On reduction of paid up share capital	Share capital (Old) A/c Dr. To Share capital A/c(New) To Capital Reduction A/c
2. On sacrifice by the Debentureholders or Creditors	Debentureholders A/c Dr. Creditors A/c Dr. To Capital Reduction A/c
3. On writing off fictitious assets (individually)	Capital Reduction A/c Dr. To Profit & Loss A/c To Preliminary Expenses A/c To Goodwill A/c To Patent A/c etc.
4. The balance of Capital Reduction A/c is transferred to Capital Reserve A/c.	Capital Reduction A/c. Dr. To Capital Reserve A/c

Illustration 2

The paid-up capital of Toy Ltd. amounted to ₹2,50,000 consisting of 25,000 equity shares of ₹10 each. Due to losses incurred by the company continuously, the director of the company prepared a scheme for reconstruction which was duly approved by the court. The terms of reconstruction were as under:

(i) In lieu of their present holdings, the shareholders are to receive:

(ii) Fully paid equity shares equal to 2/5th of their holding.

(iii) 5% preference shares fully paid-up to the extent of 20% of the above new equity shares.

(iv) 3,000 6% second debentures of ₹10 each.

(v) An issue of 2,500 5% first debentures of ₹10 each was made and fully subscribed in cash.

(vi) The assets were reduced as follows:

a. Goodwill from ₹ 1,50,000 to ₹75,000.

b. Machinery from ₹ 50,000 to ₹37,500.

c. Leasehold premises from ₹ 75,000 to ₹ 62,500.

Show the journal entries to give effect to the above scheme of reconstruction. ***Solution***

Books of Toy Ltd. JOURNAL ENTRIES

Particulars	*Dr.* ₹	*Cr.* ₹
Share capital A/c (old) Dr.	2,50,000	
To Equity share capital A/c (₹ 2,50,000 x 2/5)		1,00,000
To 5% Pref. share capital A/c (₹ 1,00,000 x 20/100)		20,000
To 6% Second debentures A/c		30,000
To Capital reduction A/c		1,00,000
(Being conversion of 25,000 Equity shares and balance being transferred to Capital reduction A/c in accordance with the Scheme of internal reconstruction)		
Bank A/c Dr.	25,000	
To 5% First debentures A/c		25,000
(Being issue of ₹ 25,000 5% First debentures for cash as per internal reconstruction scheme)		
Capital reduction A/c Dr.	1,00,000	
To Goodwill A/c		75,000
To Plant & machinery A/c		12.500
To Leasehold premises A/c		12.500
(Being sundry assets written down as per internal reconstruction scheme)		

Illustration 3

The following is the Balance Sheet of Downhill Ltd. as at 31st March, 2015:

Liabilities	₹	***Assets***	₹
20,000 Equity shares of ₹ 100 each	20,00,000	Goodwill	25,000
12% Debentures	5,00.000	Land and buildings	1,50.000
Outstanding debentures interest	1,20,000	Plant and machinery	3,00,000
Creditors	3,00,000	Furniture	80,000
		Stock	2,70,000
		Debtors	60,000
		Cash at bank	35,000
		Preliminary expenses	20,000.
		Profit and loss A/c	19,80,000
			29,20,000
	29,20,000		**29,20,000**

The following scheme of reconstruction is executed:

(i) Equity shares are reduced by ₹95 per share. They are, then, consolidated into 10,000 equity shares of ₹10 each.

(ii) Debenture holders agree to forego outstanding debenture interest. As a compensation 12% Debentures are converted into 14% Debentures, the amount remaining ₹. 5,00,000

(iii) Creditors are given the option to either accept 50% of their claim in cash in full settlement or to convert their claim into equity shares of ₹ 10 each. Creditors for ₹2,00,000 opt for shares in satisfaction of their claims.

(iv) To make payment to creditors opting for cash payment and to augment working capital, the company issues 50,000 equity shares of ₹ 10 each at par, the entire amount being payable along with applications. The issue was fully subscribed,

(v) Land and Buildings are revalued at ₹ 2,00,000 whereas Plant Machinery is to be written down to ₹ 2,10,000. A provision amounting to ₹ 5,000 is to be made for doubtful debts. Pass journal entries and draft the company's balance sheet immediately after the reconstruction.

Solution

JOURNAL ENTRIES

	Particulars	***Dr.* ₹**	***Cr.* ₹**
	Equity share capital (Rs 100) A/c Dr. To Capital reduction A/c (Being reduction in the value of equity shares by ₹ 95 ach)	19,00,000	 19,00,000
	Equity share capital (100) A/c Dr. To Equity share capital (₹ 10) A/c [Being conversion of 20,000 equity shares of ₹ 100 each (₹ 5 paid-up) into equity shares of ₹ 10 each (fully paid-up)]	1,00,000 5,00,000	 1,00,000 5,00,000
	Outstanding Debentures interest A/c Dr. To Capital reduction A/c (Being outstanding debentures interest foregone by debenture holders)	1,20,000	 1,20,000
	12% Debentures A/c Dr. To 14% Debentures A/c (Being conversion of 12% debentures into 14% debentures)	5,00,000 1,20,000	 5,00,000

	Bank A/c Dr. To Equity share capital A/c (Being 50,000 equity shares of ₹10 each issued for cash and subscribed in full)	5,00,000	 5,00,000
	Creditors A/c Dr. To Equity share capital (₹ 10) A/c To Bank A/c To Capital reduction A/c (Being creditors of ₹1,00,000 paid in cash equivalent to 50% of their claims and the rest issued equity shares of Rs 10 each in full settlement)	3,00,000	 2,00,000 50,000 5,000
	Land and buildings A/c Dr. To Capital reduction A/c (Being Land & Buildings revalued at ₹ 2,00,000)	50,000	 50,000
	Capital reduction A/c Dr. To Plant and machinery A/c To Provision for doubtful debts A/c To Goodwill A/c To Preliminary expenses A/c To P & L A/c (Being balance of Capital reduction account utilised for writing off the fictitious assets and accumulated losses)	21,20,000	 90,000 5,000 25,000 20,000 19,80,000

Note: Capital Reduction Account balance has been completely utilized.

M/s. Downhill Ltd. (And reduced) Balance Sheet *as on March 31, 2015*

	Note No.	*As on 31-3-2015*	*As on 31-3-2015*
Equity and Liabilities		₹	₹
1) Shareholder's funds:			
(e) Share Capital	A	8,00,000	
(f) Reserve and Surplus	B	-	8,00,000
2) Non-Current Liabilities			
Long-term Borrowings (secured loans)			5,00,000
3) Current Liabilities			
Trade Payable (Sundry Creditors)		Nil	
Other Current Liabilities	G		
4) Suspense Account (Balancing Figure)			
Total Equity and Liabilities			13,00,000
Assets			
Non-Current Assets			

(5) Fixed Assets: Tangible Assets Non-Current investments (assumed)	 I K		 4,90,000 -
(6) Current Assets: i) Inventories j) Sundry Debtors k) Cash & Cash Equivalents l) Short-Term loans and Advances	 O P Q R	 2,70,000 55,000 4,85,000 -	 8,10,000
Total Assets			13,00,000

Illustration 4

The following was the Balance Sheet of Continental Construction Ltd. as on 31st March 2015:

Liabilities	₹	***Assets***	₹
Authorised capital: 20,000 Equity shares of ₹ 10 each Issued, Subscribed and Paid-up capital	2,00,000	Goodwill Land and building Machinery	10,000 20,500 50,850
12,000 Shares of ₹ 10 each 1,20,000 *Less:* Calls in arrear: (₹3 per share on3,000 shares) 9,000	1,11,000	Stock Book debts Cash at Bank	10,275 15,000 1.500
Sundry creditors	15,425	Profit and loss A/c	
Provision for taxes	4,000	Balance as per last balance-sheet 22,900 *Less:* Profit for the year 2,100	 20,800
		Preliminary expenses	1,500
	1,30,425		**1,30,425**

The directors have had a valuation made of the machinery and find it over-valued by ₹10,000. It is proposed to write down this asset to its true value and to extinguish the deficiency in the Profit and Loss Account and to write off Goodwill and Preliminary Expenses, by the adoption of the following course:

1. Forfeit the shares on which the call is outstanding.
2. Reduce the paid-up capital by ₹ 3 per share.

3. Reissue the forfeited shares at ₹ 5 per share.

4. Utilise the provision for taxation, if necessary.

The shares on which the calls were in arrear were duly forfeited and reissued on payment of ₹ 5 per share. You are required to draft the journal entries necessary and the Balance Sheet of the company after carrying out terms of the scheme as set above.

Solution

JOURNAL ENTRIES

	Particulars		*Dr.₹*	*Cr.₹*
	Equity share capital A/c	Dr.	30,000	
	To Calls in arrear			9,000
	To Forfeited shares A/c			21,000
	(Being forfeiture of 3,000 equity shares as per Board's Resolution dated...)			
	Equity share capital A/c	Dr.	27,000	
	To Capital reduction A/c			27,000
	(Being reduction of the paid amount on existing			
	Bank A/c	Dr.	15,000	
	Forfeited shares A/c	Dr.	6,000	
	To Equity share capital A/c			21,000
	(Being reissue of 3,000 shares of ₹10 each ₹7 paid-			
	Forfeited shares A/c	Dr.	15,000	
	Provision for taxation A/c	Dr.	300	
	To Capital reduction A/c			15,300
	(Being transfer of balance in forfeited shares account and part of Provision for taxation account to Capital reduction account)			
	Capital reduction A/c	Dr.	42,300	
	To Machinery			10,000
	To Profit and loss A/c			20,800
	To Goodwill			10,000
	To Preliminary expenses			1,500
	(Being writing off losses, preliminary expenses and goodwill and reduction in the value of machinery by ₹ 10,000 as per the reconstruction scheme)			

Continental Construction Ltd. Balance Sheet

as on 31st March, 2015 (after reconstruction)

	Note No.	As on 31-3-2015	As on 31-3-2015
Equity and Liabilities		₹	₹
1. Shareholder's funds:			
(g) Share Capital	A	84,000	
(h) Reserve and Surplus	B	-	84,000
2. Non-Current Liabilities			
Long-term Borrowings (secured loans)			-
3. Current Liabilities			
Trade Payable (Sundry Creditors)		15,425	
Other Current Liabilities	G	3,700	19,125
4. Suspense Account (Balancing Figure)			
Total Equity and Liabilities			**1,03,125**
Assets			
Non-Current Assets			
(7) Fixed Assets:			
Tangible Assets	I		
Non-Current investments	K		61,350
(assumed)			-
(8) Current Assets:			
a) Inventories	O		
b) Sundry Debtors	P	10,275	
c) Cash & Cash Equivalents	Q	15,000	
d) Short-Term loans and Advances	R	16,500	
Total ***Assets***		-	41,775
			1,03,125

Illustration 5

Following is the Balance Sheet of ABC Ltd. as on 31st March, 2014:

BALANCE SHEET

Liabilities	₹	*Assets*	₹
Share capital		Plant and machinery	9,00,000
2,00,000 Equity shares of₹10 each		Furniture and fixtures	2,50,000
fully paid up	2,00,000	Patents and copyrights	70,000
6,000, 8% Preference shares of ₹		Investments (at cost)	
100 each	6,00,000	Market value₹55,000)	68,000
9% Debentures	12,00,000	Stock	14,00,000
Bank overdraft	1,50,000	Sundry debtors	14,39,000
Sundry creditors	5,92,000	Cash and bank balance	10,000
		Profit and Loss A/c	4,05,000
	45,42,000		**45,42,000**

The following scheme of reconstruction was finalised:

(i) Preference shareholders would give up 30% of their capital in exchange for allotment of 11 %Debentures to them.

(ii) Debenture holders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.

(iii) Stock equal to ₹ 5,00,000 in book value will be taken over by sundry creditors in full settlement of their dues.

(iv) Investment value to be reduced to market price,

(v) The company would issue 11% Debentures for ₹ 3,00,000 and augment its working capital requirement after settlement of bank overdraft. Pass necessary Journal Entries in the books of the company. Prepare Capital Reduction account and Balance Sheet of the company after internal reconstruction.

Books of ABC LtdJOURNAL ENTRIES

Date	***Particulars***	***Dr. ₹***	***Cr. ₹***
	8% Preference share capital A/c Dr. To Preference shareholders A/c To Capital reduction A/c (Being 30% reduction in liability of preference share capital)	6,00,000	 4,20,000 1,80,000
	Preference shareholders A/c Dr. To 11% Debentures A/c (Being the issue of debentures to preference shareholders)	4,20,000	 4,20,000
	9% Debentures A/c Dr. To Debenture holders A/c (Being transfer of 9% debentures to debentures holders A/c)	12,00,000	 12,00,000
	Debenture holders A/c Dr. To Plant and machinery A/c To Capital reduction A/c (Being settlement of debenture holders by allotment of plant and machinery)	12,00,000	 9,00,000 3,00,000

	Sundry creditors A/c Dr. To Stock A/c To Capital reduction A/c (Being settlement of creditors by giving stocks)	5,92,000	 5,00,000 92,000
	Bank A/c Dr. To 11 % Debentures A/c (Being fresh issue of debentures)	3,00,000	 3,00,000
	Bank overdraft A/c Dr. To Bank A/c (Being settlement of bank overdraft)	1,50,000	 1,50,000
	Capital reduction A/c Dr. To Investment A/c To Profit and loss A/c To Capital reserve A/c (Bal. Fig.) [Being decrease in investment and profit and loss account (Dr. bal.); and balance of capital reduction account transferred to capital reserve]	5,72,000	 13,000 4,05,000 1,54,000

CAPITAL REDUCTION ACCOUNT

Particulars	₹	*Particulars*	₹
To Investments A/c	13,000	By Preference share capital	1,80,000
To Profit and loss A/c	4,05,000	A/c By 9% Debenture holders	3,00,000
To Capital reserve A/c (Bal. Fig.)	1,54,000	A/c By Sundry creditors A/c	92,000
	5,72,000		**5,72,000**

ABC Ltd. (And Reduced)

BALANCE SHEET

as on 31st March, 2014

	Note No.	*As on 31-3-2015*	*As on 31-3-2015*
Equity and Liabilities		₹	₹
1. Shareholder's funds:			
(a) Share Capital	A	20,00,000	
(b) Reserve and Surplus	B	1,54,000	21,54,000
2. Non-Current Liabilities			
Long-term Borrowings (secured loans)			7,20,000
3. Current Liabilities			
Trade Payable (Sundry Creditors)		-	
Other Current Liabilities	G		-

4. Suspense Account (Balancing Figure)			
Total Equity and Liabilities			
Assets			28,74,000
Non-Current Assets			
(9) Fixed Assets:			
Tangible Assets	I		
Non-Current investments	K		2,50,000
(assumed)			1,25,000
(10) Current Assets:			
a) Inventories	O		
b) Sundry Debtors	P	9,00,000	
c) Cash & Cash Equivalents	Q	14,39,000	
d) Short-Term loans and Advances	R	1,60,000	
Total *Assets*		-	14,99,000
			28,74,000

Working Note:

Cash at bank = Opening balance + 11% Debentures issued - Bank overdraft paid

= Rs 10,000 + Rs 3,00,000 - Rs 1,50,000

= Rs 1,60,000.

When Balance of the Profit and Loss Account is not given

Sometimes in an examination problem the balance of the profit and loss account is not given. In such a case a balance sheet of the business should be prepared with the available information taking assets and liabilities at book values. The difference of the two sides as disclosed by the balance sheet should be taken as the balance of the profit and loss account.

Example

The following balances have been extracted from the Trial Balance of Not so well Limited as on 31st March, 2013.

Equity share capital A/c (₹ 10 shares)	₹ 1,00,000
Preference share capital A/c (₹ 100 each)	1,00,000
5% Debentures	1,00,000
Sundry creditors	50,000
Fixed assets (Market value 1,00,000)	1,50,000
Current assets	1,50,000

The Balance of the Profit and Loss Account can be ascertained by preparing a Memorandum Balance Sheet as on 31st March, 2013.

MEMORANDUM BALANCE SHEET

Liabilities	₹	*Assets*	₹
Share capital:	1,00,000	Fixed assets	1,50,000
Equity (₹ 10 shares)	1,00,000	Current assets	1,50,000
Preference (₹100 shares)	1,00,000	P and L A/c	50,000
15% Debentures	50,000	(accumulated loss-bal. fig.)	
Sundry creditors			
	3,50,000		3,50,000

4.1.7 Self Test Question
Theory

1. Explain the need for internal reconstruction.
2. What are the factors that influence the internal reconstruction?
3. How internal reconstruction is differ from the external reconstruction.
4. State the difference between alteration of capital and reduction of share capital.

Problems

1. Following are the liabilities and assets of Week Co. Ltd as on March, 2012:

Liabilities	₹	*Assets*	₹
1,00,000 equity shares of		Land	1,00,000
₹10 each	10,00,000	Plant & Machinery	2,30,000
Sundry Creditors	1,73,000	Furniture & Fittings	68,000
		Stock	1,50,000
		Debtors	70,000
		Cash at Bank	5,000
		Surplus A/c (Negative	5,50,000
	11,73,000	Balance)	11,73,000

The approval of the cost was obtained for the following scheme of reduction of capital:

(i) The equity shares to be reduced to ₹4 per share.

(ii) Plant & Machinery to be written down to ₹1,50,000.

(iii) Stock to be revalued at ₹ 1,40,000.

(iv) The provision on debtors for doubtful debts to be created ₹2,000.

(v) Land to be revalued at ₹1,42,000.

Pass journal entries to give effect to the above arrangement and also prepare reconstruction account.

2. The paid up capital Science Traders Ltd. amounted to ₹5,00,000 consisting of 2,000 5% cumulative preference shares of ₹. 100 each and 30,000 Equity Shares of ₹10 each. The Preference dividends were in arrear for 30,000.

A succession of losses having been incurred by the company, the Directors recommended to the shareholders the proposal to reduce the capital to provide a sum sufficient for the following purposes:

(a) To write down the book valve of patents by ₹ 70,000; Plant & Machinery by ₹17,000; and Tools and Implements by ₹2,000.
(b) To write off debit balance on Surplus Account of ₹1,98,000.
(c) Any balance made available by the reduction of capital to be written off "Experiment and Research Expenses".

The scheme duly approved and authorised, provided as follows:

(a) For every 5% Preference Share, three 4% Cumulative Preference Shares, of ₹ 100 each and twenty equity shares of ₹ 2 each.
(b) For every ₹10 of accumulated arrears of preference dividend, one equity share of ₹ 2 each; and
(c) For every five old Equity Shares, one new Equity Share of ₹2 each.

You are required to show the necessary journal entries and prepare the capital reduction account to record the above in the books of the company.

3. Following are the liabilities and assets of Gobole Co ltd as on 31st March,2012:

Liabilities	₹	*Assets*	₹
Share Capital		Goodwill	22,500
3,000 5% Preference		Land & Building	3,00,000
Sharesof ₹ 100 each	3,00,000	Machinery	4,50,000
6,000 Equity Shares of		Stock	65,000
₹100 each	6,00,000	Debtors	70,000
6% Debentures	1,50,000	Cash	7,500
Bank Overdraft	1,50,000	Surplus A/c (Negative	3,50,000
Creditors	75,000	Balance)	10,000
		Preliminary Expenses	
	12,75,000		12,73,000

On the above, the company adopted following schemes of reconstruction:

(i) The preference shares are to be reduced to fully paid shares of ₹ 75 each and equity shares are to be reduced to shares of ₹40 each fully paid.
(ii) The debenture holders took over stock and debentures in full satisfaction of their claims.
(iii) The fictitious and intangible assets are to be eliminated.
(iv) The land & buildings to be appreciated by 30% and machinery to be depreciated by 33(1/3) %.
(v) Expense of Reconstruction amounted to ₹ 4,500.

Give journal entries incorporating the above scheme of reconstruction and prepare the reconstructed balance sheet.

4. Following were the liabilities and assets of Hemla Limited as at 31st March, 2012:

Liabilities	₹	*Assets*	₹
50,000 7% Cumulative		Goodwill	2,00,000
Preference Shares o₹ 12.50 each	6,25,000	Patent	50,000
1,00,000 Equity Shares of ₹10 each		Land & Building	6,00,000
7% Debentures (Secured on	10,00,000	Plant & Machinery	5,50,000
Land & Buildings) 5,00,000			
Add: Interest Accrued 17,500		Investment at cost	60,000
		Sundry Debtors:	
Director's loans	5,17,500	Considered good 4,00,000	
Sundry creditors	1,00,000	Considered bad 30,000	4,30,000
Bank overdraft	4,00,000	Cash in hand	2,500
Contingent liabilities:	2,50,000	Stock	80,000
Suit pending in court₹ 50,000		Deferred expenditure	4,90,000
Dividends on Preference Shares		Surplus A/c (Negative	
₹ 14,000		Balance)	
	28,92,500		28,92,500

A scheme for reduction of capital was duly prepared and sanctioned whereby:

(a) The preference shares were to be reduced to an equal number of fully paid shares of ₹10 each and equity shares to an equal number of fully paid shares of 2.50 each. Authorised share capital is to be recognised into preference shares of 10 each and equity shares of 2.50 each.

(b) Stocks were to be written off by ₹ 50,000 and had debts and all intangible assets to be eliminated.

(c) The preference shareholders agreed to waive half of the dividend arrears and receive equity shares in lieu of the balance.

(d) The debentureholders agreed to take over part of company's property of the book value of ₹ 1,80,000 at an agreed price of ₹2,50,000 in satisfaction of part of their claim and to provide cash on a further floating charge of ₹1,50,000 after deducting arrears of interest due to them. And

(e) The contingent liability in respect of damages materialised by the sums stated but the company recovered ₹20,000 from a director responsible for the same out of ₹40,000 standing to his credits in loan account paying him of the balance in cash. The other directors agreed to take equity shares in satisfaction of their loans.

Show the journal entries (including for cash transactions) to give effect to the above.

Lesson 4.2 Amalgamation, Absorption and External Reconstruction

Learning Objectives

After reading this lesson you should be able to

- know the difference between reconstruction, amalgamation and absorption of companies
- understand the different methods of computation of purchase consideration
- make appropriate accounting entries in the books of the vendor company and the purchasing company

4.2.1 Introduction

There are many forms of business combinations to obtain the economies of large scale production or to avoid the cut throat competition. They are amalgamation, absorption, external reconstruction etc.

The term amalgamation is used when two or more existing companies go into liquidation and a new company is formed to take over the business of liquidated companies. The term absorption is used when an existing company takes over the business of one or more existing companies which go into liquidation. In external reconstruction, one existing company goes into liquidation and a new company is formed to take over the former company.

4.2.2 Definitions as per Accounting Standard 14 (AS-14)

a. Amalgamation – means an amalgamation pursuant to the provisions of the Companies Act 1956 or any other statute which may be applicable to companies.
b. Transferor Company – means the company which is amalgamated into another company.
c. Transferee Company – means the company to which a transferor company is amalgamated.
d. Reserve – means the portion of earnings, receipts or other surpluses of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability.

4.2.3 Types of Amalgamation

As per AS-14 there are two types of amalgamation (1) Amalgamation in the nature of merger and (2) Amalgamation in the nature of purchase.

4.2.3.1 Amalgamation in the nature of Merger (Pooling Interest Method)

An amalgamation should be considered to be an amalgamation in the nature of merge when all the following conditions are satisfied:

i. All the assets and liabilities of the Transferor Company or companies before amalgamation should become the assets and liabilities of the transferee company.

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (excluding the proportion held by the transferee company) should become the shareholders of the transferee company.

iii. The consideration payable to the above mentioned shareholders should be discharged by the transferee company by the issue of the equity shares and cash can be payable in respect of fractional shares.

iv. The business of the Transferor Company/ companies is intended to be carried on by the transferee company.

v. No adjustment is intended to be made to the book values of the assets and liabilities of the Transferor Company/ companies when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified for amalgamation in the nature of merger is not satisfied.

4.2.3.2 Amalgamation in the nature of purchase.

In the second category are those amalgamation which are in effect amode by which one company acquires another company and as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company or te business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of purchase.

So, amalgamations which do not satisfy one or more conditions specified for amalgamations in the nature of merger should be treated as 'amalgamations in the nature of purchase'.

Thus, in the amalgamations in the nature of purchase,

(a) All the assets and liabilities of the selling company may not be taken over.
(b) Less than 90% of the selling company's shareholders may become shareholders in the purchasing company.
(c) Consideration payable to shareholders of selling company may be in the form of shares or cash or in any other agreed form.
(d) Selling company's business may or may not be carried on in future.
(e) Assets and liabilities taken over by the purchasing company may be shown at values other than book values at the discretion of the purchasing company.

4.2.3 Purchase Consideration

Purchase consideration is the amount which is paid by the transferee company for the purchase the business of Transferor Company. As per AS-14, consideration for amalgamation means the aggregate of shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. Purchase consideration does not include any payment to outsiders including debenture holders. The following are the different methods for calculating the amount of purchase price:

a) Lump Sum Method

Under this method, the purchase consideration is specified at a particular figure which is paid by the Purchasing Company. And no calculation is required under this method.

b) Net Payment Method

Under this method, the purchasing price is calculated by adding the various payments made by the purchasing company in the form of cash, shares or debentures. That is, the purchasing price is the total of all payments made in cash or shares or debentures.

c) Net Assets Method (Net Worth Method)

When the full details of purchase consideration are not given, as discussed above, the purchase consideration should be calculated by adding value of only those assets which

have been taken over by the purchasing company and deduct there from the agreed value of only those assets liabilities which have been taken over by the Purchasing Company.

d) Value of Share Method

Under this method the purchase consideration is ascertained on the ratio in which the shares of new company are exchanged for the shares of Vendor Company.

4.2.4 Accounting Entries in the books of Vendor Company

A liquidator is appointed on the liquidation of a company and he represents the vendor company (liquidating company) with the new company. The following entries are made to close books of the company that goes into liquidation:

1. When assets are taken over by purchasing company (at book value)	Realisation A/c Dr. To Assets A/c
2. When all liabilities except reserves and shareholder's fund are transferred.	Liabilities A/c Dr. To Realisation A/c
3. Entry for purchase consideration receivable	Purchasing company's A/c Dr. To Realisation A/c
4. Entry for liquidation expenses paid by the vendor company	Realisation A/c Dr. To Bank A/c
5. When the liquidation expenses are paid by the Purchasing Company, there will be not entry to be passed or there will be two entries	Purchasing Company's A/c Dr. To Bank Account
6. Entry for the deposal of the assets not taken over	Bank A/c Dr. To assets A/c
7. Entry for the payment of liabilities not taken over by purchasing company	Liabilities A/c Dr. To Bank A/c
8. If there is any gain or loss on transaction (6 and 7 of above), it should be transferred to realisation (a) Loss on transaction (payment of liabilities or sale of assets) (b) Gain on transaction (payment of liabilities or sale of assets)	Realisation A/c Dr. To Assets/Liabilities A/c Assets/Liabilities A/c Dr. To Realisation A/c
9. Realisation Account is closed by transferring the profit or loss to shareholders account (a) If there is profit (b) If there is a loss	a) Realisation A/c Dr. To Shareholders A/c b) Shareholders A/c Dr. To Realisation A/c

Thus realisation Account is closed	
10. When the purchases price is received in cash or kinds	Bank A/c Dr. Shares in Purchasing Co. A/c Dr. Debentures in purchasing Co. A/c Dr. To purchasing company A/c
11. For transferring share capital account	Share capital A/c Dr. To Shareholders A/c
12. For transferring fictitious assets	Shareholder's A/c Dr. To P&L A/c To Preliminary Expenses A/c To Accumulated Loss A/c
13. To transferring profits and reserves	Reserve of the above entry (12)
14. Shareholders are now paid off	Shareholders A/c Dr. To Cash A/c To Shares in purchasing Co. A/c To Debentures in purchasing Co. A/c

Thus all the books of Vendor Company are closed.

4.2.5 Accounting Entries in the Books of Purchasing Company

The journal entries in the books of purchasing company are the same as under business acquisition. The purchase consideration is paid to the vendor company by the purchasing company. When the purchase consideration pays more than the value of the net assets than the net assets taken over, the difference in value will represent capital reserve. Goodwill is the capital loss and capital gain to the purchasing company. The journal entries are:

1. Entry for the business purchase	Business Purchase A/c Dr To Liquidator of vendor Co. A/c
2. Entry for assets and liabilities are taken over	Various assets A/c Dr To various liabilities A/c To Business purchase A/c
3. Entry for the Payment of purchase consideration	Liquidators of vendor Co. A/c Dr To Bank A/c To Debentures A/c To Share Capital A/c
4. Entry for the purchasing company paid liquidation expenses	Goodwill A/c Dr To Bank A/c

4.2.6.1 Practical Problems: Amalgamation

Illustration 1

The following are the Balance Sheets of Good Ltd. And Better Ltd. As on 31st March, 2013 .

Good Ltd.

Liabilities	₹	Assets	₹
Share Capital:		Buildings	15,000
5,000 Equity Shares of ₹. 10		Machinery	55,000
each, Fully paid –up	50,000	Stock	8,000
General Reserve	10,000	Debtors	7,000
Insurance Fund	7,000	Cash	1,500
Profit and Loss A/c	3,000		
10% Debentures of ₹ 100 each	10,000		
Trade Creditors	5,000		
Employees' Provident Fund	1,500		
	86,500		**86,500**

Better Ltd.

Liabilities	₹	Assets	₹
Share Capital:		Machinery	25,000
3,000 Equity Shares of ₹ 10	30,000	Stock	4,000
each		Debtors 5,00	
Trade Creditors	3,000	Less: Provision for	
Workmen's Profit Sharing	1,000	Doubtful Debts 5,0	4,500
Fund		Cash	500
	34,000		**34,000**

The two companies agree to amalgamate and form a new company called Best Ltd., with an authorized capital of ₹ 2,00,000 in ₹10 shares which takes over the assets and liabilities of both the companies on 1st April 2013.

The assets of Good Ltd. are taken over at a reduced valuation of 10% with exception of buildings which are accepted at book value.

Both companies are to receive 5% of the net valuation of their respective business as Good will. The entire purchase price is to be paid by Best Ltd. in fully paid equity shares of ₹10 each.

Give journal entries and Leger accounts to close the books of Good Ltd. and Better Ltd. Make opening entries in the books of Best Ltd. Also prepare the opening Balance sheet of Best Ltd. As on 1st April 2013.

Solution

Computation of Purchase Consideration

		Good Ltd. ₹	Better Ltd. ₹
1)	Assets taken over:		
	Buildings	15,000	-
	Machinery	49,500	25,000
	Stock	7,200	4,000
	Debtors	6,300	5,000
	Cash	1,500	500
	Total Assets	79,500	34,500
2)	Liabilities taken over		
	10% Debentures	10,000	
	Trade Creditors	5,000	4000
	Employees' Provident Fund	1,500	-
	Provision for doubtful Debts	-	500
	Total Liabilities	16,500	4,500
3)	Net Asset (1)-(2)	63,000	30,000
	Add: Goodwill @5% on net Assets	3,150	1,500
	Purchase consideration	66,150	31,500
	Mode of payment	Equity Share Capital	Equity Share Capital

* As per terms, Machinery, Stock and Debtors of Good Ltd. Have been reduced by 10%

Good Ltd.

Journal

Date	Particulars		Dr. ₹	Cr. ₹
	RealisationA/c	Dr.	86,500	
	To Buildings A/c			15,000
	To Machinery A/c			55,000
	To Stock A/c			8,000
	To Debtors A/c			7,000
	To Cash A/c			1,500
	(Being transfer of sundry assets at their book values)			
	10% Debentures A/c	Dr.	10,000	
	Trade Creditors A/c	Dr.	5,000	
	Employee' Provident Fund A/c	Dr.	1,500	
	To Realisation A/c			16,500
	(Being transfer of sundry liabilities at their book values)			
	Best Ltd	Dr.	66,150	
	To Realisation A/c			66,150
	(Being purchase consideration due)			
	Equity Shareholder A/c	Dr.	3,850	
	To Realisation A/c			3,850
	(Being transfer of loss on realization)			
	Equity Shares in Best Ltd	Dr.	66,150	
	To Best Ltd.			66,150
	(Being receipt of purchase consideration)			

	Equity Share Capital A/c Dr.		50,000	
	General Reserve A/c Dr.		10,000	
	Insurance Fund Dr.		7,000	
	Profit and Loss A/c Dr.		3,000	
	To Equity Shareholders A/c			70,000
	(Being transfer of share capital and accumulated profits and reserves to equity shareholders)			
	Equity Shareholders A/c Dr.		66,150	
	To Equity Shares in Best Ltd			66,150
	(Being final payment to equity shareholders)			

LEDGER ACCOUNTS

Realisation A/c

Date	Particulars	₹	Date	Particulars	₹
	To Buildings	15,000		By 10% Debentures	10,000
	To Machinery	55,000		By Trade Creditors	5,000
	To Stock	8,000		By Employees P.F.	1,500
	To Debtors	7,000		By Best Ltd. (Purchase	66,150
	To Cash	1,500		Consideration due)	3,850
				By Equity Shareholders A/c	
				(Loss Bal.Fig.)	
		86,500			**86,500**

Best Ltd. A/c

Date	Particulars	₹	Date	Particulars	₹
	To Realisation A/c	66,150		By Equity Share Capital in Best Ltd. (Purchase Consideration)	66,150
		66,150			**66,150**

Equity Shareholders A/c

Date	Particulars	₹	Date	Particulars	₹
	To Realisation A/c (Loss)	3,850		By Equity Share	50,000
	To Equity Share Capital in	66,150		Capital	10,000
	Best Ltd. (Final Payment)			By General Reserve	7,000
				By Insurance Fund	3,000
				By Profit & Loss A/c	
		70,000			**70,000**

Better Ltd

Journal

Date	Particulars	Dr. ₹	Cr. ₹
	Realisation A/c Dr.	34,500	
	To Machinery A/c		25,000
	To Stock A/c		4,000
	To Debtors A/c		5,000
	To Cash A/c		500
	(Being transfer of sundry assets at their book values)		
	Provision for Doubtful Debt A/c Dr.	500	

	Trade Creditors A/c Dr.	3,000	
	Workmen's Profit Sharing Fund Dr.	1,000	
	To Realisation A/c		4,500
	(Being transfer of sundry liabilities at their book values)		
	Best Co. Ltd Dr.	31,000	
	To Realisation A/c		31,500
	(Being purchase consideration due)		
	Realisation A/c Dr.	1,500	
	To Equity Shareholders A/c		1,500
	(Being transfer of loss on realization)		
	Equity Shares in Best Ltd A/c Dr.	31,500	
	To Best Ltd.		31,500
	(Being receipt of purchase consideration)		
	Equity Share Capital A/c Dr.	30,000	
	To Equity Shareholders A/c		30,000
	(Being transfer of hare capital)		
	Equity Shareholders A/c Dr.	31,500	
	To Equity Shares in Best Ltd		31,500
	(Being final payment to equity shareholders)		

LEDGER ACCOUNTS

Realisation A/c

Date	Particulars	₹	Date	Particulars	₹
	To Machinery	25,000		By Provision for Bad & Doubtful debts	500
	To Stock	4,000		By Trade Creditors	3,000
	To Debtors	5,000		By Workmen's Profit Sharing Fund	1,000
	To Cash	500		By Best Co. Ltd. (Purchase Consideration	31,500
	To Equity Shareholders A/c (Bal.Fig.)	1,500			
		36,000			**36,000**

Best Company Ltd. A/c

Date	Particulars	₹	Date	Particulars	₹
	To Realisation A/c (Purchase Consideration due)	31,500		By Equity Share Capital in Best Ltd.	31,500
		31,500			**31,500**

Equity Shareholders A/c

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Capital in Best Ltd.	31,500		By Equity Share Capital	30,000
				By Realisation (Profit)	1,500
		31,500			**31,500**

Journal Books of Better Ltd.

Date	Particulars	Dr. ₹	Cr. ₹
	Business Purchase A/c Dr.	97,650	
	To Liquidator of Good Ltd.		66,150
	To Liquidator of Better Ltd.		31,500
	(Being acquisition of businesses of Good Ltd. And Better Ltd. As per agreement dated….)		
	Goodwill A/c Dr.	3,150	
	Buildings A/c Dr.	15,000	
	Machinery A/c Dr.	49,500	
	Stock A/c Dr.	7,200	
	Debtors Dr.	6,300	
	Cash A/c Dr.	1,500	
	To 10% Debentures A/c		10,000
	To Trade Creditors A/c		5,000
	To Employees Provident Fund A/c		1,500
	To Business Purchase A/c		66,150
	(Being taking over of assets and liabilities of Good Ltd.)		
	Goodwill A/c Dr.	1,500	
	Buildings A/c Dr.	25,000	
	Stock A/c Dr.	4,000	
	Debtors Dr.	5,000	
	Cash Dr.	500	
	To Trade Creditors		3,000
	To Workmen's Profit Sharing Fund		1,000
	To provision for Doubtful Debts		500
	To Business Purchase A/c		31,500
	(Being taking over of assets and liabilities of Better Ltd)		
	Liquidator of Good Ltd Dr.	66,150	
	Liquidator of Better Ltd Dr.	31,500	
	To Equity Share Capital A/c		97,650
	(Being issue of fully-paid equity shares in payment of purchase consideration)		

Best Ltd. Balance Sheet
as on 1st April, 2013 (after amalgamation)

	Note No.	*As on 1-4-2013*	*As on 1-4-2013*
Equity and Liabilities		₹	₹
1. Shareholder's funds:			
(c) Share Capital	A	97,650	
(d) Reserve and Surplus	B	-	97,650
2. Non-Current Liabilities			
Long-term Borrowings (secured loans)		10,000	10,000
10% Debentures of Rs. 100 each	G		
3. Current Liabilities			
Trade Payable (Sundry Creditors)		8,000	
Other Current Liabilities			
Employees provident fund		1,500	
Workmen's Profit Sharing		1,000	
4. Suspense Account (Balancing Figure)			
Total Equity and Liabilities			10,500
Assets			**1,18,150**
Non-Current Assets			
(11) Fixed Assets:			
Tangible Assets			
Buildings	I	15,000	
Machinery	K	74,500	
Intangible Asset Goodwill		4,650	
Non-Current investments (assumed)			94,150
(12) Current Assets:			-
e) Inventories	O	11.200	
f) Sundry Debtors	P	10,800	
g) Cash & Cash Equivalents	Q	2,000	
h) Short-Term loans and Advances	R	-	24,000
Total Assets			**1,18,150**

Illustration 2

M Ltd. and N Ltd. agreed to amalgamate on the basis of the following Balance Sheet as on 31.3.2014

Liabilities	***M ₹***	***N ₹***	***Assets***	***M ₹***	***N ₹***
Share capital			Goodwill	30,000	-
₹25 each	75,000	50,000	Fixed assets	31,500	38,800
P & L A/c	7,500	2,500	Stock	15,000	12,000
Creditors	3,500	3,500	Debtors	8,000	5,200
Depreciation fund	-	2,500	Bank	1,500	2,500
	86,000	58,500		86,000	58,500

The assets and liabilities are to be taken over by a new company formed called P Ltd., at book values. P Ltd.'s capital is ₹2,00,000 divided into 10,000 equity shares of ₹10 each and 10,000 9% preference shares of ₹10 each.

P Ltd. issued the equity shares equally to the vendor companies and preference shares were issued for any balance of purchase price.

Pass journal entries in the books of P Ltd. and prepare its Balance Sheet, if the amalgamation is in the nature of purchase.

Particulars		*M Ltd.*		*N Ltd.*	
		₹	₹	₹	₹
	Sundry assets taken over		86,000		58,500
Less:	*Liabilities:*	3,500		3,500	
	Creditors	-	3,500	2,500	
	Depreciation fund				6,000
	Purchase consideration		82,500		52,500
Less:	Equity shares issued				
	Equally 1,00,000/2		50,000		50,000
Value of preference shares issued			32,500		2,500

Books of P Ltd. (Transferee company)
Journal entries

Date	*Particulars*	*L. F.*	*Dr*	*Cr*
			₹	₹
1.4.2013	Business purchase A/c Dr.		1,35,000	
	To Liquidator of M Ltd.			82,500
	To Liquidator of N Ltd.			52,500
	[Being purchase price payable to the vendor companies]			
	Fixed assets A/c Dr.		70,300	
	Stock A/c Dr.		27,000	
	Debtors A/c Dr.		13,200	
	Bank A/c Dr.		4,000	
	Goodwill A/c Dr.		30,000	
	To Creditors A/c			7,000
	To Depreciation A/c			2,500
	To Business purchase A/c			1,35,0 00
	[Being assets and liability taken over from M Ltd. and N Ltd. and goodwill thereon]			
	Liquidator of M Ltd. A/c Dr.		82,500	
	To Equity share capital A/c			
	To 9% preference share capital A/c			50,000
	[Being payment of purchase price]			32,500
	Liquidator of N Ltd. A/c Dr.		52,500	
	To Equity share capital A/c			
	To 9% preference share capital A/c			50,000
	[Being payment of purchase price]			2,500

Balance Sheet of P Ltd.

as on 1st April, 2014 (after amalgamation)

	Note No.	As on 1-4-2014	As on 1-4-2014
Equity and Liabilities		₹	₹
1) Shareholder's funds:			
a. Share Capital			
10,000 equity shares of ₹10 each fully paid	A	1,35,000	
3,500 9% preference shares of ₹ 10 each fully paid			1,35,000
b. Reserve and Surplus	B	-	
2) Non-Current Liabilities			
Long-term Borrowings (secured loans)			
10% Debentures of Rs. 100 each		-	
3) Current Liabilities			
Trade Payable (Sundry Creditors)	G	7,000	
Other Current Liabilities			
4) Suspense Account (Balancing Figure)			7,000
Total Equity and Liabilities			**1,42,000**
Assets			
Non-Current Assets			
Fixed Assets:			
Tangible Assets	I	67,800	
Intangible Asset Goodwill	K	30,000	
Non-Current investments			1.07.800
			-
Current Assets:			
i) Inventories	O	27,000	
j) Sundry Debtors	P	13,200	
k) Cash & Cash Equivalents	Q	4,000	
l) Short-Term loans and Advances	R	-	44,200
			1,42,000
Total Assets			

4.2.6.2 Practical Problems: Absorption

Illustration 3

The following is the Balance-Sheet of Usha Ltd., at 31st March, 2015.

Capital and Liabilities	₹	*Assets*	₹
Share capital:		Land and building	3,75,000
80,000 Shares of ₹ 15 each		Plant and machinery	9,00,000
fully paid	12,00,000	Stock and work-in-progress	3,52,500
5 per cent Debentures		Sundry debtors	3,73,500
7,50,000		Cash	39,000
Accrued interest 37,500		Profit and loss	3,75,000
Sundry creditors	7,87,500		
	4,27,500		
	24,15,000		24,15,000

The debentures are held by *A* Ltd. who also holds 20,000 shares acquired during the past two years at a total cost of ₹ 2,17,500.

Negotiations between Usha Ltd. and *A* Ltd. resulted in an agreement for the absorption of Usha Ltd. by *A* Ltd. on the following terms:

(i) That *A* Ltd. takes over the assets and liabilities of Usha Ltd. as at 31 March, 2015 at their books figures, subject to the revaluation of the plant and machinery at ₹6,75,000.

(ii) That the amount due in respect of debentures be set off against the purchase consideration and that they be cancelled on the completion of the transaction.

(iii) That the outside shareholders in Usha Ltd. be given ₹ 15 shares issued at par by *A* Ltd. on the basis of such shares being worth ₹ 22.50 each and the shares in Usha Ltd. being worth ₹ 7.50 each. Show journal entries required to close the books of Usha Ltd. and to record the transactions in the books of *A* Ltd. including the transfer required to close the accounts therein relating to the shares and debentures in Usha Ltd.

Solution

Books of Usha Ltd.

Date	*Particulars*	*Dr.₹*	*Cr.₹*
	Realisation account Dr.	20,40,000	
	To Land and building		3,75,000
	To Plant and machinery		9,00,000
	To Stock and W.I.P.		3,52,500
	To Sundry debtors		3,73,500
	To Cash		39,000
	(Being transfer of various assets to realisation account on the sale of business to *A*. Ltd.)		

Date	Particulars	Dr. ₹	Cr. ₹
	5% Debentures A/c Dr. Interest accrued A/c Dr. Sundry creditors Dr. To Realisation A/c (Being transfer of liabilities taken over by *A* Ltd.)	7,50,000 37,500 4,27,500	12,15,000
	A Ltd. Dr. To Realisation A/c (Being purchase price agreed to be paid by *A* Ltd.)	3,00,000	3,00,000
	Shares in *A* Ltd. Dr. To *A* Ltd. (Being receipt of shares in *A* Ltd. in discharge of purchase consideration)	3,00,000	3,00,000
	Share capital Dr. To Shareholders A/c (Being transfer of share capital to shareholders account)	12,00,000	12,00,000
	Shareholders A/c Dr. To Profit and Loss A/c To Realisation A/c (Being transfer of the debit balance in profit and loss account and the loss on realisation to shareholders)	8,00,000	3,75,000 4,25,000
	Shareholders A/c Dr. To Realisation A/c (Being adjustment for shares held by the purchasing company to the extent of the purchase consideration reduced)	1,00,000	1,00,000
	Shareholders Account Dr. To Shares in *A* Ltd. (Being distribution of shares in *A* Ltd. amongst the shareholders)	3,00,000	3,00,000

Books of *A* Ltd

Date	*Particulars*	*Dr. ₹*	*Cr. ₹*
	Business purchase A/c Dr To Liquidator of Usha Ltd. (The price agreed to be paid for the business of Usha Ltd.)	3,00,000	3,00,000

	Land and building Dr. Plant and Machinery Dr. Stock and W.I.P. Dr. Sundry debtors Dr. Cash Dr. To Sundry creditors To Debentures in Usha Ltd. To Interest accrued To Shares in Usha Ltd. To Business purchase A/c To Capital reserve (Various assets and liabilities taken over from Usha Ltd. and the cancellation of accounts relating to debentures and shares in Usha Ltd. previously purchased)	3,75,000 6,75,000 3,52,500 3,73,500 39,000	 4,27,500 7,50,000 37,500 2,17,500 3,00,000 82,500
	Liquidator of Usha Ltd. Dr. To Share capital (The allotment of 20,000 shares of Rs 15 each fully paid in discharge of the purchase consideration)	3,00,000	 3,00,000

Working Notes:

1. *Purchase consideration:*

	₹
Shares in Usha Ltd.	80,000
Less: Held by *A* Ltd.	20,000
Shares held by outside shareholders	60,000

Share exchange ratio is 1 in *A* Ltd. for every 3 shares in Usha Ltd.

Number of shares to be issued by *A* Ltd. = (60,000 / 3) = 20,000

Value of shares 20,000 x ₹15 = 3,00,000 Purchase consideration reduced on account of shareholding by the purchasing company [(20,000 ÷ 3) × 15]

= ₹ 1,00,000

REALISATION ACCOUNT

Particulars	₹	***Particulars***	₹
To Land and building	3,75,000	By 5 per cent debentures	7,50,000
To Plant and machinery	9,00,000	By Interest accrued	37,500
To Stock and W.I.P.	3,52,500	By Sundry creditors	4,27,500
To Sundry debtors	3,73,500	By *A* Ltd.	3,00,000
To Cash	39,000	By Share capital A/c	1,00,000
		By Shareholders A/c (Realisation loss)	4,25,000
	20,40,000		20,40,000

Illustration 4

Following are the balance sheets of Universal Electronics Ltd. and Computex Ltd. as on 31st March, 2012:

Universal Electronics Ltd.
BALANCE SHEET

Particulars	₹	*Particulars*	₹
Share capital:		Fixed assets	15,00,000
20,000 equity shares of ₹ 100 each, fully paid up	20,00,000	Investments	2,50,000
General reserves	15,00,000	Current assets	32,50,000
Current liabilities	15,00,000		
	50,00,000		**50,00,000**

Computex Ltd.
BALANCE SHEET

Particulars	₹	*Particulars*	₹
Share capital:		Goodwill	1,00,000
10,000 Equity shares of ₹ 100		Other fixed assets	3,00,000
each, fully paid up	10,00,000	Current assets	14,00,000
General reserves	5,00,000		
Current liabilities	2,00,000		
Proposed dividend	1,00,000		
	18,00,000		18,00,000

Computex Ltd. is to be absorbed by Universal Electronics Ltd. on the following terms:

(i) Computex Ltd. declares a dividend of 10 per cent before absorption for the payment of which it is to retain sufficient amount of cash.

(ii) The net worth of Computex Ltd. is valued at ₹14,50,000.

(iii) The purchase consideration is satisfied by the allotment of fully-paid shares of ₹ 100 each in Universal Electronics Ltd. Following further information is also to be taken into consideration:

(a) Universal Electronics Ltd. holds 2,500 shares in Computex Ltd. at a cost of ₹ 2,00,000.

(b) The stocks of Computex Ltd. include items valued at ₹50,000 from Universal Electronic Ltd. (Cost to Universal Electronics Ltd. ₹ 37,500).

(c) The creditors of Computex Ltd. include ₹ 15,000 due to Universal Electronics Ltd.

Show ledger accounts in the books of Computex Ltd. to give effect to the above and balance sheet of Universal Electronics Ltd. after absorption.

Solution

Computation of Purchase Consideration:

	₹
Net Worth of Computex Ltd.	14,50,000
Less: 1/4 (for 2,500 shares) for shares held by Universal Electronics Ltd.	3,62,500
Purchase Consideration	10,87,500

Books of Computex Ltd.

REALISATION ACCOUNT

Particulars	₹	*Particulars*	₹
To Goodwill To Fixed assets To Current assets (14,00,000-1,00,000)	1,00,000 3,00,000 13,00,000	By Current liabilities By Univ. electronics Ltd. By Share capital A/c By Equity shareholders (loss) A/c	2,00,000 10,87,500 3,62,500 50,000
	17,00,000		**17,00,000**

UNIVERSAL ELECTRONICS LTD.

Particulars	₹	*Particulars*	₹
To Realisation A/c (purchase consideration)	10,87,500	By Shares in Universal	10,87,500
	10,87,500		**10,87,500**

PROPOSED DIVIDEND ACCOUNT

Particulars	₹	*Particulars*	₹
To Dividend payable A/c	1,00,000	By Balance B/d	1,00,000
	10,87,500		**10,87,500**

DIVIDEND PAYABLE ACCOUNT

Particulars	₹	*Particulars*	₹
To Bank A/c	**1,00,000**	By Proposed dividend A/c	**1,00,000**

SHARES IN UNIVERSAL ELECTRONICS LTD

Particulars	₹	*Particulars*	₹
To Universal Electronics Ltd.	**10,87,500**	By Eq. shareholders (outsiders) A/c	**10,87,500**

EQUITY SHARE CAPITAL ACCOUNT

Particulars	₹	*Particulars*	₹
To Equity shareholders A/c	**10,00,000**	By Balance b/d	**10,00,000**

EQUITY SHAREHOLDERS ACCOUNT

Particulars	₹	*Particulars*	₹
To Realisation A/c To Realisation A/c To Shares in Universal Electronics Ltd.	50,000 3,62,500 10,87,500	By Share capital By General reserve	10,00,000 5,00,000
	15,00,000		**15,00,000**

Balance Sheet of Universal Electronics Limited (After Absorption)
as on 31st March 2012

	Note No.	*As on 31-1-2012*	*As on 31-1-2012*
Equity and Liabilities		₹	₹
1) Shareholder's funds:			
a. Share Capital			
30,875 shares of Rs 100 each paid (out of these 10,875 shares issued to vendors)	A	-	30,87,500
b. Reserve and Surplus			
General Reserve	B	15,00,000	
Capital Reserve		1,00,000	
Profit and Loss account		25,000	15,25,000
2) Non-Current Liabilities	G	-	
3) Current Liabilities			
Trade Payable (Sundry Creditors)			
Other Current Liabilities			
4) Suspense Account (Balancing Figure)			
Total Equity and Liabilities			16,85,000 -
Assets			**63,97,500**
Non-Current Assets			
Fixed Assets:	I		
Tangible Assets	K		18,00,000
Intangible Asset Goodwill			
Non-Current investments (assumed)			50,000
Current Assets:		45,47,500	45,47,500
Total Assets			**63,97,500**

Working Notes:

(i) *Computation of capital reserve:*

Particulars	₹	₹
Fixed assets		3,00,000
Current assets	13,00,000	
Less: Reserve for unrealised profit	12,500	12,87,500
		15,87,500
Less: Investment in Computex Ltd.	2,00,000	
Current liabilities	2,00,000	
Net purchase consideration	10,87,500	14,87,500
Capital reserve		1,00,000

(ii) *Current Assets of Universal Electronics Ltd.*

Current assets		32,50,000

Add: Dividend received form Computex Ltd.	25,000
	32,75,000
Less: Inter-company Owings	15,000
	32,60,000

(iii) Current Assets of Computex Ltd.

Current assets Rs (14,00,000 -1,00,000)	13,00,000
Less: Reserve for unrealised profit	12,500
	12,87,500

Illustration 5

Big Ltd. agreed to acquire the assets of Small Ltd. except its investments, as on March 31, 2012.

Balance Sheet of Small Ltd. as on March 31, 2012.

Liabilities	₹	*Assets*	₹
Share capital (Rs. 10 each)	1,60,000	Goodwill	50,000
Reserves	43,000	Land & Buildings	80,000
8% Debentures	60,000	Plant	80,000
Provision for taxation	20,000	Investments	30,000
Creditors	37,000	Stocks	40,000
		Debtors	20,000
		Bank	20,000
	3,20,000		3,20,000

Big Ltd. will:

(a) Discharge the debentures at 8% premium by issue of 7% debentures in Big Ltd. at 10% Discount.

(b) Issue of 3 shares of Big Ltd. at a valuation of ₹ 11 for every two shares in Small Ltd.

(c) Pay ₹. 2 in cash for each share of Small Ltd. and

(d) Pay absorption expenses of ₹ 3,000

Small Ltd. sells its investments for Rs. 32,000. 1/3 of the shares received from Big Ltd. are sold at ₹ 10.50 each. Tax liability was determined at ₹24,000. Before the absorption, small Ltd. declares and pays 10% dividend to its shareholders.

You are required to give the required ledger accounts in the books of the vendor company.

Solution:

Ledger

Realisation A/c

	₹		₹
To Sundry Assets	3,04,000	By Bank (investments)	32,000
To Tax liability (24,000 – 20,000)	4,000	By Big Ltd.	2,96,000
To Shares in Big Ltd. (loss)	4,000	By 8% Debentures	60,000
To Shareholders A/c (profit)	76,000		
	3,88,000		3,88,000

Shares in Big Ltd. A/c

	₹		₹
To Big Ltd.	2,64,000	By Bank (sale)	84,000
		By Realisation (loss)	4,000
		By Shareholders	1,76,000
	2,64,000		2,64,000

Big Ltd. A/c

	₹		₹.
To Realisation	2,96,000	By Bank	32,000
To Bank (Expenses)	3,000	By Shares in Big Ltd.	2,64,000
		By Bank (For Expenses)	3,000
	2,99,000		2,99,000

Bank A/c

	₹		₹
To Balance b/d	20,000	By dividend A/c	16,000
		By Realisation (transfer)	4,000
	20,000		20,000
To Big Ltd.	32,000	By Big Ltd. (Expenses)	3,000
To Realisation (Investments)	32,000	By Tax liability	24,000
To Shares in Big Ltd.	84,000	By Creditors	37,000
To Big Ltd. (Expenses)	3,000	By Shareholders	87,000
	1,51,000		1,51,000

Shareholders A/c

	₹		₹
To Bank A/c	87,000	By Share Capital A/c	1,60,000
To Shares in Big Ltd.	1,76,000	By Reserves (43,000 – 16,000)	27,000
		By Realisation A/c	76,000
	2,63,000		2,63,000

Illustration 6

Follow are the Balance-Sheets of *P* Co. Ltd. and V Co. Ltd as on 31st March 2014:

***P* Co.Ltd.**BALANCE SHEET

Liabilities	₹	***Assets***	₹
Share Capital:		Fixed assets	2,00,000
10,000 shares of ₹ 10 each	1,00,000	Current assets	1,00,000
General reserve	1,00,000		
Creditors	50,000		
Debentures	50,000		
	3,00,000		3,00,000

V Co. Ltd. BALANCE SHEET			
Liabilities	₹	*Assets*	₹
Share Capital: 5,000 shares of ₹10 each General reserve Creditors	50,000 30,000 20,000	Shares in PCo. 2,000 shares Fixed assets Current assets	30,000 50,000 20,000
	1,00,000		1,00,00

P Co. takes over V Co. The purchase consideration is to be satisfied in the form of equity shares of *P* Co. issued on the basis of intrinsic values of shares of companies. Pass the jounal entries in both the company's books.

Solution

Intrinsic Value o/P Co. s shares:	₹
Assets (Fixed Assets + Current Assets)	3,00,000
Less: Liabilities (Creditors + Debentures)	1,00,000
Net assets	2,00,000
No. of shares	
Intrinsic value of a share 2,00,000 + 10,000 = ₹20.	10,000
Intrinsic value VCo. s shares:	
Fixed assets	50,000
Current assets	20,000
Shares in P Co. Ltd.	40,000
	1,10,000
Less: Liabilities Net assets	20,000
Value of a share = 90,000 + 5,000 = ₹18	
Purchase Consideration:	
Net assets of *V* Co.	
Value of a share of P Co.	90,000
No. of shares to be issued by P Co. to *V* Co.	20
	4,500

However, *V* Co. holds 2,000 shares in *P* Co. *V* Co. will be allowed to keep these shares since To. cannot purchase its own shares. Hence the number of shares to be issued by *P* Co. to *V*Co. for mg over business will be (4,500 - 2,000) = 2,500.

Purchase consideration = 2,500 x 20 = Rs 50,000.

Books of VCo.

JOURNAL ENTRIES

	Particulars		*Dr.* ₹	*Cr.* ₹
	RealisationA/c To Fixed assets To Current assets (Transfer of assets)	Dr.	70,000	 50,000 20,000

Creditors A/c Dr. To Realisation (Transfer of liabilities)		20,000	20,000
PCo. Dr. To Realisation (Purchase consideration due)		50,000	50,000
Shares in P Co. Dr. To PCo. (Receipt of purchase consideration)		50,000	50,000
Shares in P Co. Dr. To Realisation A/c (Revaluation of shares, already held by VCo. in PCo.)		10,000	10,000
Share capital A/c Dr. General reserve A/c Dr. To Shareholders A/c (Transfer of share capital and reserve to shareholders A/c)		50,000 30,000	80,000
Realisation A/c Dr. To Shareholders A/c (Profit on realisation)		10,000	10,000
Shareholders A/c Dr. To Shares in PCo. (Payment to shareholders)		90,000	90,000

REALISATION ACCOUNT

Particulars	₹	*Particulars*	₹
To Fixed assets	50,000	By Creditors	20,000
To Current assets	20,000	By P Co.	50,000
To Shareholders (Profit)	10,000	By Shares held by PCo.	10,000
	80,000		80,000

SHAREHOLDERS ACCOUNT

Particulars	₹	*Particulars*	₹
		By Share capital	50,000
To Shares in PCo.	90,000	By General reserve	30,000
		By Realisation A/c (profit)	10,000
	90,000		**90,000**

SHARES IN *P* CO.

Particulars	₹	*Particulars*	₹
To Balance b/d	30,000		90,000
To PCo.	50,000	By Shareholders A/c	
To Realisation A/c	10,000		
	90,000		**90,000**

Books of *P* Co.
JOURNAL ENTRIES

	Particulars	*Dr.* ₹	*Cr.*₹
	Business purchases A/c Dr. To Liquidator of VCo. (For purchase consideration due)	50,000	 50,000
	Fixed assets Dr. Current assets Dr. To Creditors A/c To Business purchase A/c (Taking over of assets and liabilities)	50,000 20,000	 20,000 50,000
	Liquidator of *V* Co. Dr. To Share capital To Securities premium (Payment of purchase consideration)	50,000	 25,000 25,000

4.2.6.3 Practical Problem: External Reconstruction

Illustration 7

On 31st March 2012, the following was theBalance Sheet of Moon Ltd:

Liabilities	₹	Assets	₹
1,20,000 Equity Shares of ₹ 10 each Capital Reserve Loan Sundry Creditors	12,00,000 20,000 3,60,000 3,00,000	Plant and Machinery Furniture & FixturesStock Sundry Debtors Cash at Bank Profit & Loss Account	9,00,000 1,50,000 4,00,000 2,20,000 1,00,000 1,10,000
	18,80,000		18,80,000

The new company Suraj Ltd. was incorporated which took over fixed assets and stock of Moon Ltd. for ₹. 12,60,000 payable as to ₹.9,00,000 in the form of 1,80,000 equity shares of Rs.5 each and ₹3,60,000 in the form of 3,600 12% Mortgage debentures of ₹100 each. Loan creditor accepted the debentures in Suraj Ltd. in discharge of the loan. Sundry debtors realised ₹2,05,000. Expenses of liquidation amounted to ₹8,000 and were met by Moon Ltd. The available cash was distributed among sundry creditors in full satisfaction of their claim.Close the books of Moon Ltd. and draw the initial Balance Sheet of Suraj Ltd.

Solution:

Calculation of Purchase Consideration:

Equity Share Capital:	1,80,000 x 5	=₹9,00,000.
12% Debentures :	3,600 x 100	=₹3,60,000
Total		=₹12,60,000

Books of Moon Ltd.
Realisation Account

Date	Particulars	₹	Date	Particulars	₹
	To Plant & Machinery	9,00,000		By Suraj Ltd.	12,60,000
	To Furniture & Fixtures	1,50,000		By Bank A/c (Debtors)	2,05,000
	To Stock	4,00,000		By Creditors A/c (Profit)	3,000
	To Sundry Debtors	2,20,000		By Equity Shareholders	
	To Bank A/c (Expenses)	8,000		A/c (Loss) (Bal. Fig.)	2,10,000
		16,78,000			16,78,000

Suraj Ltd

Date	Particulars	₹	Date	Particulars	₹
	To Realisation A/c	12,60,000		By Shares in Suraj Ltd.	9,00,000
	(Purchase Consideration)			(1,80,000 x 5)	3,60,000
				By Debentures in Suraj Ltd.	
		12,60,000			12,60,000

Bank Account

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	1,00,000		By Realisation A/c	8,000
	To Realisation A/c	2,05,000		By Creditors A/c (Bal.	2,97,000
		3,05,000		Fig.)	3,05,000

Sundry Creditors Account

Date	Particulars	₹	Date	Particulars	₹
	To Bank	2,97,000		By Balance b/d	3,00,000
	To Realisation A/c	3,000			
	(Bal. Fig.)	3,00,000			3,00,000

Equity Shareholders Account

Date	Particulars	₹	Date	Particulars	₹
	To P & L A/c (Loss)	1,10,000		By Equity Share	
	To Realisation A/c (Loss)	2,10,000		Capital A/c	12,00,000
	To Shares of Suraj Ltd.	9,00,000		By Capital Reserve A/c	20,000
	(Purchase consideration)				
		12,20,000			12,20,000

Balance Sheet of Suraj Ltd
as on 31st March 2012

	Note No.	*As on 31-1-2012*	*As on 31-1-2012*
Equity and Liabilities		₹	₹
1) Shareholder's funds:			
a. Share Capital	A		9,00,000
1,80,000 equity shares of ₹5 each partly paid			1,90,000
b. Reserve and Surplus	B	-	
2) Non-Current Liabilities			3,60,000
Long-term Borrowings (secured loans)		-	
10% Debentures of Rs. 100 each			
3) Current Liabilities	G		
Trade Payable (Sundry Creditors)			
Other Current Liabilities			
4) Suspense Account (Balancing Figure)			
Total Equity and Liabilities			14,50,000
Assets			
Non-Current Assets			
(5) Fixed Assets:			10,50,000
Tangible Assets	I		-
Intangible Asset Goodwill	K		-
Non-Current investments (assumed)		.	
(6) Current Assets:			
a. Inventories	O	4,00,000	
b. Sundry Debtors	P	-	
c. Cash & Cash Equivalents	Q	-	
d. Short-Term loans and Advances	R	-	4,00,000
Total Assets			**14,50,000**

4.2.7 Self Test Question
Theory

1. Define the term "Amalgamation". What are the objects for amalgamation of business houses?

2. Explain the difference between amalgamation and absorption of companies.

3. How to calculate the purchases consideration?

4. What do you mean by Internal and External Reconstruction?

Problems

1. The following are the summarized balance sheet of Amar Ltd and Samar Ltd as on 31st March 2014.

Liabilities	Amar Ltd ₹	Samar Ltd ₹	Assets	Amar Ltd ₹	Samar Ltd ₹
Issued Share capital:			Goodwill	---	1,20,000
Shares of Rs. 10 each	8,00,000	6,00,000	Fixed assets	6,00,000	2,40,000
Profit and loss a/c	1,40,000	---	Current assets	4,20,000	2,80,000
Creditors	80,000	2,40,000	Profit and loss a/c	---	2,00,000
	10,20,000	8,40,000		10,20,000	8,40,000

Amar Ltd. agreed to take over the business of Samar Ltd. as on the date of balance sheets. After due negotiations, it was determined that the shares of Amar Ltd are worth ₹ 12 each and the shares of Samar Ltd. are worth ₹5 each.

You are required to make the necessary entries in the books of Amar Ltd and draw up its balance sheet immediately after the takeover.

2. The following is the balance sheet of XYZ Ltd. on 31st March 2014.

Liabilities	₹	*Assets*	₹
20,000 shares of ₹10 each	2,00,000	Land & Building	1,00,000
Debentures	1,00,000	Plant & Machinery	1,50,000
Sundry Creditors	30,000	Work in progress	30,000
Reserve fund	25,000	Stock	60,000
Dividend equalization fund	20,000	Furniture and Fittings	2,500
Profit & loss app. a/c	5,100	Sundry debtors	25,000
		Cash at Bank	12,500
		Cash in hand	100
	3,80,100		3,80,100

The company is absorbed by ABC company Ltd; on the above date. The consideration for the absorption is the discharge of debentures at a premium of 5% taking over the liability in respect of the sundry creditors and payment of ₹7 in cash and one share of ₹5 in ABC co, Ltd. at the market value of ₹ 8 per share in exchange for one share in XYZ Co. Ltd. the cost of liquidation of ₹ 5,000is to be met by the purchasing company.Pass journal entries in the books of both the companies. Show how the purchase price is arrived at.

3. The following are the balance sheets of Star Ltd. and Shine Ltd. as on 31st March 2013.

Liabilities	Star Ltd ₹	Shine Ltd ₹	Assets	Star Ltd ₹	Shine Ltd ₹
Share Capital:			Building	5,00,000	2,50,000
Shares of ₹ 10 each	7,50,000	6,00,000	Machinery	2,00,000	1,25,000
			Stock	2,00,000	2,35,000
General Reserves	4,75,000	50,000	Sundry debtors	1,60,000	2,50,000
12% Debentures	--	1,00,000	Bank	4,00,000	50,000
Creditors	1,50,000	1,00,000			
Bills Payable	85,000	60,000			
	14,60,000	9,10,000		14,60,000	9,10,000

Star Ltd. agreed to absorb Shine Ltd. as on 31st March 2013as per the following terms:

(i) Star Ltd. shall take over all the assets and liabilities of Shine Ltd.(including debentures). In addition it shall pay ₹ 2,50,000 for Goodwill.

(ii) Building of Star Ltd are to be shown at ₹ 7,75,000. Absorption expenses of ₹ 15,000 are to be met by Star Ltd.

(iii) Shares of both the companies are to be valued on net assets basis and the ratio of exchange of shares has to be determined on that basis.

You are required to give journal entries and balance sheet after the absorption in the books of Star Ltd.

4. Balance sheet of B Co. Ltd. as on 31st March 2013 is as follows:

Liabilities	₹	*Assets*	₹
Share Capital		Fixed assets	83,00,000
50,000 shares of ₹100 each	50,00,000	Current assets	69,00,000
Capital reserves	10,00,000	Investments	17,00,000
General reserves	36,00,000	Goodwill	2,00,000
Unsecured loans	22,00,000		
Sundry creditors	42,00,000		
Provision for taxation	11,00,000		
	1,71,00,000		1,71,00,000

B. Co. Ltd. is amalgamated with Bee Sons Ltd. as on March 31, 2013 on which date the balance sheet of Bee Sons Ltd, is as follows:

Liabilities	₹	*Assets*	₹
Share Capital:		Fixed assets	1,60,00,000
8,00,000 shares of ₹10 each	80,00,000	Current assets	1,68,00,000
General reserves			
Secured loans	1,00,00,000		
Sundry creditors	40,00,000		
Provision for tax	46,00,000		
Provision for dividend	52,00,000		
	10,00,000		
	3,28,00,000		3,28,00,000

For the purpose of amalgamation the goodwill of B.Co.Ltd.is considered value less. There are also arrears of depreciation in B Co. Ltd. amounting to ₹.4, 00,000.the shareholders in B Co. Ltd. are allotted in full satisfaction of their claims, shares in Bee Sons' Ltd. in the same proportion that the respective intrinsic values of the shares of the companies bear to each other.Pass journal entries in the books of both companies to give effect to the above.

5. The following is the balance sheet of Ram Limited on 30.03.2012

Liabilities	₹	Assets	₹
Equity share capital			
₹10each	1,50,000	Good will	20,000
6%cumulative per shares		Plant	1,50,000
₹10 each	1,00,000	Stock	80,000
5% debentures	50,000	Debtors	1,20,000
Employees profit sharing A/c	14,000	Cash at bank	8,800
Bank overdraft	20,000	P&L Account	40,200
Creditors	91,500	Preliminary expenses	5,000
Interest on debenture due	2,500	Commission on issue of	
Contingent liabilities:		shares	4,000
Arrears of preference			
Dividend ₹ 12, 000	---		
	4,28,000		4,28,000

Raj Ltd. agreed to absorb Ram Ltd. from 1.3.12 on the following items:

a) Raj Ltd. is to take over all tangible assets except cash
b) It is to pay the debenture holders at a premium of 10% by issue of its 6% preference shares of ₹10each.
c) It is to issue one equity share of ₹10 each and make a payment of ₹4 in cash in exchange of every two equity shares in Ram Ltd.
d) Creditors will receive 90% of the sums due to them in fully paid equity shares of ₹10 each in Raj Ltd. in full settlement of their claims.
e) Preference shareholders will be issued 5% debentures in Raj Ltd.

Prepare the necessary ledger accounts to close the books of Ram Ltd.

6. Black Limited and White Limited propose to amalgamate. Their balance sheets as on 31st March, 2012 were: *(in ₹.)*

Liabilities	***Black Ltd.***	***White Ltd.***	***Assets***	***Black Ltd.***	***White Ltd.***
Equity shares of ₹ 10 each	4,00,000	1,50,000	Fixed assets (*Less* Depreciation)	3,30,000	1,00,000
General reserve	1,80,000	15,000	Investments(face value ₹ 80,000)3% Tax Free G.P. Notes	72,000	
Profit and loss A/c	60,000	23,000	Stocks	1,60,000	40,500
Creditors	1,04,500	24,000	Debtors	93,500	50,000
			Cash and Bank balance	89,000	22,000
	7,44,500	**2,12,500**		**7,44,500**	**2,12,500**

Particulars	Black Ltd. ₹	White Ltd. ₹
Net Earnings (after taxation):		
Year ended 31 March, 2010	1,23,000	41,500
Year ended 31 March, 2011	1,09,500	31,400
Year ended 31 March, 2012	99,000	27,000

Goodwill may be taken at 4 years' purchase of average super profits from trading on the basis of 10% normal trading profit on closing capital invested. Bright Limited is formed for the purpose of amalgamation of both companies. Advice upon capitalization of Bright Ltd. and suggest a scheme of exchange of shares for that purpose (Consider only break-up value). Draft the Balance Sheet of Bright Limited.

7. A Co Ltd. sells its business to B Co.Ltd. as on 31st March 2012 on which date its Balance Sheet was as under:-

	₹		₹
Share Capital:		Building	2,00,000
40,000 Shares of ₹100 each	4,00,000	Machinery	2,63,000
General Reserve	80,000	Furniture and Fittings	70,000
Profit and loss Account	28,000	Stock	85,500
10% Debentures	2,00,000	Trade Debtors	37,500
Trade Creditors	42,000	Cash at Bank	86,000
		Underwriting Commission	8,000
	7,50,000		7,50,000

B Co. Ltd. agreed to take over the assets except cash at bank at book values, except that furniture and fittings were valued at ₹56,000 and to take over trade creditors. The Consideration was discharged by the allotment at par of 40,000 fully paid equity shares of ₹10each B.Ltd. Converted 10% debentures into 2,000 fully paid 12%debentures of ₹.100 each allotted at par. A Co. Ltd. met the expenses of liquidation totaling ₹6,000. Prepare accounts in A Co. Ltd's ledger.

Lesson 4.3 Liquidation of Companies

Learning Objectives:

After reading this lesson you should be able to

- know the difference between reconstruction, amalgamation and absorption of companies
- understand the different methods of computation of purchase consideration
- make appropriate accounting entries in the books of the vendor company and the purchasing company

4.3.1 Introduction

The word 'Liquidation' has not been used anywhere in the Companies Act, 1956. It is the word 'winding up' which has been used in this Act. By winding up of a Company, we mean, "Winding up of a Company is the process whereby its life is ended and its property is administered for the benefit of its creditors and members. And an administrator, called a Liquidator, is appointed and he takes control of the Company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights."

A Company is an artificial person. It is created by law. Therefore, the law alone can dissolve it. On dissolution, Company's name is struck off from the Register of Companies (maintained by Registrar of Companies). This fact may also be published in the official gazette. Liquidation of a Company, which is also called winding tip of a Company, may be defined as the process through which the affairs of the Company are stopped for the purpose of liquidation, for which an officer, called liquidator, is appointed to take charge of the assets and liabilities of the Company. His duties are to realise the assets, discharge the liabilities and distribute the surplus, if any, to the members of the Company.

4.3.2 Liquidation and Insolvency

Liquidation is different from insolvency. Liquidation resembles insolvency in the respect that in both cases the assets are realised, proceeds applied to discharge the liabilities and surplus, if any, is distributed to members - proprietors or partners. Their term 'insolvency' is applicable to individuals, partnerships and Hindu Undivided Family whereas the term 'liquidation* is appropriate to a Joint Stock Company. A person is said to be an insolvent when his liabilities exceed his assets or has committed an act of

insolvency, and against whom an order of adjudication is passed by a competent court. It is not necessary that a Company should be liquidated although it may be in insolvent circumstances and further it may sometimes become necessary to liquidate even a solvent Company. Insolvency of a person is governed by the Insolvency Act whereas liquidation of a Company is governed by the Companies Act. Proceedings under the Insolvency Acts are known as insolvency proceedings, whereas proceedings for the winding up of a Company are known as liquidation proceedings. An Official Receiver or Official Assignee is appointed in case of insolvency and Liquidator is appointed in case of liquidation. An order of discharge entitles the person, who was declared insolvent, to start a business afresh. In case of Companies, there is no question of starting the business by the same Company as the liquidation puts as end to the Company once and for all.

4.3.3 Modes of Winding Up

The modes of winding up may be discussed under the following three heads, namely:

1. Compulsory winding up by the court.
2. Voluntary winding up without the intervention of the court.
3. Voluntary winding up with the intervention of the court i.e., under the supervision of the court.

4.3.3.1. Compulsory Winding up by the Court

Winding up of a Company by an order of the court is called the compulsory winding up. Section 433 of the Companies Act lays down the circumstances under which a Company may be compulsorily wound up. They are:

(a) If the Company has by special resolution, resolved that the Company may be wound up by the court.

(b) If default is made in delivering the statutory report to the Registrar or in holding the statutory meeting.

(c) If the Company does not commence its business within a year from its incorporation or suspends it for a whole year.

(d) If the number of members is reduced, in the case of a public Company below seven, and in the case of a private company below two.

(e) If the Company is unable to pay its debts.

(f) If the court is of the opinion that it is just and equitable mat the company should be wound up.

Persons Entitled to Apply for Liquidation

The Petition for winding up of a Company may be presented by any of the following persons (Sec. 439).

(1) The Company.

(2) The creditors which include contingent creditors, prospective creditors, secured creditors, debentureholders, or a trustee for debentureholders.

(3) The contributories - comprise present and past shareholders of a Company (Sees. 426 and 428).

(4) The Registrar.

(5) Any person authorized by the Central Government on the basis of report of inspectors.

4.3.3.2 Voluntary Winding up

A voluntary winding up occurs without the intervention of the court. Here the Company and its creditors mutually settle their affairs without going to the court. This mode of winding up takes place on:

(a) The expiry of the prefixed duration of the Company, or the occurrence of event whereby the Company is to be dissolved, and adoption by the Company in general meeting of an ordinary resolution to wind up voluntarily; or (b) The passing of a special resolution by the Company to wind up voluntarily.

Section 488 provides for two types of voluntary winding up; (a) Members voluntary winding up and (b) Creditor's voluntary winding up.

(a) Member's Voluntary Winding up

This type of winding up occurs only when the Company is solvent. It requires a declaration of the Company's solvency at the meeting of Board of Directors. The declaration must specify the director's opinion that the Company has no debt or it will be able to pay its debts in full within appoint a liquidator and fix his remuneration. With his appointment, all the powers of the Board and the managing director or manager cease unless the company in general meeting sanctions otherwise. The liquidator must annually call a general meeting to lay before it an account of his dealings and the conduct of the winding up. When the company's affairs are fully wound up, he must (a) prepare an Account - Liquidator's Final Statement of Account - to show the disposition and disbursement of the company's property; (b) Call a final meeting of the company of

laying the final account before it, and (c) send a copy of the account and a return of the meeting to the* Registrar of Companies. The company thereafter dissolves.

(b) Creditor's Voluntary Winding up

It occurs in the absence of declaration of solvency i.e., when the company is insolvent. Hence, the Act empowers the creditors of dominate over the members in this mode of winding up so as to effectively protect their interest. It requires the company to hold the creditors' meeting wherein the Board must make a full statement of the company's affairs together with a detailed list of creditors including their estimated claims. Both the members and creditors at their respective meeting nominate a liquidator and on their disagreement, the creditor's nominee is appointed as the liquidator. All the powers of the Board then cease unless the creditor's meeting sanctions otherwise. The liquidator must annually call here not only the members* meeting but also the creditors' meeting to lay an account of his dealings and the conduct of the winding up. So also, he must call a final general meeting of the members and creditors for the company's dissolution as in the case of member's winding up.

4.3.3 3 Winding up Subject to Supervision of the Court

Winding up with the intervention of the court is ordered where the voluntary winding up has already commenced. As a matter of fact, it is the voluntary winding up but under the supervision of the court. A court may approve a resolution passed by the Company for voluntary winding up but the winding up should continue under the supervision of the court. The court will issue such an order only under the following circumstances:

(a) If the resolution for winding up was obtained by fraud by the company; or

(b) If the rules pertaining to winding up are not being properly **adhered** to; or

(c) If the liquidator is found to be prejudicial or is negligent in releasing the assets of the company.

The Court may exercise the same powers as it has in the case of compulsory winding up

4.3.4 Consequences of Winding Up

The consequences of winding up may be discussed under the following heads:

1. An official designated as liquidator will take over the administration of the Company. In case of compulsory winding up, the official liquidator, attached to the" High Court, functions as liquidator of the Company. In case of voluntary winding up,

such an official is appointed by the members or the creditors depending upon members, or creditor's voluntary winding up.

2. The powers of the Board of Directors will terminate and will now vest in the liquidator.
3. No suit or other legal proceedings can be proceeded with against the Company except with permission of the court.
4. The order for winding up has the effect of a notice of discharge to the employees of the company, except where the business of the company is continued by the order of the court.
5. A shareholder is liable to pay the full amount upto the face value of the shares held by him. Not only the present members but past member are also liable in the event of winding up of the company. The liabilities of present member in the amount remaining unpaid on the shares held by him while a past member can be called upon to pay if the contributions made by the present members are not adequate.
6. A Company, whether solvent or insolvent, can be wound up under the Act. In case of solvent company, all claims of its creditors when proved are fully met. In case of insolvent company, the rules under the Law of Insolvency shall apply.

4.3.4.1 Order of Payment

The following amounts are realised by the liquidator: (a) From the Debtors of the Company, (b) From sale proceeds of the assets of the Company, (c) The surplus amount from fully secured creditors and (d) By making calls for the amount remaining unpaid on the shares.

Payments are made by liquidator in the following order:

1. **Secured Creditors:** They need not prove their claims against the Company. They may realise their securities and satisfy the debts. They may put up their claim before the liquidator for deficiency, if any. If the secured creditors feel that their securities may not realise a sufficient amount, they may relinquish the securities held by them and prove their whole debt before the liquidator.
2. **Legal expenses:** AH legal expenses are met out of the cash realised.
3. **Remuneration of the Liquidator:** Generally the liquidator gets his remuneration in the form of commission. This is based on the assets realised. Cash and Bank balance

is not included unless its inclusion is specifically mentioned. Surplus of secured creditors is mostly included in the amount of assets realised for calculation of liquidator's commission' When instruction for including full amount of security belongs to fully secured creditors is given, then full amount is included in the amount of total assets realised for calculation of commission. When the liquidator is given remuneration on the amount distributed to unsecured creditors also in addition to his remuneration on the amount of the assets, the following points may be noted in this connection:

(a) If sufficient amount is available to pay all the creditors then the amount of remuneration will be:

$$\frac{\text{Amount of unsecured creditors} \times \text{Percentage of Commission}}{100}$$

(b) If the available amount is not sufficient to pay all the creditors then the amount of remuneration will be:

$$\frac{\text{Amount of unsecured creditors} * \text{Percentage of Commission}}{100 + \text{Percentage of Commission}}$$

4. Expenses and cost of winding up.
5. Payment to preferential creditors.
6. Payment to debenture holders and creditors who have floating charge on the assets of the Company.
7. Payment to unsecured or ordinary creditors.
8. Payment to members or contributories.

Regarding members, if any of them has paid in excess of the amount of call made on him, that will be returned to him first and then the preference shareholders are given and thereafter, if any, surplus is left, that will be distributed among the equity shareholders. Any surplus still left, llio go to the Equity shareholders unless the preference shares an w n as per the terms of the issue.

4.3.4.2 Preferential Creditors (Sec. 530)

In every mode, of winding up, the following debts are paid in priority to all other debts (including debentures under any floating change where the company's assets available for payments of general creditors are insufficient) after the retention of the sums necessary for the Is and expenses of winding up, and will rank equally among

themselves and be paid in full unless the assets are inadequate in which case they shall abate in equal proportions.

(1) All revenues, taxes, cesses and rates due from the Company to the Government or to a al authority which have become due and payable within 12 months before, the date of the appointment of provisional liquidator, or otherwise the date of winding up order in case of compulsory winding up and the date of passing of the resolution for winding up in the case of voluntary winding up.

(2) AU wages or salaries (including earned by way of commission) of an employee in respect services rendered to the company and due for a period not exceeding four months within the 12 months before the relevant date and any compensation payable to any workman under the industrial Disputes Act, 1947 not exceeding in all Rs 1,000 of each claimant.

(3) A11 accrued holiday remuneration becoming payable to any employee (or in case of his death, to any other in his right) on the termination of his employment before or by the winding up order or resolution.

(4) Unless the company is being wound up voluntarily for reconstruction or amalgamation, II amounts due, in respect of contributions, payable during the 12 months before the relevant date, the company under the Employees State Insurance Act, 1948 or any other law.

(5) Unless the company is being wound up voluntarily for reconstruction or amalgamation, where it has taken out a workman's compensation insurance policy, all compensation due under he Workmen's Compensation Act 1923.

(6) A11 sums due to an employee from a provident fund, pension, gratuity or any other welfare fund maintained by the company.

(7) The expenses of any investigation held in pursuance of Section 235 or 237, in so far as they are payable by the Company.

Where a person advances money for the payment of employee's wages or salary and holiday remuneration stated above under (2) and (3) he will be treated as a preferential creditor.

4.3.4.3 Statement of Affairs to be made to Official Liquidator

As per Section 454 of the Companies Act, the Officers or Directors of the Company under winding up order, must make out and submit, within 21 days of the

court's order, or within such extended time, not exceeding three months time, as the liquidator or court may allow, a statement containing the following particulars.

(a) The assets of the company, stating separately the cash balance in hand and at the bank, if any, and negotiable securities, if any, held by the company.

(b) Its debts and liabilities.

(c) The names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts; and in the case of secured debts, particulars of the securities given, whether by the company or an officer thereof, their value and the dates on which they were given.

(d) The debts due to the company and the names, residences and occupations of the persons from whom they are due and die amount likely to be realised on account thereof.

(e) Such further or other information as may be prescribed or as the official liquidator may require.

The statement must be in the prescribed form and properly verified by an affidavit. It should be open for inspection by a creditor, or contributory of the company, on payment of a prescribed fee. The concerned creditor or contributory can also have an extract from it. The form prescribed by the Supreme Court in this regard is FORM No. 57 (See Rule 127).

4.3.4.3.1 STATEMENT OF AFFAIRS AND LISTS TO BE ANNEXED

Statement as to the affairs of .... Ltd. on the .... day of .. . . being the date of the winding up order (or order appointing Provisional Liquidator or the date direct by the Official Liquidator, as the case may be) showing assets at estimated realisable values and liabilities expected to rank.

	Assets not specifically pledged (as per List 'A')	Estimated realizable values ₹
	Balance at Bank Cash in hand Marketable securities	

Bills Receivable

Trade Debtors

Loans and advances

Unpaid Calls

Stock-in-trade

Work in Progress

Freehold Property, Land and Buildings

Leasehold Property

Plant and Machinery

Furniture, Fittings, Utensil etc.

Investments other than marketable securities

Livestock

Other property, viz.

	(a)	**(b)**	**(c)**	**(d)**
Assets specifically pledged (as per list 'B')	Estimated realisable values	Due to secured creditors	Deficiency ranking as unsecured	Surplus to last column
	₹	₹	₹	₹

Freehold property

Estimated surplus from assets specifically pledged

Estimated total assets available for preferential creditors, debenture holders secured by a floating charge, and unsecured creditors (carried forward)

	SUMMARY OF GROSS ASSETS ₹	
	Gross realisable value of assets specifically pledged Other Assets Gross Asset	
Gross Liabilities ₹	**Liabilities** (to be deducted from surplus or added to deficiency as fee case may be)	
	Secured creditors (as per List 'B') to the extent to which claims are estimated to be covered by assets specifically pledged (item	

	(a) or (b) in preceding page, whichever is the less) (insert in 'Gross Liabilities' column only) Preferential Creditors (as per List 'C') Estimated balance of assets available for Debentureholders secured by a floating charge and unsecured creditors Debentureholders secured by a floating charge (as per List 'D') Estimated Surplus/Deficiency as regard Debenture holder) Unsecured Creditors (as per List 'E'): Estimated unsecured balance of claims of creditors partly secured on specific assets, brought from preceding page (c) Trade Accounts Bills Payable Outstanding Expenses Contingent Liabilities (state nature) Estimated Surplus/Deficiency as regards creditors (being difference between): Gross Assets brought from preceding page Gross Liabilities as per column (e) Rs Issued and called-up Capital: Preference shares of each called-up (as per list 'F') ₹ Equity shares of each called-up (as per List 'G') ₹ Estimated Surplus/Deficiency as regard member (as per list 'H') ₹______________________	

*Note: The figures must be read subject to the following notes:

(1) (/) There is not unpaid Capital liable to be called up or

(g) The Nominal amount of unpaid capital liable to be called up is ₹.... estimated to produce Rs.... which is/is not charged in favour of Debentureholders (Strike out (/) or(g)).

(2) The Estimates are subject to costs of the winding-up and to any surplus or deficiency on trading pending realisation of the assets.

The details of the particulars to be given in the Statement of Affairs can be summarised as follows:

LIST A gives a complete list of assets which are not in the hands of our pledged in favour of secured creditors.

LIST B gives the list of assets which are specifically pledged with creditors both fully secured and partly secured. LIST C is a list of preferential creditors and me amounts due.

LIST D is a list of debenture holders having a floating charge.

LIST E contains names of unsecured creditors and the amount due. ‘

LIST F gives the names and holdings of preference shareholders.

LIST G is a list of equity shareholders together with the amount of the shares held.

LIST H is a statement showing how the surplus or deficiency in the statement of affairs arose as a result of the profits and losses of the Company.

Steps in Preparing the Statements of Affairs

1. Put down the “free” assets (assets not specifically pledged) at their realisable values.
2. Add any surplus expected from securities in the hands of the creditors.
3. Deduct preferential creditors.
4. Deduct debentures having a floating charge or similar other creditors.
5. Deduct unsecured creditors together with unsatisfied balance of partly secured creditors.
6. Deduct Share Capital.

If at any stage the deduction to be made is more than the amount available, deficiency appears, otherwise there is a surplus.

4.3.4.3.2 List ‘H’ - Deficiency or Surplus Account

The period covered by this Account must commence on a date not less than 3 years before the date of the winding-up order (or the order appointing Provisional Liquidator, or the date directed by Official Liquidator) or, if the Company has not been incorporated for the whole of that period, the date of formation of the Company, unless the Official Liquidator otherwise agrees.

Items Contributing to Deficiency (or Reducing Surplus)	₹
1. Excess (if any) of Capital and Liabilities over assets on the ... 20... as shown by Balance Sheet (copy annexed)	
2. Net dividends and bonuses declared during the period from . . . . 20.... to the date of the statement	
3. Net trading losses (after charging items shown in note below for the same period)	
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars on annexed schedule)	
5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement (give particulars on annexed schedule)	
6. Other items contributing to deficiency or reducing surplus.	
Items Reducing Deficiency (or Contributing to Surplus):	
7. Excess (if any) of assets over Capital and Liabilities on the .... 20 ... as shown in the Balance Sheet (copy annexed)	
8. Net trading profits (after charging items shown in note below) for the period from .... 20... to the date of statement	
9. Profits and income other than trading profit during the same period (give particulars on annexed schedule)	
10. Other items reducing Deficiency or Contributing to Surplus:	
Deficiency/Surplus as shown in Statement of Affairs. _______	

Note as to net Trading Profits and Losses:

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this account:

Provisions for depreciation, renewals, or diminution in value of fixed assets. Charges for Indian Income-tax and other Indian taxation on profits. Interest on debentures and other fixed loans, payments to directors made by the Company and required by law to be disclosed in the accounts. Exceptional or non-recurring expenditure.

Less Exceptional or non-recurring receipts:

Balance, being other trading profits or losses.

Net trading profits or losses as shown in Deficiency or Surplus ~ account above

Dates Signature

4.3.4.3.3 Liquidator's Final Statement of Account

Liquidator's Statement of Account of the Winding-up (Member's / Creditor's Voluntary Winding up) Pursuant to Section 497/509.

1. Name of the Company ....Ltd.
2. Nature of proceeding:
3. Date of commencement of the winding up:

4. Name and address of the liquidators:

Statement showing how the winding-up has been conducted and the property of the company has been disposed of from 20 ... (commencement of winding-up) to .... 20 ... (close of winding-up).

Receipts	Estimated Value	Value realised	Payments	Payment
Assets:			Legal Charges	
Cash at Bank			Liquidator's remuneration:	
Cash in hand			where applicable.	
Marketable Securities			% on `... realised	
Bills Receivable			% on ` ... distributed	
Trade Debtors				
Loans and advances			Total	
Stock-in-trade			(By whom fixed)	
Work in Progress			Auctioneer's and valuer's	
Leasehold Property			charges	
Plant and Machinery			Costs of possession and	
Furniture-Fittings, Utensils, etc.			maintenance of estate	
Patents, Trade Marks, etc.			Costs of notices in Gazette	
			and	
Investments other than			newspapers	
Marketable Securities			Incidental outlay	
Surplus from Securities			(Establishment charges and	
Unpaid calls at Commen-			other expenses of liquidation)	
cement of winding-up				
Amounts received from			Total costs and charges	
calls on contributories				
made in winding-up			(0 Debentureholders*	
			payment's	
Receipts per Trading			of `... per Debentureholders	
Account viz.,			Payment of `... per `	
Total			(ii) Creditors	
Less payment to redeem			+ Preferential	
securities			+ Unsecured	
Cost of execution			Dividend (s) ... P. in the	
Payments per Trading			rupee on `... (The estimate of	
Account			the amount expected to rank	
			for dividend was Rs...) (w)	
			Returns to Contributories:	
			P. per rupee/share	
			P. per rupee/share	
			P. per rupee/share	

*State the number; Preferential Creditors need not be separately shown if all creditors have been paid in full.

+ State nominal value and class of Share.

(1) The following assets estimated to be of the value of Rs ... have proved to be unrealisable: (Give details of the assets which have proved to be unrealisable)

(2) Amount paid into the Companies Liquidation Account in respect of Rs

(a) Unclaimed dividends payable to creditors in the winding-up Rs

(b) Other unclaimed distribution in the winding-up Rs

(c) Money held by the Company in trust in respect of dividends or other sum due before the commencement of the winding-up to any person as a member of the company.

(3) Add here any remarks the Liquidator thinks desirable:

Dated this .... day of.... 20 ...

I declare that the above statement is-true and contains a full and accurate account of the winding-up from the commencement to the close of the winding-up.

Dated this ……….. day of ……….. 20 ……… (Sd.) Liquidator

4.3.5.1 Practical Problem: Preparation of Statement of Affairs

Illustration 1

X Co. went into compulsory liquidation on 31st March 2004. The following information are received on this date from the books of the company:

	₹
Equity Share Capital: 3,000 shares of ₹100 each, ₹ 80 paid up	2,40,000
5% Pref. Share Capital: 2,000 Shares of ₹ 100 each fully paid, but on 100 shares ₹25 were not paid, it is estimated that ₹ 1,000 will be recovered on these shares	2,00,000
6% first mortgage debentures having a floating charge on all the assets of the company except uncalled on capital	3,00,000
Fully secured creditors which have first charge on Land and Buildings	60,000
Partly secured creditors which have second charge on Land and Buildings to the extent of ₹ 30,000	50,000
Preferential creditors	5,000
Unsecured trade creditors *(i.e.,* addition of Preferential Creditors)	1,20,000
Bank Overdraft	75,000
liability on Bills discounted ₹ 10,000 estimated liability	4,500
B/R (out of which one bill of ₹ 5,000 is bad)	15,000
Book Debts - Good	1,25,000
Book Debts - Bad	21,000
Stock (estimated to realize ₹1,50,000)	1,20,000
Machinery lodged with the Bank as security for overdraft (estimated realisable value of machine ₹1,10,000)	1,50,000
Land & Buildings (estimated realisable value ₹1,00,000)	1,30,000
Cash in hand	6,000

Prepare a statement of affairs and deficiency account.

STATEMENT OF AFFAIRS

						Estimated Realizable Value
	Assets not Specifically Pledged (as per List 'A')					₹
	Cash in hand					6,000
	Bills Receivable					10,000
	Debtors					1,25,000
	Stock in Trade					1,50,000
	Unpaid Calls (Amount received)					1,000
	Assets specifically pledged (as per List 'B')	(*a*) Estimated realisable value	(*b*) Due to secured creditors	(*c*) Deficiency ranking as unsecured	(*d*) Surplus carried to last column	
	Land and buildings (1,00,000 – 30,000)	70,000	60,000	-	10,000	
	Land & Buildings	30,000	50,000	20,000	-	
	Machinery	1,10,000	75,000	-	35,000	
		2,10,000	**1,85,000**	**20,000**	**45,000**	
	Estimated surplus from Assets specifically pledged					45,000
	Estimated total assets- available for Preferential Creditors Debenture holders secured by a floating charge and unsecured Crs. carried forward					3,37,000
	Summary of Gross Assets:					
	Gross Realisable value of assets specifically pledged				2,10,000	
	Other Assets				2,92,000	
					5,02,000	

Gross Liabilities	**Liabilities**	₹
₹	(To be deducted from surplus or added to deficiency as the case may be)	
1,65,000	Secured Crs. (as per List 'B') to the extent to which claims are estimated to be covered by assets specifically pledged (item (a) or (b) above whichever is less)	-
5,000	Preferential creditors as per List 'C' Estimated Balance of Assets of Assets available for Debenture holders secured by a floating charge and Unsecured creditors	5,000 3,32,000
3,00,000	Debentures secured by a floating charge as per List 'D'	3,00,000
	Estimated Surplus as regards Debentureholders	32,000
20,000	Unsecured Creditors as per List 'E' Estimate unsecured balance of claims of Creditors partly secured	

	on specific assets item (c) above 20,000	
1,20,000	Unsecured Trade Creditors 1,20,000	
4,500	Contingent Liabilities (regarding Bills Discounted) 4,500	1,44,500
6,14,500		
	Estimated Deficiency as regards creditors being difference between	
	Gross Liabilities ₹. 6,14,500 and gross assets ₹5,02,000	1,12,500
	Issued and Called up capital: 2,000, 5% pref. shares of ₹100 each as per List 'F' 2,00,000 Less: Irrecoverable Unpaid Calls 1,500 1,98,500 3,000 Equity shares of ₹100 each, ₹. 30 per share paid up as per List 'G' 2,40,000	4,38,500
	Estimated Deficiency as regards members as per List 'H'	5,51,000

List 'H' Deficiency account

Items Contributing to Deficiency	₹.
1. Excess of Capital and Liabilities over assets on 31st March, 2004 as shown by Balance Sheet (copy annexed)	4,80,500
2. Net Dividends and Bonuses during the period from .... to the date of Statement	-
3. Net Trading losses for the same period	-
4. Losses other than trading losses written off or for which provision has been made in the books during the same period	-
5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement:	
Bills Receivable 5,000 Book Debts (bad) 21,000 Machinery 40,000 Land and Buildings 30,000 Bills Discounted 4,500 1,00,500	1,00,500
6. Other items contributing to Deficiency	-
Items Reducing Deficiency	5,81,000
7. Excess of Assets over Capital	-
8. Net Trading profit for the period	-
9. Profit and Income other than trading profit during the same period: Stock ₹. 30,000	30,000
10. Other items reducing deficiency	-
Deficiency as shown by the statements	5,51,000

4.3.5.2 Practical Problem: Preparation of Liquidator Final Statement of Accounts

Illustration 2

The Ultra Optimist Ltd. went into Liquidation. Its assets realised ₹ 3,50,000 excluding amount realised by sale of securities held by the secured creditors. The following was the position:

	₹
Share Capital:10,000 shares of ₹10 each	
Secured Creditors(securities realised ₹40,000)	35,000
Preferential Creditors	6,000
Unsecured Creditors	1,40,000
Debentures hacing a floating charge on the assets of the company	2,50,000
Liquidation Expenses	5,000
Liquidator's Remuneration	7,500

Prepare the Liquidator's Final Statement of Account.

Solution

THE ULTRA OPTIMIST LTD.
Liquidator's Final Statement of Account

	Value realised ₹		Amount paid ₹
Assets Realised Other Assets Surplus from securities	 3,50,000 5,000	Liquidator's Remuneration Expenses of liquidation Debentures having a floating charges Creditors: preferential Unsecured Creditors- 61.79% Of ₹1,40,000	 7,500 5,000 =2,50,000 6,000 86,500
	3,55,000		3,55,000

Illustration 3A Company went into liquidation on 31st March,2012 when the following Balance Sheet was prepared.

Liabilities		₹.	Assets	₹.
Share Capital			Good Will	50,000
Subscribed and paid up			Leasehold Property	48,000
Capital19,500 shares of			Plant and Machinery	65,500
₹.10 each		1,95,000	Stock	56,800
Sundry Creditors			Sundry Debtors	64,820
Preferential	24,200		Cash	2,500
Partly Secured	55,310		Profit and Loss Account	98,680
Unsecured	99,790	1,79,300		
Bank Overdraft (unsecured)		12,000		
		3,86,300		3,86,300

The Liquidator realised the assets as follows: ₹

Leasehold property which was used in the first instance to pay the

Partly secured creditors pro rata 35,000

Plant and Machinery 51,000

Stock 39,000

Sundry Debtors 58,500

Cash 2,500

The expenses of liquidation amounted to ₹1,000 and the liquidator's remuneration was agreed at 2.5% on the amount realised, including cash, and 2% on the amount paid to the unsecured creditors. You are required to prepare the Liquidator's final Accounts showing the distribution.

Solution

Liquidator's Final Statement Of Account

	Estimated Value ₹	Value realised ₹		Amount paid ₹
Assets Realised			Liquidator's Remuneration:	
Cash	2,500	2,500	2.5% on ₹1,86,000 4,650	
Debtors	64,820	58,500	2% on ₹24,200 484	
Stock	56,800	39,000	2% on ₹1,18,300 2,366	7,500
Plant and Mach	65,500	51,000	Expenses of liquidation	1,000
			Preferential Creditors	24,200
			Unsecured Creditors(89.55%)	1,18,300
		5,15,000		5,15,000

Note: a) Goodwill valued at ₹50,000 in books is valueless:

b) The total amount due to the unsecured creditors is ₹1,32,100 calculated as follows: ₹

Unsatisfied balance of partly secured creditors 20,310

Unsecured Creditors 99,790

Bank Overdraft 12,000

1,32,100

Illustration 4 The following is the Balance Sheet of A Ltd. on March 31,2012

Liabilities	₹.	Assets	₹.
Share Capital		Patents	40,000
2,000 14% p.shares of ₹.100	2,00,000	Land and Building	1,00,000
		Plant and Machinery	2,50,000
1,000 equity shares of ₹.100 each ₹.75paid	75,000	Stock	55,000
		Sundry Debtors	1,10,000
3,000 Equity shares of		Cash	75,500
₹.100 each ₹.60 paid	1,80,000	Profit and Loss Account	83,500
14% Debentures having a floating charges on all assets	1,00,000		
Interest outstanding	14,000		
Sundry Creditors	1,45,000		
	7,14,000		7,14,000

The Company went into liquidation on the above date.The preference dividends were in arrear for two years. The arrears are payable automatically on liquidation. Creditors include a loan for ₹ 50,000 on the mortgage of Land and Building. The assets were realised as follows:

Land and Buildings	1,20,000
Machinery and Plant	2,00,000
Patents	30,000
Stock	60,000
Sundry Debtors	80,000

The expenses of liquidation amounted to ₹ 10,900. The liquidator is entitled to a commission of 3 percent on all assets realized except cash and a commission of 2 percent amounts distributed among unsecured creditors. Preferential creditors amount to ₹ 15,000 . Assume the payment was made on September 30, 2012. Prepare the Liquidator's Statement of Account.

Solution

Liquidator's Statement of Account

	Estimated Value ₹	Value realised ₹		Amount paid ₹
Assets Realised			Liquidator's	
Cash	75,500	75,500	Remuneration:	
Debtors	1,10,000	80,000	3% on ₹.4,90,00014,700	16,600
Stock	55,000	60,000	2%on ₹95,0001,900	
Plant and Mach	2,50,000	2,00,000		10,900
			Expenses of liquidation	
Patents	40,000	30,000	Debentures having a	
Surplus from			floating charges1,00,000	

securities		70,000	Interest up to 30th September, 2012 21,000	1,21,000
			Creditors: preferential	15,000
			Others	80,000
			Preference Shareholders	2,00,000
			Arrears of Preference Dividend	56,000
			Equity share holders:	
			₹15on1,000shares 15,000	
			₹0.25on 4,000shares 1,000	16,000
		5,15,000		5,15,000

Illustration 5

Balance Sheet of **Asok Limited** *as on 31st March, 2013*

Liabilities	`	*Assets*	`
Share Capital:		**Fixed Assets:**	
1,000, 6% Preference shares of		Machinery	1,90,000
₹ 100 each fully paid	1,00,000	Furniture	10,000
2,000 Equity shares of ₹100		**Current Assets:**	
each fully paid	2,00,000	Stock	1,20,000
2,000 Equity shares of ₹100		Debtors	2,40,000
each, ₹75 paid	1,50,000	Cash at bank	50,000
Loan—bank (secured on stock)	1,00,000	**Miscellaneous Expenditure:**	
Current Liabilities and Provisions:		Profit and loss A/c	3,00,000
Creditors	3,50,000		
Income-tax payable	10,000		
	9,10,000		9,10,000

The company went into liquidation on 1st April, 2013. The assets were realised as follows: ₹

	₹
Machinery	1,66,000
Furniture	8,000
Stock	1,10,000
Debtors	2,30,000
Liquidation expenses amounted to	4,000

he liquidators are entitled to a commission at 2% on amount paid to unsecured creditors excluding preferential creditors. Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable. Prepare Liquidator's Statement of Account.

Solution

Liquidator's Statement of Account

	Estimated Value ₹	Value realised ₹		Amount paid ₹
Assets Realised			Liquidator's	7,000
Cash	50,000	50,000	Remuneration:	
Debtors	55,000	60,000	(2% on ₹ 3,50,000)	4,000
Plant and	2,50,000	1,66,000	Expenses of liquidation	
Machinery			Preferential Creditors	10,000
			Income-tax payable	
Furniture	10,000	8,000	Unsecured creditors	3,50,000
Surplus from			Preference shareholders	
securities (stock)		10,000	(1,000, 6% preference	
Call on 1,800 equity			shares of ₹100 fully paid)	1,00,000
shares @ ₹15 per		27,000	Equity share holders:	
share *(W.N.* 2)			₹10 on2,000shares	20,000
		4,91,000		4,91,000

Working Notes:

I. Computation call per equity share ₹

(/) Total Payments side excluding final payment to equity shareholders 4, 71,000

Less: Total of receipts excluding call money 4, 64,000

Surplus (Deficit) (7,000)

Add: Notional call on 1,800 equity shares @ ₹ 25 each 45,000

Notional surplus 38,000

Notional surplus per share ₹ 30,000 3,800 = 10

(ii) Call on partly paid up shares and final payment of fully paid up shares

Call on 1,800 partly paid up equity shareholders should be ₹25 — ₹10 = ₹15 per share. This will result in a collection of ₹ 27,000

2. Final Payment to fully paid shareholders: 2,000 fully paid up equity shareholders will get final payment a ₹10 per share from the net proceeds of call on partly paid up shares amounting to ₹ 27,000.
3. Final payment to 2,000 fully paid up equity shareholders = (2,000 x 10) = ₹20,000.

4.3.7 Self Test Question

Theory

1. What do you mean by liquidation of company? Describe the different modes of winding-up.
2. Give the performa of the statement o affairs and the Deficiency/ Surplus Account.
3. Give the performa of the liquidator final statement of accounts.

Problems

1. A Company went into liquidation on 31st March,2012 when the following Balance Sheet was prepared:

Liabilities		₹.	Assets	₹.
Share Capital			Good Will	50,000
Subscribed and paid up ₹ 10 each		1,95,000	Leasehold Property	48,000
			Plant and Machinery	65,500
Creditors :		75,000	Stock	56,800
Preferential	24,200		Sundry Debtors	64,820
Partly Secured	55,310		Cash	2,500
Unsecured	99,790	1,79,300	Profit and Loss Account	98,680
Bank Overdraft (unsecured)		12,000		
		3,86,300		3,86,300

The Liquidator realised the assets as follows:

Leasehold property which was used in the first instance to pay the Partly secured creditors pro rata	35,000
Plant and Machinery	51,000
Stock	39,000
Sundry Debtors	58,500
Cash	2,500

The expenses of liquidation amounted to Rs.1,000 and the liquidator's remuneration was agreed at 2.5% on the amount realised, including cash, and 2% on the amount paid to the unsecured creditors.

You are required to prepare the Liquidator's final Accounts showing the distribution.

2. The following balance are extracted from 'A' Ltd.'s Balance sheet as on 31.3.2012.

	₹
Equity share capital	1,00,000
6% preference share capital	2,00,000
6% debentures	1,50,000
Fully secured creditors(security value- ₹ 35,000)	30,000
Partly secured creditors(security value –₹ 10,000)	20,000
Preferential creditors	6,000
Bills payable	1,00,000
Unsecured creditors	70,000
Bank overdraft	10,000
Bills receivables	15,000
Bills discounted(one bill for ₹10,000 is bad)	40,000
Book debts:	
Good	10,000
Doubtful-(estimated to realise50%)	7,000
Bad	6,000
Land and building(estimated at ₹ 1,00,000)	1,50,000
Stock (estimated at ₹40,000)	50,000
Machinery	5,000
Cash in hand	100

Prepare statement of affairs as on 31.3.2012.

3. The following information was extracted from the books of a limited company on 31.3.2013 on which date a winding up order was made:

	₹
Cash in hand	12,000
Book debts:	
Good	3,80,000
Doubtful(estimated to produce (₹` 30,000)	80,000
Bad	45,000
Shares(estimated to produce ₹ 6,00,000)	7,20,000

Freeholds (estimated to produce ₹ 18,50,000)	21,00,000
Plants etc. (estimated to produce ₹6,30,000)	6,00,000
Fixtures & fittings (estimated to produce ₹ 80,000)	1,20,000
Equity share capital:	
2,00,000 shares of ₹10 each	20,00,000
14% preference share capital	
3,00,000 shares of ₹10 each	30,00,000
Call in arrears (estimated to produce ₹20,000)	40,000
14% first mortgage debentures secured by a floating charge on all the assets	
of the company	20,00,000
Creditors fully secured (value of securities ₹4,00,000)	3,50,000
Creditors partly secured (value of securities ₹ 2,00,000)	4,00,000
Preferential creditors	75,000
Unsecured creditors	27,00,000
Bank overdraft secured by a second charge on all the assets of the company	2,00,000

From the above information, prepare a statement of affairs and a deficiency account.

4. The Ramanna Co. Ltd. went into voluntary liquidation as on 31st March 2012when its financial position was as follows:

Liabilities	₹	*Assets*	₹
7% preference share Capital		Goodwill	10,000
of ₹ 100 each	1,00,000	Buildings	1,85,000
10,000 equity shares		Plant& machinery	1,58,000
of ₹ 10Each. ₹ 7.50 paid	75,000	Sundry debtors	86,000
40,000 equity shares		Stocks	1,01,000
of ₹10Each ₹ 5 paid	2,00,000	Cash	56,400
Mortgage loan on building		Profit & loss a/c	16,600
& plant & machinery	1,50,000		
Sundry creditors	54,000		
Bills payable	16,500		
Bank overdraft secured			
on stock	10,000		
Outstanding salaries			

and taxes	7,500	
	6,13,000	6,13,000

The assets realized as follows: Building an Plant & Machinery ₹3,00,000; Similarly debtors ₹. 70,000 and stock ₹. 48,000. Liquidation expenses amounted to ₹ 2,500 and the liquidator's remuneration was fixed at ₹ 5,000. Prepare the Liquidator's final statement of account.

5. The summarized Balance Sheet of Mathew Ltd. as on 31.3.2012 being the date of voluntary winding up is as under:

Liabilities	₹	*Assets*	₹
Share capital:		Land & Buildings	3,86,000
12% Cumulative shares:		Plant & Machinery	8,21,000
10,000 shares of ₹100 each		Stock in trade	1,84,000
fully paid up	10,00,000	Book debts	13,37,000
Equity share capital:		Profit & Loss A/c	3,72,000
5,000 equity shares of ₹ 100 each			
₹60 per share called and			
paid up	3,00,000		
5,000 equity shares of Rs. 100 each,			
₹ 50 per share called and			
paid up	2,50,000		
paid up share capital	15,50,000		
15% debentures	4,00,000		
Preferential creditors	1,05,000		
Bank overdraft	3,03,000		
Traders creditors	7,42,000		
	31,00,000		31,00,000

Preference dividend is in arrear for two years. By 31.3.2012 the assets were realised as follows:

Land & Buildings ₹ 9,84,000; Stock-in- trade ₹ 1,63,000

Plant & Machinery ₹ 7,12,000; Book debts ₹ 11,91,000;

Expenses of liquidation are ₹ 54,000.

The remuneration of the liquidator is 3% of the realization. Income tax payable on liquidation is ₹ 44,500. Assuming that the final payments are made on 31.3.2012, prepare the liquidator's final statement of account.

6. The following is the balance sheet of M/s Unfortunate Ltd. as on 31.3.2012

Liabilities	₹	*Assets*	₹
4,000 6% preference shares of		Land & Buildings	2,00,000
₹ 100 each fully paid up	4,00,000	Plant & Machinery	5,00,000
2,000 equity shares of ₹ 100		Patents	80,000
each, ₹ 75 per share paid up	1,50,000	Stock at cost	1,10,000
6,000 equity shares of ₹ 100		Sundry Debtors	2,20,000
each, ₹ 60 per share paid up	3,60,000	Cash at bank	60,000
5% Debentures (having		Profit & Loss A/c	2,40,000
floating charge on all assets)	2,00,000		
Interest outstanding on debentures			
(also secured as above)	10,000		
Creditors	2,90,000		
	14,10,000		14,10,000

On that date, the company went into voluntary liquidation. The dividends on preference shares were in arrear for two years. Creditors include a loan of ₹ 1,00,000 on mortgage of Land & Buildings. The assets realized were as under: Land & Buildings ₹2,40,000; Plant & Machinery ₹ 1,60,000.

The expenses of liquidation amounted to ₹ 21,800. The liquidator is entitled to a commission of 3% on all assets realized (except cash at bank) and commission of 2% on amounts is distributed among unsecured creditors. Preference creditors amount to ₹ 30,000. All payments were made on 30th June 2012. Prepare the liquidator's final statement of account.

Lesson 5.1Final Statements of Accounts of Banking Company

Learning Objectives

After reading this lesson you should be able to

- Know the important provisions relating to final accounts of banking companies
- Familiar with the prescribed formats of the Profit and Loss Account and Balance Sheet of a banking company
- Understand the mode of disclosure of accounting policies adopted by a banking company and accounting treatment for specific adjustment in final accounts
- Prepare final accounts of banking companies.

5.1.1 Introduction

In India, banking companies are governed by the Banking Regulation Act 1949. Section 5(b) of the Act defines banking as "the accepting, for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise". In Short the main functions of banking companies is to accepting deposits from the public for lending or investment. Till 1949, there was no special legislation to regulate banking companies but since that year the Banking Regulation Act applies to corporate entities carrying on the business of banking in India. Such companies are also subject to the Companies Act, 1956. All nationalized banks are also subject to the Banking Regulation Act except in regard to appointment of directors and disposal of profit etc.

5.1.2 Business of banking companies

According the Sec.6 of the Act, a banking company can also carry on the following business along with the primary function.

i) borrowing, raising, or taking up of money;
ii) lending or advancing of money;
iii) drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes and other instrument;
iv) granting and issuing of letter of credit, travelers cheques and circular notes;
v) buying, selling and dealing in bullion,

vi) buying and selling on commission, underwriting and dealing in stock, shares, debentures, bonds, etc.;

vii) on receiving of all kinds of bonds, scripts or valuables on deposit or for safe custody or otherwise;

viii) collecting and transmitting of money and securities;

ix) acting as agents for any Government or local authority or any other person or persons;

x) contracting for public and private loans and negotiating and issuing the same;

xi) carrying on and transacting every kind of guarantees and indemnity business;

xii) undertaking and executing trusts;

xiii) undertaking and administration of estates as executor, trustee or otherwise;

xiv) establishing and supporting associations, funds, trusts and conveniences for the benefit of employees, their dependants and the general public;

xv) acquiring, constructing, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

xvi) doing all such things as are incidental or conducive to the promotion or advancement of the business of the company.etc

The main objective of this chapter is to study the technique of preparing the finial accounts of the banking companies.

5.1.3 Legal Requirements

The Important provisions relating to final accounts of a banking company are as follows:

1. Prescribed form: Profit & Loss Account and the Balance Sheet are included in the final accounts of the banking company. There is no separate Profit & Loss Appropriation Account prepared in case of a banking company and appropriations are done in the Profit & Loss Account itself. The formats of the Profit & Loss Accounts and the Balance Sheet are given the Third Schedule of Banking Regulation Act. These formats have been revised w.e.f 1st April, 1991.

2. Accounting year: On account of the amended provisions of the Income Tax Act 1961 requiring every company to close its accounts on 31st March every year w.e.f

financial year ending 31st March 1989, now a banking company also closes its accounts on 31st March each year

3. **Prohibition of trading:** A banking company can neither itself nor on behalf of the others deal in buying or selling or bartering of goods except in connection with the realization of security given to or held by it (Section 8).

4. **Minimum Capital and Reserves:** In order to maintain the strong capital structure of the banking companies operated in India, the sum of its paid up capital and reserves shall not be less than the amount mentioned under section 11 of Banking Regulation Act. On the recommendation of the Narasimhan Committee, the Reserve bank introduced the risk weighted assets ratio in April 1992 for strengthen the capital base of the banks. This ratio is known as Capital Adequacy Ratio.

5. **Payment of commission, brokerage, etc:** A banking company cannot pay, by way of commission, brokerage, discount or remuneration in respect of shares issued by it, an amount exceeding in the aggregate 2.5 per cent of the paid-up value of the said shares (Section 13).

6. **Charge on uncalled capital**: A banking company cannot create any change upon its uncalled capital and any such charge shall be void (Section 14).

7. **Payment of dividend:** Under section 15, a banking company cannot pay dividend all of its capitalised expenses (including preliminary expenses, organization expenses, share selling commission, brokerage, amount of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written off. However, a banking company is permitted to pay dividend without writing off the following items:

i) Depreciation in the value of its investments in approved securities where such depreciation has not actually been capitalized or otherwise accounted for as a loss.

ii) Depreciation in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditors of the banking company.

iii) Bad debts, if any, where adequate provision has been made to the satisfaction of the auditors of the banking company (Section 15).

8. **Limits as to investments in shares and debentures**: RBI, IRBI, has removed limits on investments made by the banks in the equity and debentures issues of 17 institutions. These include IDBI, IFCI, ICICI, Export Import Bank of India, IRBI, NABARD, NHB, UTI, GIC, RCTFC, TDICI, Tourism Finance Corporation of India, etc.

9. **Statutory Reserve:** As per Section 17, banking companies operating in India shall transfer every year at least 25% of its profit before any appropriations to a Statutory reserve (Reserve fund).

10. **Cash Reserve Ratio (CRR):** Banks are required to maintain with the Reserve Bank of India a cash reserve as specified percent of the total of its demand and time liabilities in India. Time to time it is revised by the RBI and now the ratio is 5% w.e.f. January 17, 2009

11. **Statutory Liquidity Ratio (SLR):** Banks are also required to maintain at least 25% of the demand and time liabilities in the form of liquid assets like cash, gold or unencumbered. It can be vary in between range of 25% to 40%.

12. **Non – Banking Assets:** These are the assets which are not used in the ordinary course of business of banking, but they are such immovable and movable properties which come under the possession of the banking company for recovering the amount due from customers.

5.1.4 Accounting System

Banking Company accounting system is different from that of a trading or manufacturing company and the following are the main features of a bank's accounting system are as follows:

1. Entries in the personal ledgers are made directly from the vouchers
2. From such entries in the personal ledgers each day summary sheets in total are prepared which are posted to the control accounts in the general ledger.
3. The general ledger's trial balance is extracted and agreed every day.
4. All entries in the personal ledgers and summary sheets are checked by persons other than those who have recorded entries. It helps in detection of mistakes.
5. A trial balance of detailed personal ledgers is prepared periodically and gets agreed with the general ledger control accounts.
6. Two vouchers are prepared for every transaction not involving cash.

5.1.5 Books maintained by banks

1. Receiving Cashier's Counter Cash Book.
2. Paying Cashier's Counter Cash Book.
3. Current Accounts Ledger.
4. Saving Bank Accounts Ledger.
5. Fixed Deposit Accounts Ledger.
6. Investment ledger.
7. Bills Discounted and Purchased Ledger.
8. Loan Ledger.
9. Cash Credit Ledger.
10. Customers' Acceptances, endorsements and Guarantee Ledger.
11. Recurring Deposits Accounts Ledger, etc.

5.1.6 Final Accounts of Banks

As per Section 29, a banking company incorporated in India, is required to prepare, at the end of each accounting year, a Balance sheet and profit and Loss Account as on the last working day of the year. Form B of Schedule III of the Banking Regulation Act used to present Profit and Loss Account. The following revised form is prescribed w.e.f. from March 31, 1992.

Form of Profit and Loss Account for the year ended 31st March 20..

		Schedule No.	Year ended 31.03.20…. (current year) ₹	Year ended 31.3.20…. (previous year) ₹
I.	*Income*			
	Interest earned	13		
	Other income	14		
	Total			
II.	*Expenditure*			
	Interest expended	15		
	Operating expenses	16		
	Provisions and Contingencies			
	Total			

III. Profit/Loss: Net Profit/Loss for the year Profit/Loss brought forward Total *IV. Appropriations:* Transfer to statutory reserve Transfer to other reserves Transfer to Government/proposed dividend Balance carried over to balance sheet Total	-- 	xxx xxx xxx	xxx xxx xxx

Schedules to be annexed with Profit and Loss Account

Schedule 13: Interest earned			
I. Interest/Discount on advances/bills **II.** Income on Investments **III.** Interest on Balances with RBI and other inter-bank fund **IV.** Others			
Total		xxx	xxx
Schedule 14: Other income			
I. Commission, exchange and brokerage **II.** Profit on sale of investments *Less* : Loss on sale of investments **III.** Profit on revaluation of investments *Less* : Loss on revaluation of investments **IV.** Profit on sale of land, building and other assets *Less* : Loss on sale of land, building and other Assets **V.** Profit on exchange transactions *Less* : Loss on exchange transactions **VI.** Income earned by way of dividends etc. from subsidiaries/companies and/or joint ventures abroad/in India **VII.** Miscellaneous Income			
Total		xxx	Xxx
Note: Under items II to V loss figures may be shown on brackets.			
Schedule 15: Interest expended			

I. Interest on deposits II. Interest on Reserve Bank of India/inter-bank borrowing III. Others Total		xxx	xxx
Schedule 16: Operating expenses			
I. Payments to and provision for employees **II.** Rent, taxes and lighting **III.** Printing and stationery **IV.** Advertisement and Publicity **V.** Depreciation on the Bank's Property **VI.** Director's fees, allowances and expenses **VII.** Auditor's fees and expenses (including branch auditors) **VIII.** Law charges **IX.** Postage, telegrams, telephones etc. **X.** Repairs and maintenance **XI.** Insurance **XII.** Other Expenditure Total		xxx	xxx

5.1.6.1 RBI's Instruction regarding the various item in Profit and Loss Account

Profit and Loss Account			
Item	Schedule	Coverage	Notes and instructions for compilation
Interest earned	13	**I.** Interest/discount on advances/bills	Includes interest and discount on all types of loans and advances like cash credit, demand loans, overdraft, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue, interest and also interest subsidy, if any, relating to such advances/bills.
		II. Income on Investments	Includes all income derived from the investment portfolio by way of interest and dividend.
		III. Interest on balances	Includes interest on balances with

		with Reserve Bank of India and other Interbank funds	Reserve Bank and other banks, call loans, money market placements, etc.
		IV. Others	Includes any other interest/discount income not included in above heads.
Other Income	14	**I.** Commission, exchange and brokerage	Includes all remuneration on services such as commission on collections, commission/ exchange on remittances and transfers, commission on letter of credit and guarantees, commission on Government business commission on other permitted agency business including consultancy and other services, broke-rage, etc. on securities. It does not include foreign exchange income.
		II. Profit on sale of investments Less: Loss on sale of investments	Includes profit/loss on sale of securities, furniture land and buildings, motor of vehicle, gold, silver etc.
		III. Profit on revaluation of investments Less: Loss on revaluation of investments	Only the net position should be shown. If the net position is a loss, the amount should be shown as deduction. The net profit/loss on revaluation of assets may also be shown under this item.
		IV. Profit on sale of land, building and other assets Less : Loss on sale of land, buildings and other assets	
		V. Profit on exchange transactions Less : Loss on exchange transactions	Includes profit/loss on dealing in foreign exchange all income earned by way of foreign exchange commission and charges on foreign exchange, transactions excluding interest which will be shown under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.

		VI. Income earned by way of dividends etc. from subsidiaries, companies and/or joint ventures abroad/in India **VII.** Miscellaneous income	 Includes recoveries from constituents for the godown rents, income from bank's properties, security charges, insurance etc. and any other miscellaneous income. In case any item under this head exceeds one percentage of the total income, particulars may be given in the notes.
Interest Expended	15	**I.** Interest on deposits **II.** Interest on Reserve Bank of India/inter-bank borrowings **III.** Others	Includes interest paid on all types of deposits including deposits from banks and others institutions. Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks. Includes discount/interest on all borrowings/refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.
Operating expenses	16	**I.** Payments to and Provisions for employees **II.** Rent, taxes and lighting **III.** Printing and Stationery	Includes staff salaries / wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity liveries to staff, leave fare concessions, staff welfare, medical allowance to staff etc. Includes rent paid by the banks on building and other municipal and other taxes paid (excluding income tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear under the head 'Payments to and provisions for employees'. Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity

			expenditure.
		IV. Advertisement and publicity	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.
		V. Depreciation on Bank's property	Includes depreciation on bank's own property: motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non banking assets, etc.
		VI. Directors' fees, allowances and expenses	Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowances, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of local Committee members may also be included under this head.
		VII. Auditors' fees and expenses (including branch auditors' fees and expenses)	Includes fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services the expenses incurred in that context including fees may not be included under this head but shown under 'other expenditure'.
		VIII. Law charges	All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.

		IX. Postage, telegrams, telephones, etc.	Includes all postal charges like stamps, telegram, telephones, teleprinter, etc.
		X. Repairs and maintenance	Includes repairs to banks' property, their maintenance charges, etc.
		XI. Insurance	Includes insurance charges on bank's property, insurance premium paid to DepositInsurance & Credit Guarantee Corporation, etc. to the extent they are not recovered from the concerned parties.
		XII. Other expenditure	All expenses other than those not included in any of the other heads like, license fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. may be included under this head. In case any particular item under this head exceeds one percentage of the total income particulars may be given in the notes.
Provisions and contingencies Treatment of accumulated losses			Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for diminution in the value of investments, transfers to contingencies and other similar items.

5.1.6.2 RBI's Instruction regarding the various item in Balance Sheet

The Balance Sheet of a banking company is to be prepared in Form A given in third schedule to the Act. Unlike the previous form the present one is devoid of details, the latter being shown in the schedules. RBI has given guidelines for compiling the balance sheet. Below are given Form A, the schedules thereunder and the instructions of RBI and in that order.

The Third Schedule (See Section 29)
Form of Balance Sheet
Form 'A'

Balance Sheet of (here enter name of the Banking company)

Balance Sheet as on 31st March----

	Schedule No.	As on 31.03.20…. (current year) ₹	As on 31.3.20…. (previous year) ₹
Capital & Liabilities			
Capital	1		
Reserve & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			
Cash and balances with Reserve Bank of India	6		
Balance with banks and Money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total Assets			
Contingent liabilities	12		
Bills for collection			

Schedules

Schedule 1 - Capital

	As on 31.03.20…. (current year) ₹.	As on 31.3.20…. (previous year) ₹.
I. For Nationalised Banks Capital (Fully owned by Central Government)		
II. For Banks Incorporated outside India		
Capital (i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head) (ii) Amount of deposit kept with the RBI under Section 11(2) of the Banking Regulation Act, 1949 **Total**		

III. For other Banks Authorised Capital (Shares of Rs. each) Issued Capital (Shares of Rs. each) Subscribed Capital (Shares of Rs. each) Called-up Capital (Shares of Rs. each) *Less* : Calls unpaid *Add* : Forfeited shares **Total**		
Schedule 2- Reserves & Surplus		
I. Statutory Reserves Opening Balance Additions during the year Deductions during the year **II. Capital Reserves** Opening Balance Additions during the year Deductions during the year **III. Share Premium** Opening Balance Additions during the year Deductions during the year **IV. Revenue and other Reserves** Opening Balance Additions during the year Deductions during the year **V. Balance in Profit and loss Account** **Total : (I, II, III, IV and V)**		
Schedule 3 - Deposits		
A. I. Demand Deposits (i) From banks (ii) From others **II. Savings Bank Deposits** **III. Term Deposits** (i) From Banks (ii) From others **Total :(I, II and III)** **B.** (i) Deposits of branches in India (ii) Deposits of branches outside India **Total**		
Schedule 4 - Borrowings		
I. Borrowings in India (i) Reserve Bank of India (ii) Other banks (iii) Other institutions and agencies **II. Borrowings outside India Total : (I and II)** Secured borrowings included in I & II above – Rs.		

Schedule 5 - Other Liabilities and Provisions		
I. Bills payable **II.** Inter-office adjustments (net) **III.** Interest accrued **IV.** Others (including provisions) **Total**		

Schedule 6 - Cash and Balances with Reserve Bank of India		
I. Cash in hand (including foreign currency notes) **II. Balances with Reserve Bank of India** (i) In Current Account (ii) In Other Accounts **Total : (I & II)**		

Schedule 7 - Balances with Banks & Money at Call & Short Notice		
I. In India (i) Balances with banks (a) in Current Accounts (b) in Other Deposit Accounts (ii) Money at call and short notice (a) with banks (b) with other institutions **Total : (i & ii)** **II. Outside India** (i) In Current Accounts (ii) in other Deposits Accounts (iii) Money at call and short notice **Total** **Grand Total (I & II) :**		

Schedule 8 - Investments		
I. Investments in India in (i) Government securities (ii) Other approved securities (iii) Shares (iv) Debentures and Bonds (v) Subsidiaries and/or joint ventures (vi) Others (to be specified) **Total** **II. Investments outside India in** (i) Government securities (Including local authorities) (ii) Subsidiaries and/or joint ventures abroad (iii) Other investments (to be specified) **Total** **Grand Total :(I & II)**		

Schedule 9 - Advances		
A. (i) Bills purchased and discounted (ii)Cash credits, overdrafts and loans repayable on demand (iii)Term loans **Total** **B.** (i) Secured by tangible assets (ii) Covered by Bank/Government Guarantees (iii) Unsecured **Total**		
C. I. Advances in India (i) Priority Sectors (ii) Public Sector (iii) Banks (iv) Others **Total** **II. Advances outside India** (i) Due from banks (ii) Due from others (a) Bills purchased and discounted (b) Syndicated loans (c) Others **Total** **Grand Total :(C. I & II)**		
Schedule 10 - Fixed Assets		
I. Premises At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date **II. Other Fixed Assets** (including Furniture and Fixtures) At cost as on 31st March of the preceding year Additions during the year Deductions during the year Depreciation to date **Total : (I & II)**		
Schedule 11 - Other Assets		
I. Inter-office adjustments (net) **II.** Interest accrued **III.** Tax paid in advance/tax deducted at source **IV.** Stationery and stamps **V.** Non-banking assets acquired in satisfaction of claims **VI.** Others* **Total**		
*In case there is any unadjusted balance of loss the same may be shown under this item with appropriate foot-note.		

Schedule 12 - Contingent Liabilities		
I. Claims against the bank not acknowledged as debts **II.** Liability for partially paid investments **III.** Liability on account of outstanding forward exchange contracts **IV.** Guarantees given on behalf of constituents (a) In India (b) Outside India **V.** Acceptances, endorsements and other obligations **VI.** Other items for which the bank is contingently liable **Total**		

5.1.6.2 Guidelines of Reserve Bank of India for Compliance of Financial Statements

Guidelines of Reserve Bank of India for Compliance of Financial Statements			
Given below are the compliance notes of the Reserve Bank of India for balance sheet and profit and loss account as per the revised formats.			
Balance Sheet			
Item	***Schedule***	***Coverage***	***Notes and instructions for compilation***
Capital	1	**Nationalised Banks** (Fully Owned by Central Government) Banking companies incorporated outside india **Other Banks (Indian)** Authorised Capital (....Shares or Rs. each) Issued Capital (..Shares of Rs......each) subscribed Capital (......Shares of Rs.....each) Called up Capital (...........Shares of Rs........each. Less: Calls unpaid........ Add: Forfeited shares.....Paid up to capital.........	The capital owned by Central Government as on the date of the Balance Sheet including contribution from Government, if any, for participating in World Bank Projects should be shown. (*i*) The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head. (*ii*) The amount of deposits kept with RBI, under sub-section 2 of section 11 of the Banking Regulation Act, 1949 should also be shown. Authorised, Issued, Subscribed, Called-up Capital should be given separately. Calls-in-arrears will be deducted from Called up capital while the paid-up value of forfeited shares should be added thus arriving at the paid-up capital. Where necessary, items which can be combined should be shown under one head for instance 'Issued and Subscribed Capital'.

			Notes – General The changes in the above items, if any, during the year, say, fresh contribution made by Government, fresh issue of capital, capitalisation of reserves, etc. may be explained in the notes.
Reserves and Surplus	2	**(I) Statutory Reserves**	Reserves created in terms of Section 17 or any other section of Banking Regulation Act must be separately disclosed.
		(II) Capital Reserves	The expression 'capital reserves' shall not include any amount regarded as free for distribution through the profit and loss account. Surplus on revaluation should be treated as Capital Reserves. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves. Surplus on translation of the financial statements of foreign branches (which includes fixed assets also) is not a revaluation reserve.
		(III) Share Premium	Premium on issue of share capital may be shown separately under this head.
		(IV) Revenue and other Reserves	The expression 'Revenue Reserve' shall mean any reserve other than capital reserve. This item created will include all reserves other than those separately classified. The expression Reserve shall not include any amount retained by way of providing renewals or diminution in value of assets or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.
		(V) Balance of Profit	Includes balance of profit after appropriations. In case of loss the balance may be shown as a deduction. **Notes – General** Movements in various categories of Reserves should be shown as indicated in the schedule

Deposits	3	**A.(I) Demand Deposits**	
		(i) from banks	Includes all bank deposits repayable on demand.
		(ii) from others	Includes all demand deposits of the non-bank sectors. Credit balances in over-drafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, certificates of deposits, etc. are to be included under this category.
		(II) Saving Bank Deposits	includes all savings bank deposits (including inoperative savings bank accounts)
		(III) Term Deposits	
		(i) from banks	Includes all types of bank deposits repayable after a specified term.
		(ii) from others	Includes all types of deposits of the non-bank sector repayable after a specified term. Fixed deposits, cumulative and recurring deposits, cash certificates, certificates of deposits, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non-resident deposits accounts, etc. are to be included under this category.
		B. (i) Deposits of branches in India (ii) Deposits of branches outside India	The total of these two items will agree with the total deposits.
			Notes – General (*a*) Interest payable on deposits which is accrued but not due should not be included but shown under other liabilities. (*b*) Matured time deposits and cash certificates, etc. should be treated as demand deposits. (*c*) Deposits under special schemes should be included under term deposits if they are not payable on demand. When each deposits have matured for payments they should beshown under demand deposits. (*d*) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks which may or may not have a presence in India.

Borrowings	4	**(I) Borrowings in India** (i) Reserve Bank of India (ii) Other banks (iii) Other institutions and agencies **(II) Borrowings outside India** Secured borrowings included above	Includes borrowings/refinance obtained from Reserve Bank of India. Includes borrowings/refinance obtained from commercial banks (including cooperative banks). Includes borrowings/refinance obtained from Industrial Development Bank of India, Export-Import Bank of India, National Bank for Agriculture and Rural Development and other institutions, agencies (including liability against participation certificates, if any) Includes borrowings of India branches abroad as well as borrowings of foreign branches. This item will be shown separately. Includes secured borrowings/refinance in India and outside India. **Notes – General** (*i*)The total of I & II will agree with the total borrowings shown in the balance sheet. (*ii*) Inter-office transactions should not be shown as borrowings. (*iii*) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc. should be classified depending upon documentation, as 'deposits' 'borrowings', etc. (*iv*) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head 'Borrowings'. Hence, advances will be shown at the gross amount on the assets side

Other liabilities and provisions	5	**I.** Bills payable **II.** Inter-office adjustment (net) **III.** Interest accrued **IV.** Others (including provisions)	Includes drafts, telegraphic transfers, travellers' cheques, mail transfers payable, pay slips, bankers cheques and other miscellaneous items. The inter-office adjustments balance, if in credit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. Includes interest accrued but not due on deposits and borrowings. Includes the net provision for income tax and other taxes like interest tax (less advance payment tax deducted at source etc.), surplus in aggregate in provisions for bad debts provision account, surplus in aggregate in provisions for depreciation in securities,contingency funds which are not disclosed as a reserve but are actually in the nature of
			reserves, proposed dividend/ transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and fund kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance etc. Certain types of deposits like staff security deposits, margin deposits, etc. where the repayment is not free, should also be included under this head. **Notes – General** (i) For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items. (ii)The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability. (iii)It is proposed to show only pure deposits under this head 'deposits' and hence all surplus provisions for bad and doubtful debts, contingency funds, secret reserves, etc. which are not netted off against the relative assets, should be brought under the head 'Others (including provisions)'. (iv) The amount of subordinated debt raised against Tier II capital should be indicated.

Cash and Balances with the Reserve bank of India	6	**I.** Cash in hand (including foreign currency notes) **II.** Balances with Reserve Bank of India (i) in Current Account (ii) in other Accounts	Includes cash in hand including foreign currency notes and also of foreign branches in case of banks having such branches.
Balances with banks and money at call and short notices	7	**I. In India** (i) Balances with banks (a) in current accounts (b) in other Deposit accounts (ii) Money at call andshort notice (a) with banks (b) with other institutions	Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately. Includes deposits repayable within 15 days orless than 15 days notice lent in the inter-bank call money market.
		II. Outside India (i) Current accounts (ii) Deposits accounts (iii) Money at call and short notice	Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balances held with foreign branches by other branches of the bank should not be shown under this head but should be included in inter-branch accounts. The amounts held in 'current accounts' and 'deposit accounts' should be shown separately. Includes deposits usually classified in foreign countries as money at call and short notice.

Investments	8	**I. Investments in India**	
		(i) Government securities	Includes Central and State Government securities and Government treasury bills. These securities should be shown at the book value. However, the difference between the book value and market value should be given in the notes to the balance sheet.
		(ii) Other approved securities	Securities other than Government securities, which according to the Banking Regulation Act, 1949 are treated as approved securities*, should be included here.
		(iii) Shares	Investments in share of companies and corporations not included in item (*ii*) should be included here.
		(iv) Debentures and Bonds	Investments in debentures and bonds of and corporations not included in item (*ii*) should be included here.
		(v)Investmentsin subsidiaries/ joint ventures	Investments in subsidiaries/joint ventures (including RRBs) should be included here.
		(vi) Others	Includes residual investments, if any, like gold, commercial paper and other instruments in the nature of shares/ debentures/ bonds.
		II. Investments outside India	
		(i) Government securities (including local authorities)	All foreign Government securities including securities issued by local authorities may be
		(ii) Subsidiary and/ or joint ventures abroad	All investments made in the share capital of subsidiaries floated outside India and/or joint ventures abroad should be classified under this head.
		(iii) Others	All other investments outside India may be shown under this head.

Advances	9	A. (i) Bills purchased and discounted (ii) Cash credits, over-drafts and loans repayable on demand (iii) Term loans B. (i) Secured by tangible assets (includes advances against book debts) (ii) Covered by Bank/ Government Guarantee (iii) Unsecured C. **I.** Advances in India (i) Priority sectors (ii) Public sector (iii) Banks (iv) Others **II.** Advances outside India (i) Due from banks (ii) Due from others (a) Bills purchased and discounted (b) Syndicate loans (c) Others	In classification under section 'A'. All out standings in India as well as outside less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads. Including overdue installments. All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC & ECGC are to be included. All advances not classified under (*i*) and (*ii*) will be included here. Total of 'A' should tally with the total of 'B'. Advances should be broadly classified into 'Advances in India, and 'Advances outside India'. Advances in India will be further classified on the sectoral basis as indicated. Advances to sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank are to be classified under the head 'Priority sector'. Such advances should be excluded from item (ii) *i.e.,* advances to public sector. Advances to Central and State Governments and other Government undertaking including Government companies and corporations which are, according to the statutes, to be treated as public sector companies are to be included in the category "Public Sector". All advances to the banking sector including co-operative banks will come under the head 'Banks'. All the remaining advances will be included under the head 'Others' and typically this category will include non-priority advances to the private, joint and co-operative sectors. **Notes – General** (*i*) The gross amount of advances including refinance but excluding rediscounts provisions made to the satisfaction of auditors should be shown as advances. (*ii*) Term loans will be loans not repayable on demand.

			(*iii*) Consortium advances would be shown net of share from other participating banks/ institutions.
Fixed Assets	10	**I.** Premises (i) At cost as on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Premises wholly or partly owned by the banking company for the purpose of business after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of the revision made.
		II. Other Fixed Assets(including furniture and fixtures) (i) At cost on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Motor vehicles and other fixed assets other than premises but including furniture and fixtures should be shown under this head.
Other Assets	11	**I.** Inter-office adjustments (net)	The inter-office adjustments balance, if in debit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balances of inter-office adjustment accounts, all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown representing mostly items in transit and unadjusted items.
		II. Interest accrued	Interest accrued but not due on investments and advances and interest due but not collected on investments will be the main components of this item.
		III. Tax paid in advance/tax deducted at source	As banks normally debit the borrowers' accounts with interest due on the balance sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised on the ordinary course should be shown under this head.

		IV. Stationery and stamps **V.** Non-banking assets acquired in satisfaction of claims. **VI.** Others	The amount of tax deducted at source on securities, advance tax paid etc. to the extent that these items are not set off against relative tax provisions should be shown against this item. Only exceptional items of expenditure on stationery like bulk purchase of securities paper, loose leaf or other ledgers, etc. which are shown as quasi-asset to be written off over a period of time should be shown here. The value should be on a realistic basis and cost escalation should not be taken into account, as these items are for internal use. Immovable properties/tangible assets acquired in satisfaction of claims are to be shown under this head. This will include items like claims which have not been met, for instance, clearing items, provision netted against this item so that only realisable value is shown under this head. Accrued income other than interest may also be included here. Outstanding in credit card operations should be shown as part of “advances” (Schedule instead of clubbing these under “Other Assets”
Contingent Liabilities	12	**I.** Claims against the bank not acknowledged as debts **II.** Liability for partly paid investments **III.** Liability on account of outstanding forward exchange contracts **IV.** Guarantees given on behalf of constituents (i)In India (ii)Outside India **V.**Acceptances endorsements and other obligations **VI.** Other items for which the Bank is contingently liable	Liability on partly paid shares, debentures, etc. will be included under this head. Outstanding forward exchange contracts may be included here. Guarantees given for constituents in India and outside India may be shown separately. This item will include letters of credit and bills accepted by the bank on behalf of customers. Arrears of cumulative dividends, bills rediscounted, commitments under under-writing contracts, estimated amounts of contracts remaining to be executed on capital account and not provided for, etc. are to be included here.
Bills for Collection			Bills and other items in the course of collection and not adjusted will be shown against this item in the summary version only. No separate schedule is proposed.

5.1.7 ACCOUNTING TREATMENT FOR SPECIFIC ITEMS

The following considerations are to be made under the accounting treatment of discounting of bills:

1. Bad Debts: Bad debts are to be deducted from interest and discount in the Profit & Loss Account (Schedule 13). This is also deducted from Advances in Balance Sheet (Schedule 9).
2. Provision for bad & doubtful debts: This is to be shown in the Profit & Loss Account under the head Provision and Contingency (Schedule 16). This is also shown in Balance Sheet under "Other liabilities & Provisions" (Schedule 5).
3. Provision for taxation: Provision for Taxation to be shown in the Profit & Loss Account under the heading "Provision and Contingencies" (Schedule 16). This will then appear in the Balance Sheet under "Other liabilities and Provisions" (Schedule 5).
4. Rebate on bills discounted (R.B.D): (Unearned discount received in advance or unexpired discounted). This refers to unexpired discount. A banking company charges discount in advance for the full period of the bill of exchange or promissory note discounted with it.

5.1 8 TREATMENT OF INTEREST ON DOUBTFUL DEBTS:

Sometimes loan due from a merchant may become doubtful to recover, under this circumstances the interest due from such doubtful debt cannot be credited to interest ac, instead it must be credited to a separate account called "Interest Suspense Account", till the loan is realized.

Accounting Entries:

i) For interest due on Merchant Loan Account which is treated as doubtful:

Merchant Loan A/c Dr

To Interest Suspense A/c

ii) On realization of a portion of interest, the remaining becoming bad:

Interest Suspense A/c (full amount) Dr

To Interest A/c (Portion of the interest expected to realise)

To Merchant Loan A/c (Portion of the interest that becomes bad)

iii) For Receipt of Loan amount along with interest:

Cash A/c (Principal plus a portion of interest falling good) Dr

Bad debts A/c (Portion of doubtful debts over debts falling good) Dr

To Merchant Loan A/c

5.1 9 Provision for NPA on Loans and Advances

In conformity with the prudential norms, provisions should be made on the non-performing assets on the **basis of classification of assets.** The banks should make provision against loss assets, doubtful assets, sub-standard assets and standard assets as follows:

Loss Assets

The entire assets should be written-off after obtaining necessary approval from the competent authority. If the assets are permitted to remain in the books for any reason-, ***100% of the outstanding should be provided for.***

Doubtful Assets

(a) ***100 per cent*** of the extent to which the advance is ***not covered by the realisable value of the security***to which the bank has a valid recourse should be made and the realisable value is estimated on a realistic basis.

(b) In regard to the ***secured portion,*** provision may be made on the following basis, at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful:

Period for which the advance has remained in 'doubtful' category	**Provision requirement**
Up to one year	20 per cent
One to three years	30 per cent
More than three years (i) Outstanding stock of NPA As a on March 31, 2004	- 50 per cent as on March 31, 2004 - 60 per cent with effect from March 31, 2005 - 75 per cent with effect from March 31, 2006 - 100 per cent with effect from March 31, 2007
(ii) Advances classified as 'doubtful' for more than three years on or after April 1, 2004.	100 per cent with effect from March 31, 2005

Sub-standard Assets

A general provision of ***10 per cent*** on total outstanding should be made without making any allowance for DICGC/ECGC guarantee cover and securities available.

Standard Assets

From the year ending 31.03.2000, the banks should make a general provision of a Minimum of ***0.25 per cent*** on standard assets. There is no objection if the banks create provision beyond the specified limits on their own.

5.1 10 Practical problem on rebate on bills discounted and non performing assets

Illustration 1

On 31st March 2013 a bank held the following bills discounted by it earlier.

Date of bills 2013	Terms of bills months	Discounted @% p.a	Amount of bills ₹
i) January 17	4	17	7,30,000
ii) February 7	3	18	14,60,000
iii) March 9	3	17.5	3,64,000

You are required to calculate the rebate on bills discounted. Also show the necessary journal entry for the rebate.

Solution

Date of bill 2013	Date of maturity 2013	No of days away from	Discount Rate	Amount of bill ₹	discount for days After 31.3.2013
January 17	May 20	50	17%	7,30,000	17,000
February 7	May 10	40	18%	14,60,000	28,800
March 9	June 12	73	17.5%	3,64,000	12,740
Closing rebate on bills					58,540

Journal Entries

Date	Particulars	Dr.	Cr.
31.3.2013	Discount Received A/c	58,540	
	To Rebate on bills discounted		58,540

Illustration 2

Following are the statements of interest on advances in respect of performing and non-performing assets of Madura Bank Ltd. Find out the income to be recognised for the year ended 31st March, 2012. [all figures in rupees lakhs]

Performing Assets	Interest earned	Interest received
Cash credit and overdrafts	1,800	1,060
Term loan	480	320
Bills Purchased and discounted	700	550
Non-performing Assets		
Cash credit and overdrafts	450	70
Term Loan	300	40
Bills purchased and discounted	350	36

Solution

As per RBI's 'Prudential Norms', interest on performing assets should be recognised as income on **accrual basis.** However, interest on non-performing assets should not be recognised as income unless the same has been **realised.**

Calculation of Income to be Recognised

Particulars	₹	₹
1. Interest on Cash Credit and Overdraft		
— Performing assets (earned)	1,800	
—Non-performing assets (received)	70	1,870
2. Interest on Term Loan		
— Performing assets (earned)	480	
— Non-performing assets (received)	40	520
3. Bills Purchased and Discounted		
— Performing assets (earned)	700	
— Non-performing assets (received)	36	736
Total Income to be Recognised		3,126

Illustration 3

The following two term loan accounts were sanctioned by UBI Main Branch, Kolkata on 1st January, 2005. The details are given below;

Particulars		**Loan A/C A & Co.**	**Loan A/c B & Co.**
(i) Amount of loan	₹	6,00,000	10,00,000
(ii) Period		5 years	5 years
(iii) Basis of Installment		Quarterly	Half yearly
(iv) Rate of interest	(%)	12	12
(v) Amount of installments	₹	30,000 + Interest	1,00,000+ Interest

You are required to find out the date of which these accounts will become NPA. Assume that there is no recovery.

Solution

Calculation of Date of NPA

Particulars	**Loan A/C A & Co.**	**Loan A/c B & Co.**
Date of Loan	1.1.2005	1.1.2005
Basis of Installment	Quarterly	Half yearly
Due Date for 1st Installment	31.3.2005	30.6.2005
Overdue starts	1.4.2005	1.7.2005
Date of NPA Symptom (Exact date of NPA> 90 days)	29.6.2005	28.9.2005

Illustration 4.

The following two term loan accounts were sanctioned by UBI Main Branch, Kolkata on 1st January, 2005. The details are given below;

Particulars		Loan A/C A & Co.	Loan A/c B & Co.
(i) Amount of loan	₹	6,00,000	10,00,000
(ii) Period		5 years	5 years
(iii) Basis of Installment		Quarterly	Half yearly
(iv) Rate of interest	(%)	12	12
(v) Amount of installments	₹	30,000 + Interest	1,00,000+ Interest

You are required to find out the date of which these accounts will become NPA. Assume that there is no recovery.

Solution

Calculation of Date of NPA

Particulars	Loan A/C A & Co.	Loan A/c B & Co.
Date of Loan	1.1.2005	1.1.2005
Basis of Installment	Quarterly	Half yearly
Due Date for 1st Installment	31.3.2005	30.6.2005
Overdue starts	1.4.2005	1.7.2005
Date of NPA Symptom (Exact date of NPA> 90 days)	29.6.2005	28.9.2005

Illustration 5

From the following information find out the amount of provisions to be shown in the Profit and Loss Account of a Commercial Bank.

Assets	(₹ in lakhs)
Standard	4,000
Sub-standard	2,000
Doubtful one year	900
Doubtful three years	400
Doubtful more than three years	300
Loss on Assets	500

Solution **Calculation of Required Provision**

Type of Assets	Amount (₹ in Lakhs	% of Provision	Required Provision (₹ in Lakhs)
Standard	4,000	0.25	10
Sub-standard	2,000	10.00	200
Doubtful up to one year (Note1)	900	20.00	180
Doubtful up to three years (Note 1)	400	30.00	120
Doubtful more than three years (Note 1)	300	50.00	150
Loss	500	100.00	500
Total Provision Required			1,160

Working Note: (1) It is assumed that doubtful assets are all fully secured. If it is unsecured then 100% provision is to be made.

Illustration 6

From the following details, compute the amount of provision required to be made in the Profit and Loss Account of Evergreen Bank Ltd. for the year 2011-12:

Assets	(₹in Lakhs)
Standard	16,000
Sub-standard	12,000
Doubtful:	
— One year (secured)	4,800
— For two to three years (secured)	3,600
— For more than three years (secured by mortgage of machinery worth Rs 1,000 lakhs)	1,800
Non-recoverable assets	3,000

Solution

Calculation of Required Provision

Type of Assets	Amount (₹ in Lakhs)	% of Provision	Required Provision (₹ in Lakhs)
Standard	16,000	0.25	40
Sub-standard	12,000	10.00	1,200
Doubtful—one year (secured)	4,800	20.00	960
—for two to three year (secured)	3,600	30.00	1,080
— for more than three years (secured)	1,000	50.00	500
— for more than three years	800	100.00	800
(unsecured)	3,000	100.00	3,000
Non-recoverable assets			
Total Provision Required			7,580

5.1.10 Preparation of Profit and Loss Account

Illustration 7

From the following particulars, prepare a Profit and Loss Account of Maruthi BankLtd., for the year ended 31.03.2014.

	₹ (in '000)		*₹ (in ' 000)*
Interest on loans	350	Interest on cash credits	250
Interest on fixed deposits	320	Rent and taxes	20
Rebate on bills discounted	60	Interest on overdrafts	35
Commission charged to customers	12	Directors' and Auditor's fees	4
Establishment expenses	66	Interest on saving bank accounts	85
Discount on bills discounted	250	Postage and telegrams	3
Interest on current accounts	65	Sundry charges	1
Printing and advertisements	5		

Solution:

Maruthi Bank Ltd.

Profit and Loss Account for the year ended 31.03.2014

		Schedule No.	Year ended 31.03.2014 ₹ (in ' 000)	Year ended 31.03.2013 ₹ (in ' 000)
I.	*Income*			
	Interest earned	13	885	
	Other income	14	12	
	Total		897	
II.	*Expenditure*			
	Interest expended	15	470	
	Operating expenses	16	93	
	Total		563	
III.	*Profit/Loss:*			
	Net Profit for the year (I-II)		334	
	Profit brought forward		-	
	Total		334	
IV.	*Appropriations:*			
	Transfer to statutory reserve (25% of 334)		83.5	
	Transfer to other reserves		-	
	Transfer to Government/proposed dividend	-	-	
	Balance carried over to balance sheet		250.5	
			334	

Working notes:

Schedule 13: Interest earned

	₹ (in '000)	
Interest on loans	350	
Discount on bills discounted	250	
Interest on cash credits	250	
Interest on overdraft	35	
Total	885	

Note: Rebate on bills is the closing rebate and it will be shown in schedule 5 in Balance Sheet

Schedule 14: Other income

Commission charged to customers	12	
Total	12	

Schedule 15: Interest expended

Interest on fixed deposits	320	
Interest on current accounts	65	
Interest on savings bank accounts	85	
	470	

Schedule 16: Operating expenses

Establishment expenses	66	
Printing and Advertisements	5	
Rent and Rates	20	
Director's and Auditor's fees	4	
Postage & Telegrams	3	
Sundry charges	1	
Total	93	

Provisions and Contingencies

	Nil	
	Nil	

Illustration 8

The following figures are extracted from the books of Deena Bank Ltd. as on 31.03.2014.

	₹in 000		₹in 000
Interest and discount received	40,85,700	Rent received	75,000
Commission, exchange and brokerage	3,00,000	Salaries and allowances	2,50,000
Directors' fees and allowances	70,000	Legal charges paid	74,600
Postage and telegrams	65,350	Depreciation on building	34,500
Preliminary expenses	20,000	Audit fees	5,500
Interest paid on deposits	27,55,500	Stationery	22,575
Profit on sale of investments	1,50,000		

Additional information:

(i) One of a customers to whom a sum of ₹7,00,000 thousand has been advanced has become insolvent. It is expected that only 50% can be recovered from his private

(ii) For the remaining debts, a provision of ₹ 1,00,000 thousand was necessary.

(iii) Rebate on bills discounted as on 31.03.2013₹10,000thousand and on 31.03.2014₹ 12,000thousand.

(iv) Provide ₹5,00,000 thousand for taxation.

(v) Write off all preliminary expenses.

Prepare Profit and Loss Account as per the legal requirement.

Solution:

Deena Bank Ltd.
Profit & Loss A/c for the year ended 31st March 2014

		Schedule No.	*Year ended 31.03.2014 (current year)* ₹in 000
I.	*Income*		
	Interest earned	13	40,83,700
	Other income	14	5,25,000
	Total		46,08,700
II.	*Expenditure*		
	Interest expended	15	27,55,500
	Operating expenses	16	5,42,525
	Provisions & contingencies		9,50,000
	Total		42,47,025
III.	*Profit/Loss*		
	Net profit for the year (I-II)		3,61,675
	Profit brought forward		-
	Total		3,61,675
IV.	*Appropriations:*		
	Transfer to statutory reserves (25% of 3,61,675)		90,419
	Transfer to other reserves		-
	Transfer to Government/proposed dividend		-
	Balance carried over to Balance Sheet		2,71,256
			3,61,675

Working notes:

Schedule 13: Interest earned

		₹in 000
	Interest and discount received	40,85,700
Add	Rebate on bills discounted on 31.12.86	10,000
		40,95,700
Less:	Renate on bills discounted on 31.12.87	12,000
		40,83,700

Schedule 14: Other income

	₹in 000
Commission exchange & brokerage	3,00,000
Rent received	75,000
Profit on sale of investments	1,50,000
	5,25,000

Schedule 15: Interest expended

	₹in 000
Interest paid on deposits	27,55,500

Schedule 16: Operating expenses

	₹in 000
Directors' fees and allowances	70,000
Postage and telegrams	65,350
Stationery	22,575
Preliminary expenses	20,000
Salaries and allowances	2,50,000
Legal charges paid	74,600
Depreciation on building	34,500
Audit fees	5,500
Total	5,42,525

Provision and Contingencies

	₹in 000
Bad debts (7,00,000 x 50%)	3,50,000
Provision for bad debts	1,00,000
Provision for taxation	5,00,000
Total	9,50,000

Illustration 9

From the following information, prepareProfit and Loss Account of Khan Bank Ltd., for the year ended 31st March 2014.

	₹in 000		₹in 000
Interest on loans	650	Salaries and allowances	140
Discount on bill discounted	415	Rent, taxes and insurance	40
Commission, exchange and brokerage	24		
Directors' fees and allowances	25	Legal charges paid	3
Postage and telegrams	2	Depreciation on building	10
Interest paid on fixed deposits	430	Audit fees	12
Interest on over drafts	210	Printing and Stationery	4
Interest on cash credits	410	Locker rent	5
Interest on Savings bank deposits	125	Repairs to bank property	2
Provident fund contribution	12	Transfer fees	2
Local committee fees and allowances	10	Advertisement	4
Loss on sale of Government securities	5	Loss on sale of furniture	2

Additional information:

(i) Rebate on bills discounted on 31st March, 2013₹19,000.

(ii) Rebate on bills discounted on 31st March 2014 ₹26,000.

(iii) Bad debts to be written off ₹40,000.

(iv) Provide for taxation ₹50,000.

Solution:

Khan Bank Ltd.
Profit and Loss A/c for the year ended 31st March.2014

	Schedule No.	₹(in '000)
I. *Income:*		
Interest earned	13	1,678
Other income	14	24
		1,702
II. *Expenditure:*		
Interest expended	15	555
Operating expenses	16	264
Provisions and contingencies		90
		909
III. Profit/Loss:		793
Net Profit for the year (I-II)		-
Profit brought forward		
		793

IV.	Appropriations:		
	Transfer to statutory reserve		158.4
	(20% of 7,93,00)		-
	Transfer to other reserves		-
	Transfer to Government/proposed dividend		
	Balance carried over to Balance Sheet		634.4
			798.0

Working notes:

Schedule 13 : Interest earned

		₹(in '000)
	Interest on loans	650
	Discount on bills discounted	415
	Interest on overdraft	210
		1,685
Add:	Opening rebate on bills discounted	19
		1,704
Less:	Closing rebate on bills discounted	26
		1,678

Schedule 14 : Other income

			₹(in'000)
	Lockers rent		5
	Commission, exchange and brokerage		24
	Transfer fees		2
			31
Less:	Loss on sale of Govt. securities	5	
	Loss on sale of furniture	2	7
			24

Schedule 15 : Interest expended

Interest on fixed deposits	430
Interest on savings bank deposits	125
	555

Schedule 16 : Operating expenses

Salaries and allowances	140
Rent, taxes, insurance and lighting	40
Repairs to bank property	2
Director's fees and allowances	25
Provident fund contribution	12
Local committee fees and allowances	10
Audit fees	12
Printing and Stationery	4
Postage and telegrams	2
Depreciation	10
Advertisement	4
Legal charges	3
	264

Provisions and contingencies

Bad debts written off	40
Provision for taxation	50
	90

5.1.11 Preparation of Balance Sheet Account

Illustration 10

From the following particulars prepare the balance sheet of Vikram Bank Ltd, as on 31[st]March, 2014:

Particular	Dr. ₹	Cr. ₹
Share capital	---	10,00,000
Reserve fund	---	16,00,000
Fixed deposit	---	40,00,000
Savings bank deposits	---	60,00,000
Current A/c	---	2,20,00,000
Money at call and short notice in India	20,00,000	---
Bills discounted and purchased in India	9,00,000	---
Investments at cost:		
Central and State Govt. Securities	10,00,00,000	---
Debentures	4,00,000	---
Bullion	24,00,000	---
Reserve for buildings	---	10,00,000
Premises at cost	10,00,000	---
Addition to premises	20,00,000	---
Depreciation fund on premises	---	80,00,000
Cash with Reserve Bank of India	34,00,000	---
Cash with State Bank of India	12,00,000	---
Unclaimed dividend	---	24,000
Unexpired discount	---	50,000
Loans, advances, overdraft and cash credit in India	10,00,00,000	---
Branch adjustment	57,94,000	---
Silver	2,00,000	---

Advance payment of tax	1,10,000	---
Interest accrued on investments	2,60,000	---
Non-banking assets acquired	70,000	---
Borrowings from banks in India	---	2,50,000
Bills payable	---	20,00,000
Profit and loss A/c including ₹ 2,10,000 for the year	---	4,10,000
Dividend fluctuation fund	---	6,00,000
	4,69,34,000	**4,69,34,000**

Additional information:

i) The bank had bills for collection for its constituents ₹3,00,000 and acceptances ₹4,00,000.

ii) There was of claim of ₹2,00,000 against the bank but not acknowledged as debt. The liabilities for bills re-discounted was ₹ 32,000.

iii) Liability for forward exchange contract was ₹20,00,000.

iv) The Directors decided to reserve ₹ 2,000 for unexpired discounts and transfer reserve for building to depreciation fund.

Solution

Vikram Bank Limited

BALANCE SHEETas on 31st March, 2014

		₹('000)
	Schedule	
Capital and liabilities	1	1,000
Capital	2	2,608
Reserve and surplus	3	32,000
Deposits	4	250
Borrowings	5	11,076
Other liabilities and provisions		46,934
Total		
ASSETS		
Cash and balance with RBI	6	3,400
Balance with banks and money at call and short notice	7	1,400
Investments	8	12,800
Advances	9	10,900
Fixed assets	10	12,000
Other assets	11	6,434
		46,934
Contingent liabilities	12	2,632
Bills of collection		300

Schedule1: Capital		
		₹('000)
Issued, subscribed and paid up		1,000
Schedule2: Reserves & Surplus		₹('000)
(i) Statutory reserve		1,600
Addition during the year		42
(ii) Revenue and other reserves:		
Dividend equalisation fund		600
(iii) Profit and loss A/c (368 - 2)		366
Total		2,608
Schedule3: Deposits		
		₹('000)
Demand deposits		22,000
Savings bank deposits		6,000
Term deposits		4,000
	Total	**32,000**
Schedule 4: Borrowings		
Borrowings in India		₹('000) 250
Schedule5: Other Liabilities and Provisions		
		₹('000)
Bills payable		2,000
Unexpired discount		52
Unclaimed dividends		24
Depreciation fund		9,000
	Total	11,076
Schedule 6: Cash and Balances with Reserve Bank of India		
		₹('000)
Balances with RBI		3,400
Schedule 7: Balances with Banks & Money at Call & Short Notice		
		₹('000)
Balance with SBI		1,200
Money at call and short notice		200
	Total	1,400

Schedule 8: Investments	
	₹('000)
Central and State Government Securities	10,000
Debentures	400
Bullion	2,400
Total	12,800

Schedule 9: Advances	
Bills purchased and discounted	₹('000)
Loans, cash credit, advances and overdrafts	900
	10,000
Total	10,900

Schedule10: Fixed Assets	
	₹('000)
Premises at cost	10,000
Addition during the year	2,000
Total	12,000

Schedule 11: Other Assets	
	₹('000)
Branch adjustment	5,794
Silver	200
Advance payment of tax	110
Interest accrued on investments	260
Non-Banking assets	70
Total	6,434

Schedule 12: Contingent Liabilities	
	₹('000)
Claims against the bank not acknowledged as debt	200
Liability on bills discounted	32
Liability for forward exchange contract	2,000
Acceptances, endorsements and other obligations	400
Total	2,632

Illustration 11

On 31st March 2014the following balances stood in the books of Asian Bank Ltd. after preparation of its profit and Loss Account:

	₹('000)
Share Capital: Issued and subscribed	4,000
Reserve fund (under section17)	6,200
Fixed deposits	42,600
Savings bank deposits	19,000
Current accounts	23,200
Money at calls and short notice	1,800
Investments	25,000
Profit and Loss Account (cr) 1st April 2010	1,350
Dividend for 2010-2011	400
Premises	2,950
Cash in hand	380
Cash with RBI	10,000
Cash with other banks	6,000
Bills discounted and purchased	3,800
Loans, cash credits and over drafts	51,000
Bills payable	70
Unclaimed dividend	60
Rebate on bills discounted	50
Short loans (borrowing from other banks)	4,750
Furniture	1,164
Other assets	336
Net Profit for 2013-2014	1,550

Prepare balance sheet of the bank as on 31st March 2014.

Solution

Asian Bank Ltd Balance Sheet as on 31st March.2014

Capital and liabilities	Schedule	₹('000)
Capital	1	4000
Reserve and surplus	2	8700
Deposits	3	84800
Borrowings	4	4750
Other liabilities and provisions	5	180
Total		102430
Assets		
Cash and balance with RBI	6	10380
Balance with banks and money at call and short notice	7	7800
Investments	8	25000
Advances	9	54800
Fixed assets	10	4114
Other assets	11	336
		102430
Contingent liabilities	12	Nil
Bills of collection		Nil

Schedules

Schedule 1 – Capital			
		As on 31.03.2014 (current year) ₹('000)	As on 31.3.2013 (previous year) ₹('000)
I. Share Capital:		4000 4000	
Schedule 2- Reserves & Surplus			
I. Statutory Reserves			
Reserve Fund		6200	
II. Share Premium			
III. Balance in Profit and loss Account		Nil	
Opening Balance	1350		
Less: Dividend 2015-14	400		
	950		
Add: Net profit after deducting statutory reserve	1162.5	2112.5	
Statutory reserve		387.5	
		8700	
Schedule 3 – Deposits			

A. I. Demand Deposits (i) From banks (ii) From others **II. Savings Bank Deposits** **III. Term Deposits** (i) From Banks (ii) From others **Total :(I, II and III)**	- 23200 19000 42600 - 84800	
Schedule 4 – Borrowings		
I. Borrowings in India (i) Other banks	4750 4750	
Schedule 5 - Other Liabilities and Provisions		
I. Rebate on Bills Discounted II. Bills payable III. Unclaimed dividend	50 70 60 180	
Schedule 6 - Cash and Balances with Reserve Bank of India		
I. Cash in hand **II. Balances with Reserve Bank of India** (i) In Deposit Account	380 10000 10380	
Schedule 7 - Balances with Banks & Money at Call & Short Notice		
I. In India (i) Money at call and short notice (a) cash with banks	1800 6000 7800	
Schedule 8 – Investments		
I. Investments in India in	25000	
Schedule 9 – Advances		
A. (i) Bills purchased and discounted (ii)Cash credits, overdrafts and loans payable on demand (iii)Term loans	3800 51000 - 54800	
Schedule 10 - Fixed Assets		
I. Premises **II.** Furniture	2950 1164 4114	
Schedule 11 - Other Assets		
I Other assets	336	
Schedule 12 - Contingent Liabilities		

	Nil	

5.1.12 Preparation of Profit and Loss Account and Balance Sheet

Illustration 12

The following Trial Balance was extracted from the books of the United Bank of India as on 31 March 2014:

	₹('000)	₹('000)
Capital (fully owned by Central Govt.)		3,00,000
Cash in hand	46,350	-
Investments Bonds of Companies	1,94,370	-
Other investment in Shares	1,55,630	-
Gold Bullion	15,130	-
Interest Accrued on Investments	24,620	-
Security deposits of employees	-	15,000
Savings account balance	-	7,420
Current account ledger control A/c	-	97,000
Fixed deposits	-	23,050
Share premium a/c	-	90,000
Statutory reserve	-	1,40,000
Silver Bullion	2,000	-
Constituents' liability for acceptance and		-
endorsements	56,500	-
Buildings	65,000	
Furniture	5,000	77,230
Borrowing from banks	-	
Money-at-call and short notice	26,000	-
Advances	2,00,000	6,500
Profits and loss account balance	-	
Bills discounted and purchased	12,500	43,500
Bills for collection	-	56,500
Acceptances and endorsements	-	72,000
Interest	7,950	25,300
Commission and brokerage	-	42,000
Discounts	-	-
Bills receivable being bills for collection	43,500	-
Audit fees	5,000	-
Loss on sale of furniture	1,000	-
Directors' fees	1,000	-
Salaries	21,200	-
Postage	50	600
Rent	-	1,200

Profit on Bullion	-	-
Managing directors' remuneration	12,200	2,700
Miscellaneous income	-	-
Loss on sale of investments	30,000	-
Deposit with reserve bank of India	75,000	-
Branch adjustments	20,000	20,000
Depreciation reserve on building	-	
Total	10,20,000	10,20,000

You are required to prepare a Profit and Loss Account for the year ended 31st March 2014 and Balance Sheet as at that date after considering the following:

i) Provide rebate on bills discounted ₹. 5,000,000

ii) A scrutiny of the Current Account Ledger reveals that there are accounts overdrawn to the extent of ₹25,000 and the total of the credit balances is ₹122,000,000.

iii) Claims by employees for bonus ₹15,000,000 is pending award of arbitration.

iv) Depreciation on building for the year amounts to ₹5,000.000

v) Out of profits for the yet 25 per cent thereof transferred to Statutory Reserve and the Directors proposed a dividend of 8 per cent , subject to deduction of tax.

Solution

Balance Sheet of United Bank of India as on 31st March 2014			
	Schedule No.	As on 31.03.2014. (current year) ₹('000)	As on 31.3.2013 (previous year) ₹('000)
Capital & Liabilities			
Capital	1	300000	
Reserve & Surplus	2	267900	
Deposits	3	152470	
Borrowings	4	77230	
Other liabilities and provisions	5	44000	
Total		**841600**	
Assets			
Cash and balances with Reserve Bank of India	6	121350	
Balance with banks and Money at call and short notice	7	26000	
Investments	8	365500	
Advances	9	237500	
Fixed Assets	10	45000	
Other Assets	11	46620	
Total		**841600**	
Contingent liabilities	12	71500	
Bills for collection		435000	

Schedules

Schedule 1 – Capital		
	As on 31.03.2014 (current year) ₹('000)	As on 31.3.2013 (previous year) ₹('000)
I. Capital (Fully owned by Central Government)	3,00,000 3,00,000	
Schedule 2- Reserves & Surplus		
I. Statutory Reserves Opening Balance Additions during the year	 1,40,000 11,080 1,51,080	
II. Share Premium Opening Balance	 90,000 90,000	
III. Balance in Profit and loss Account	26,820 26,820	
Total : (I, II, III, IV and V)	2,67,900	
Schedule 3 – Deposits		
A. I. Demand Deposits (i) From banks (ii) From others	 - 1,22,000 1,22,000	
II. Savings Bank Deposits	7,420	
III. Term Deposits (i) From Banks (ii) From others	 - 23,050	
Total :(I, II and III)	1,52,470	
Schedule 4 – Borrowings		
I. Borrowings in India (i) Other banks	 77,230 77,230	
Secured borrowings included in I above – Rs. 77,230 (assumed)		
Schedule 5 - Other Liabilities and Provisions		
I. Security Deposits of Employees	15,000	
II. Rebate on Bills Discounted	5,000	
III. Proposed Dividends	24,000 44,000	
Schedule 6 - Cash and Balances with Reserve Bank of India		
I. Cash in hand	46,350	
II. Balances with Reserve Bank of India (i) In Deposit Account	 75,000 1,21,350	

Schedule 7 - Balances with Banks & Money at Call & Short Notice		
I. In India		
(i) Money at call and short notice		
(a) with banks	26,000	
	26,000	
Schedule 8 – Investments		
I. Investments in India in		
(i) Shares	1,55,630	
(ii) Bonds	1,94,370	
(iii) Gold Bullion	15,130	
	3,65,130	
Schedule 9 – Advances		
B. (i) Bills purchased and discounted	12,500	
(ii)Cash credits, overdrafts and loans payable on demand	2,25,000	
(iii)Term loans	-	
	2,37,000	
Schedule 10 - Fixed Assets		
I. Premises		
At cost as on 31.3.91	65,000	
Less: Depreciation to date	25,000	
	40,000	
Schedule 11 - Other Assets		
I. Inter-office adjustments (net)	20,000	
II. Interest accrued	24,620	
III. Silver	2,000	
	46,620	
Schedule 12 - Contingent Liabilities		
I. Claims against the bank not acknowledged as debts	15,000	
II. Acceptances, endorsements and other obligations	56,500	
	71,500	

Form of Profit and Loss Account for the year ended 31.3.2014

	Schedule No.	Year ended 31.03.2014 (current year) ₹('000)	Year ended 31.3.2013 (previous year) ₹('000)
I. Income			
Interest earned	13	1,09,000	
Other income	14	(1,200)	
Total		1,07,800	
II. Expenditure		7,950	
Interest expended	15	44,450	
Operating expenses	16	---	
		52,400	

	Particulars				
	Provisions and Contingencies				
	Total				
III.	*Profit/Loss:*			55,400	
	Net Profit/Loss for the year			6,500	
	Profit/Loss brought forward			61,900	
	Total				
IV.	*Appropriations:*			11,080	
	Transfer to statutory reserve @20 %			24,000	
	Proposed dividend			26,820	
	Balance carried over to balance sheet			61,900	
	Total				
	Schedule 13: Interest earned				
I.	Interest/Discount on				
	advances/bills	72,000			
	Income on Discount	42,000			
	Balances as per Books	1,14,000			
		5,000		1,09,000	
	Less: Rebate on bills discounted			1,09,000	
	Schedule 14: Other income				
I.	Commission, exchange and brokerage			25,300	
II.	Loss on sale of investments			(1,000)	
III.	Loss on revaluation of investments			(30,000)	
IV.	Profit on Bullion			(1,200)	
V.	Rent			600	
VI.	Miscellaneous Income			2,700	
	Note: Loss figures are being shown in			(1,200)	
	brackets				
	Schedule 15: Interest expended				
I.	Interest on deposits			7,950	
				7,950	
	Schedule 16: Operating expenses				
	Payments to and provision for employees			21,200	
	Rent, taxes and lighting			-	
	Printing and stationery			-	
	Advertisement and Publicity			-	
	Depreciation on the Bank's Property			5,000	
	Director's fees, allowances and expenses			13,200	
	\Auditor's fees and expenses			5,000	
	(including branch auditors)				
	Law charges			-	
	Postage, telegrams, telephones etc.			50	
	Repairs and maintenance			-	
	Insurance			-	
	Other Expenditure			-	
	Total			44,450	

5.1.13 Self Test Questions

Theory

1. What are the main features of a bank's accounting system?
2. Explain thespecial features of slip system of posting.
3. Give in brief the various provisions of the Banking Regulation Act, 1949 relating to the annual accounts of a Banking Company.
4. How does rebate on bills discounted arise and how is it brought into record? Explain this with a suitable example.
5. Describe the particulars of advances which must be given either in the Balance Sheets or in the separate schedule to and forming part of the Balance Sheet of Banking Company in India.
6. Give a proforma of a Profit and Loss Account of a Banking Account.
7. Give a proforma of a Balance Sheet of a Banking Account.
8. What are non-performing assets? Discuss the accounting policy to be followed regarding recognition of income in relation to non-performing assets.
9. "Once an asset becomes non-performing, it remains non-performing forever". Comment.
10. State the guidelines given by the RBI regarding making provisions of different categories of bank advances.

Problems

1. From the following information, find out the amount of provision to be shown in the profit and loss account of a commercial bank :

Assets	₹in lakhs
Standard	800
Substandard	6,000
Doubtful:	
For one year	1,000
For three years	600
For more than three years	400
Loss assets	1,200

2. The following are the figures extracted from the books of Sukalyan Bank Ltd. as on 31.03.2015.

	₹		₹
Interest and Discount received	20,30,000	Directors' fees and	
Interest paid on Deposits	12,02,000	allowance	12,000
Issued and Subscribed Capital	5,00,000	Rent and taxes paid	54,000
Reserve under Section 17	3,50,000	Stationery and printing	12,000

Commission, Exchange and Brokerage	90,000	Postage and telegram	25,000
		Other expenses	12,000
Rent received	30,000	Audit fess	4,000
Profit on sale of investment	95,000	Depreciation on Bank's properties	
Salaries and Allowances	1,05,000		12,500

Other information:

(i) Provision for bad and doubtful debts necessary ₹2,00,000.
(ii) Rebate on bills discounted as on 31.03.2005, ₹7,500.
(iii) Provide ₹3,50,000 for income tax.
(iv) The directors desire to declare 10% dividend.

Make the necessary assumptions and prepare the Profit and Loss Account in accordance with the law.

3. The following are the figures extracted from the books of New Era Bank Limited, as on 31.03.2015: (figures in rupees)

	₹		₹
Interest and Discount received	37,05,738	Commission, exchange and brokerage	1,90,000
Interest paid on Deposits	20,37,452		
Issued and Subscribed Capital	10,00,000	Rent received	65,000
Salaries and Allowances	2,00,000	Profit on sale of investments	2,00,000
Directors' fees and allowances	30,000	Depreciation on Bank's properties	30,000
Rent and taxes paid	90,000		
Postage and telegrams	60,000	Stationery expenses	40,000
Statutory reserve fund	8,00,000	Preliminary expenses	25,000
		Auditors' fees	5,000

Other Information:

(a) Transfer 25% of Profit to Statutory Reserve.

(b) Provide ₹.6,50,000 for doubtful debts.

(c) Rebate on bills discounted on 31.03.2014 was ₹12,000 and on 31.03.2015 was ₹16,000.

(d) Provide ₹ 6,50,000 for Income tax.

(e) The directors desire to declare 10% dividends.

Prepare the Profit and Loss Account of New Era Bank Ltd. for the year ended on 31.03.2015.

4. From the following information prepare the Profit and Loss Account of ABC Bank Ltd. for the year ended on 31st March 2014 in the prescribed form.

	₹		₹
Commission	8,200	Establishment	54,000
Interest on fixed deposits	2,75,000	Postage and telegrams	1,400
Interest on savings bank A/cs	68,000	Sundry charges	4,000
Interest on overdrafts	1,54,000	Director's fees	3,000
Discount on bills discounted	1.95,000	Auditor's fees	1,200
Interest on current accounts	42,000	Printing and stationery	2,900
Interest on loan	2,59,000	Sundry charges	1,700
Rebate on bills discounted		Interest on cash credit	2,23,000

Bad debts to be written off amounted to ₹40,000. Provision for taxation may be made @ 55%.Balance of profit from last year was ₹1,20,000. The directors have recommended a dividend of ₹ 20,000 for the shareholders.

5. Form the following information relating to Lakshmi Bank Ltd., prepare the Profit & Loss A/c for the year ended 31st March, 2015.

	₹		₹
Rend received	72,000	Salaries and allowances	2,18,800
Exchange and commission	32,800	Postage	5,600
Interest on fixed deposits	11,00,000	Sundry charges	4,000
Interest on savings bank A/cs	2,72,000	Director's & Auditor's fees	16,800
Interest on onverdrafts	2,16,000	Printing	8,000
Discount on bills discounted	7,80,000	Law charges	3,600
Interest on current accounts	1,68,000	Locker rent	1,400
Interest on cash credits	8,82,000	Transfer fees	2,800
Depreciation on bank property	20,000	Interest on loans	10,36,000

6. From the following information, prepare Profit and Loss Account of Vasavi Bank Ltd. for the year ended on 31st March, 2015. (₹in '000)

Interest on loans	300	Interest on temporary overdrafts in accounts	30
Interest on fixed deposits	275		
Commission	10	Interest on Savings Bank deposits	87
Exchange and brokerage	20		
Salaries and allowances	150	Postage, telegram and stamps	10
Discount on bills (Gross)	152	Printing & Stationery	20
Interest on cash credits	240	Sundry expenses	10
Audit fees	10	Rent	15
		Taxes and licences	10

Additional information:

(1) Rebate on bills discounted ₹30,000; (2) Salary of Managing Director ₹ 30,000; (3)Provision for bad debts ₹ 40,000; (4) Provision for Income tax is to be made@ 55%(round off to the nearestthousand); and (5) Interest of ₹ 4,000 on doubtful debts was wrongly credited to interest on loans account. Working should form part of your answer.

7. From the following particulars of Nandini Bank Ltd., having its own premises, prepare the balance sheet in the prescribed from as on 31st March 2015.

	₹ (in thousands)
Authorised capital	4,000
Subscribed capital 4,00,000 shares of Rs. 10 each ₹ 5 paid	2,000
Investments	7,000
Bills discounted (in India)	15,000
Profit and Loss (Cr)	850
Endorsement on bills for collection	100
Liability of customers for acceptances	5,000
Money at call and short notice	9,000
Cash in hand	2,000
Cash with RBI	4,000
Reserve	3,000
Cash with State Bank	4,000
Letters of credit issued	500
Telegraphic transfers payable	800
Bank drafts payable	1,200
Short loans	40
Rebate on bills discounted	10
Acceptances for customers	5,000
Loans for customers	10,000
Cash credits	10,000
Overdrafts	1,000
Bills purchased (payable outside India)	1,000
Current and deposit accounts	56,000

Investment fluctuation fund	100
Bills for collection	100

Notes: Prepare a trial balance and determine the balancing figure which constitutes the value of premises

8. The following is extracted from the books of Prospects Bank Ltd. as on 31.3.2014. Prepare Profit and Loss Account and a Balance Sheet.

r.	(₹in '000)	Cr	(₹in '000)
Printing and Stationary	35	Statutory Reserve	900
Land and Buildings	1,500	Other income	75
Postage	20	Interest & Discounts	800
Deposit with RBI	100	Borrowing from other Banks	300
Cash Credit, Overdraft. etc.	1425	Profit on Sale of investments	20
Term Loans	1,275	Savings Deposit	325
Interest Accrued (Dr)	50	Paid-up Capital	2,000
Cash in Hand	200	Profit & Loss Account (Cr.)	650
Deposits with other Banks	400	Current Account	125
Investments	300	Fixed Deposit	275
Bills Purchased and Discounted	100	Commission Exchange & Brokerage	200
Interest paid	120	Bills Payable	25
Salaries	75	Rent Recived	80
Repairs	25	Borrowing from RBI	100
Furniture	250		
Total	**5875**	**Total**	**5875**

The Bank has accepted bills on behalf of customers worth ₹2,00,000.Depreciation is to be charged ₹80,000 on Land and Buildings and ₹3,500 on Furniture. Create provision for Taxation ₹1,10,000.

Lesson 5.2

Final Statements of Accounts of Insurance Companies

Learning Objectives

After reading this lesson you should be able to

- Know the important provisions relating to final accounts of insurance companies
- Familiar with the prescribed formats of the Revenue account, Profit and Loss Account and Balance Sheet of a insurance company
- Understand the mode of disclosure of accounting policies adopted by a insurance company and accounting treatment for specific adjustment in final accounts
- Prepare final accounts of both life and general insurance companies.

5.2.1 Introduction

In an Insurance Contract one party agrees for a consideration called premium to indemnify the other against a possible loss or to pay a stated sum of money on the happening of a particular event. This agreement or contract when put in writing is known as **policy**. The person whose risk is covered is called **insured or assured** and the company or corporation which insures is known as **insurer, assurer or underwriter**. The consideration in return for which the insurer agrees to make good the loss is known as **premium**.

5.2.2 Types of Insurance

From accounting point of view, the insurance may be divided into two as follows:

1. **Life Insurance**

Section 2 of Indian Insurance Act 1938 defines life insurance as "life insurance business is the business of effecting contracts upon human life".It is a long term contract in which the assured must pay the premium at stated intervals and the insurer guarantee to pay a certain sum of money to the assured on the happening of the event which is certain (either death or expiry of the fixed period).

2. **General Insurance**

All insurance other than life insurance is general insurance. Under this type of insurance,the insurer undertakes to indemnify the loss suffered by the insured on

happening of a certain event in consideration for a fixed premium. Usually all these are short term agreements for a year. Fire insurance, marine insurance, accident insurance, burglary insurance, third party insurance etc. are the examples for general insurance.

5.2.3 FINANCIAL STATEMENTS OF INSURANCE COMPANIES

Insurance Regulatory and Development Authority (IRDA) has issued the regulations regarding the preparation of financial statements.

5.2.3.1 Final Accounts of Life Insurance Companies

Application of Accounting Standards

Every balance sheet, receipts and payment account [Cash Flow Statement] and profit & loss A/c [shareholder's A/c] of the insurer shall be in confirmiry with the accounting standards (AS) issued by the ICAI, to the extent applicable to the insurer carrying on general insurance business, except that:

(i) AS 3 – Cash Flow Statement shall be prepared only under the direct method.

(ii) AS 13 – accounting for investment shall not be applicable.

(iii) AS 17 – segment reporting shall apply irrespective of whether the securities of the insurer are traded publically.

tes to Forms *A-RA* and *A-PL*

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Re-insurance premiums whether on business cede or accepted are to be brought into account goes (i.e., before deducting commission) under the head re-insurance premiums.

(c) Claims insured shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-ended.

(d) Items of expenses and income in excess of one per cent of the total premium (less re-insurance) or Rs. 5,00,000 whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(g) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under "advance taxes and taxes deducted at source".

(h) Income from rent shall include only the realised rent. It shall not include any national rent.

The final accounts of a life insurance company consist of (a) Revenue Account, (b) Profit and Loss A/c and (c) Balance Sheet. The formats of this given by IRDA are as follows:

FORM A-RA

Revenue Account for the year Ended 31st March, 20…..

Particulars	*Schedule*	*Current Year (₹000)*	*Previous Year (₹000)*
Premiums Earned (Net) a. Premium b. Reinsurance ceded c. Reinsurance accepted Income from investments a. Interest, Dividend & Rent – Gross b. Profit on sale / Redemption of investments c. (Loss on sale / redemption of investments) d. Transfer / Gain on revaluation / change in fair value Other income (to be specified)	 **1**		
TOTAL (A)			
Commission Operating Expenses related to insurance business Provision for doubtful debts Bad debts written off Provision for tax Provisions (other than taxation) a. For distribution in the value of investments (net) b. Others (to be specified)	 **2** **3** **4**		
TOTAL (B)			
Benefits paid (net) Interim bonus paid Change in the valuation of liability in respect of life policies a. Gross b. Amount ceded in reinsurance Fire/ Marine/Miscellaneous business			
TOTAL (C)			
Surplus (Deficit) *(D) = (A) - (B) - (C)* Appropriations Transfer to Shareholders' Account Transfer to Other Reserves (to be specified) Balance being funds for future Appropriations			
TOTAL (D)			

FORM A-PL

Profit & Loss A/c for the year Ended 31st March, 20…..

Particulars	*Schedule*	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
Amounts transferred from/to the policyholders account (Technical Account) Income from investments a. Interest, Dividend & Rent – Gross b. Profit on sale / Redemption of investments c. (Loss on sale / redemption of investments) Other income (to be specified)			
TOTAL (A)			
Expenses other than those directly related to the insurance business Bad debts written off Provisions (other than taxation) a) For diminution in the value of investments (Net) b) Provision for doubtful debts c) Others (to be specified)			
TOTAL (B)			
Profit (loss) before tax Provision for taxation Profit (loss) after tax Appropriations a) Balance at the beginning of the year b) Interim dividends paid during the year c) Proposed final dividend d) Dividend Distribution Tax e) Transfer to Reserves or other accounts (to be specified) Profit earned……………to the balance sheet			

FORM A-BS

Balance Sheet as at 31st March, 20….

Particulars	*Schedule*	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
SOURCES OF FUNDS			
Shareholder's funds			
Share capital	**5**		
Reserves And Surplus	**6**		
Credit/[Debit]Fair Value Change Account	**7**		
Sub-Total			
Borrowings			
Policyholders' Funds:			
Credit/[Debit]Fair Value Change Account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			

Sub-Total Funds for future appropriations			
TOTAL			
APPLICATION OF FUNDS			
Investments	**8**		
Shareholders’	**9**		
Policyholders’	**10**		
Assets held to cover linked liabilities			
Loans	**11**		
Fixed Assets	**12**		
Current Assets			
Cash and Bank Balances			
Advances and Other Assets	**13**		
Sub-Total (A)	**14**		
Current Liabilities			
Provisions			
Sub-Total (B)	**15**		
Net Current Assets *(C)=(A)-(B)*			
Miscellaneous Expenditure (to the extent not Written off or adjusted)			
Debit Balance in Profit and Loss Account (Shareholders’ Account)			
TOTAL			

CONTIGENT LIABILITIES

Particulars	*Current Year (₹.’000)*	*Previous Year (₹.’000)*
I. Partly paid-up investments		
II. Claims, other than against policies, not acknowledged as debts by the company		
III. Underwriting commitments outstanding (in respect of shares and securities)		
IV. Guarantees given by or on behalf of the company		
V. Statutory demands/liabilities in dispute, not provided for		
VI. Reinsurance obligations to the extent not provided for in accounts		
Others (to be specified)		
TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE – I Premium

Particulars	*Current Year (₹.’000)*	*Previous Year (₹.’000)*
1. First year premiums		
2. Renewal premiums		
3. Single premiums		
Total		

SCHEDULE 2 – Commission Expense

Particulars	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
Commission paid Direct - First year premiums Renewal premiums Single premiums Add: Commission on Re-insurance Accepted Less: Commission on Re-insurance Ceded **Net Commission**		

SCHEDULE – 3 Operating Expenses Related to Insurance Business

Particulars	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1) Employees' remuneration & welfare benefits 2) Travel, conveyance and vehicle running expenses 3) Trading Expenses 4) Rent, Rates and Taxes 5) Repairs 6) Printing & stationery 7) Communication expenses 8) Legal & Professional charges 9) Medical fees 10) Auditors' fees, expenses etc a. As auditor b. As adviser or in any other capacity, in respect of: i. Taxation matters ii. Insurance matters iii. Management services; and c. In any other capacity 11) Advertisement and publicity 12) Interest & bank charges 13) Others(to be specified) 14) Depreciation **TOTAL**		

SCHEDULE-4 – Benefit Paid (Net)

Particulars	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Insurance claims: a. Claims by death, b. Claims by maturity, c. Annuities/Pension payment, d. Other benefits specify. 2. (Amount ceded in reinsurance): a. Claims by death, b. Claims by maturity, c. Annuities/Pension payment, d. Other benefits specify.		

3. Amount accepted in reinsurance: a. Claims by death, b. Claims by maturity, c. Annuities/Pension payment, d. Other benefits specify. **TOTAL**		

SCHEDULE-5 –Share Capital

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Authorised capital Equity shares of Rs…..each 2. Issued Capital Equity shares of Rs…..each 3. Subscribed Capital equity shares of Rs…..each 4. Called-up Capital Equity shares of Rs…..each Less: Calls unpaid Add: Equity Shares forfeited (Amount originally paid up) Less: Par value of equity shares bought back Less: Preliminary Expenses Expenses including commission or brokerage on underwriting or subscription of shares **TOTAL**		

SCHEDULE-5A – Pattern of Shareholding

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Promoters *Indian *Foreign Others TOTAL		

SCHEDULE-6 – Reserves and Surplus

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Capital Reserve 2. Capital Redemption Reserve 3. Share Premium 4. Revaluation Reserve 5. General Reserves Less: Debit balance in P&L A/c, if any Less: Amount utilized for buy back. 6. Catastrophe Reserve 7. Other Reserves (to be specified) 8. Balance of Profit in P&L A/c TOTAL		

SCHEDULE-7 – Borrowings

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Debentures/Bonds 2. Banks 3. Financial Institutions		

4. Others (to be specified) TOTAL		

SCHEDULE-8 – Investments-Shareholders

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Long –term Investments 1. Government securities and Government Guaranteed Bonds including treasury bills 2. Other approved securities 3. Other investments a) Shares *(aa)* Equity *(bb)* Preference b) Mutual Funds c) Derivative Instruments d) Debentures/Bonds e) Other securities (to be specified) f) Subsidiaries Investment Properties – Real Estate 4. Investments in Infrastructure and Social sector 5. Other than Approved Investments **Short –term Investments** 1. Government securities and Government Guaranteed Bonds including treasury bills 2. Other approved securities 3. Other investments a) Shares *(aa)* Equity *(bb)* Preference b) Mutual Funds c) Derivative Instruments d) Debentures/Bonds e) Other securities (to be specified) f) Subsidiaries Investment Properties–Real Estate 4. Investments in Infrastructure and Social sector 5. Other than Approved Investments TOTAL		

SCHEDULE-8A – Investments-Policyholder

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Long –term Investments 1. Government securities and Government Guaranteed Bonds including treasury bills 2. Other approved securities 3. a. Shares *(aa)* Equity *(bb)* Preference		

b. Mutual Funds c. Derivative Instruments d. Debentures/Bonds e. Other securities (to be specified) f. Subsidiaries g. Investment Properties – Real Estate 4. Investments in Infrastructure and Social sector 5. Other than Approved Investments **Short –term Investments** 1. Government securities and Government Guaranteed Bonds including treasury bills 2. Other approved securities 3. Other investments A. Shares *(aa)* Equity *(bb)* Preference B. Mutual Funds C. Derivative Instruments D. Debentures/Bonds E. Other securities (to be specified) F. Subsidiaries G. Investment Properties–Real Estate 4. Investments in Infrastructure and Social sector 5. Other than Approved Investments TOTAL		

SCHEDULE-9 – Loans

Particulars	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Security-wise Classification *Secured* a. On mortgage of property *(aa)* In India *(bb)* Outside India b. On Shares, Bonds, Govt. Securities, etc. c. Loans against Policies d. Others (to be specified) Unsecured TOTAL **2. Borrower-wise Classification** a. Central and State Governments b. Banks and Financial Institutions c. Subsidiaries d. Companies e. Loans against policies f. Others (to be specified)		

TOTAL **3. Performance-wise Classification** a. Loans classified as standard *(aa)* In India *(bb)* Outside India b. Non-performing loans less provisions *(aa)* In India *(bb)* Outside India TOTAL **4. Maturity-wise Classification** a. Short Term b. Long Term TOTAL		

SCHEDULE-10 – FIXED ASSETS

Particulars	*Cost/Gross Block*				*Depreciation*				*Net Block*	
	Opening	*Additions*	*Deduction*	*Closing*	*Up to LastYear*	*ForThe Year*	*On Sales/ Adjustments*	*ToDate*	*As atYear End*	*Previous Year*
Goodwill Intangibles (specify) Land-Freehold Leasehold Property Buildings Furniture & Fittings Information Technology Equipment Vehicles Office Equipment Others (Specify nature) TOTAL Work-in-progress Grand Total **PREVIOUS YEAR**										

SCHEDULE-11 – CASH AND BANK BALANCES

Particulars	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Cash (including cheques, drafts and stamps) 2. Bank Balances a. Deposit Accounts *(aa)* Short-term (due within 12 months of the date of		

Balance Sheet) *(bb)* Others b. Current Accounts c. Others (to be specified) 3. Money at call and short notice a. With banks b. With other institutions 4. Others (to be specified) TOTAL Balances with non-scheduled banks in 2 and 3 above CASH & BANK BALANCES 1. In India 2. Outside India TOTAL		

SCHEDULE-12 – ADVANCES AND OTHER ASSETS

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Advances 1. Reserve deposits with ceding companies 2. Application money for investments 3. Prepayments 4. Advances to Directors/Officers 5. Advance tax paid and taxes deducted at source (Net provision for taxation) 6. Others (to be specified) TOTAL (A) **Other Assets** 1. Income accrued on investments 2. Outstanding Premiums 3. Agents' balances 4. Foreign Agencies Balances 5. Due from other entities carrying on insurance business (including reinsurers) 6. Due from subsidiaries/holding company 7. Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938] 8. Others (to be specified) TOTAL(B) TOTAL (A+B)		

SCHEDULE-13 –CURRENT LIABILITIES

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Agents' balances 2. Balances due to other insurance companies 3. Deposits held on re-insurance ceded 4. Premiums received in advance 5. Unallocated premium 6. Sundry creditors 7. Due to subsidiaries/holding company 8. Claims outstanding 9. Annuities Due 10. Due to Officers/Directors 11. Others (to be specified) TOTAL		

SCHEDULE-14 – PROVISIONS

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. For taxation (less payments and taxes deducted at source) 2. For proposed dividends 3. For dividend distribution tax 4. Others (to be specified) TOTAL		

SCHEDULE-15 – MISCELLANIOUS EXPENDITURE

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Discount allowed on issue of shares/debentures 2. Others (to be specified) TOTAL		

Disclosures forming part of financial statement

A. The following shall be disclosed by way of notes to the balance sheet

1. Contingent liabilities:

   a. Partly paid up investments

   b. Underwriting commitments outstanding

   c. Claims, other than those under policies, not acknowledged as debts

   d. Guarantee given by or on behalf of the company

   e. Statutory demands/liabilities in dispute, not provided for

f. Reinsurance obligations

2. Encumbrances to assets of the company in and outside India.
3. Commitments made and outstanding for loans, investments and fixed assets
4. Actuarial assumptions for claim liabilities in the case of policies exceeding four years
5. Premiums, less reinsurance, written from business in/outside India
6. Extent of premium income recognised, based on varying risk pattern, category wise, with basis and justification therefore, including whether reliance has been placed external evidence
7. Value of contracts in relation to investments, for:
   i. Purchase where deliveries are pending, and
   ii. Sales where payments are overdue.
8. Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.
9. Historical costs of those investments valued on fair value basis.
10. Computation of managerial remuneration
11. Basis of amortisation of debt securities
12. (a) unrealised gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'Fair value change A/c' and on realisation reported in P&L A/c.

    (b)Pending realisation, the credit balance in the 'Fair value change A/c' is not available for distribution.
13. Fair value of investment property and the basis there for.
14. Claims settled and remaining outstanding for a period of more than six months on the balance sheet date.

5.2.3.2 Practical Problems in Life Insurance Business

Illustration 1

Best Life Insurance Co. Ltd. had a paid up capital of ₹10,00,000 divided into 1,00,000 shares of ₹10 each. Its net liability on all contracts in force as on 31st March, 2014 was ₹96,00,000 and on 31st March 2013 this liability was ₹84,00,000. The company has paid an interim bonus of ₹2,60,000 and 20% of the surplus is to be allocated to shareholders, 20% to reserves and balance carried forward. The following figures are extracted from the books of the company for the year ended 31st March, 2014.

Particulars	₹	Particulars	₹
Premium less re – insurance premium	57,20,000	Commission	2,20,000
Interest, dividend and rent Fees	28,00,000	Surrenders	3,20,000
Fees	16,000	Surplus on revaluation of reversions	20,000
Income – tax	4,40,000	Re-insurance irrecoverable	16,000
Management expenses	7,00,000	Claims less re-insurance claims	34,00,000
Annuities	50,000	Consideration for annuities granted	1,60,000

Prepare Revenue Account

Solution

Best Life Insurance CO. Ltd.
Revenue account for the year ended 31st March, 2014

Particulars		Schedule	(₹000)
Premiums earned – net		1	57,20
Income from investments			
Interest, Dividends and Rent – Gross			28,00
Surplus on Revaluation of Reversions			20
Other income:			
Consideration from Annuities Granted			1,60
Fees			16
Total (A)			87,16
Commission		2	2,20
Operating Expenses related to insurance Business		3	7,00
Re-insurance irrecoverable			16
Income – tax			4,40
Total (B)			13,76
Benefits Paid (Net)		4	37,70
Interim Bonuses Paid			2,60
Change in valuation of liability in respect of life policies:			
Net liability on all Contracts on 31.3.2014	96,00		
Less: Net Liability on all Contracts on 31.3.2013	84,00		12,00
Total (C)			52,30
Surplus/ (Deficit) (D) = (A) – (B) – (C)			21,10
Appropriations			
Transfer to Shareholder's Account (20% of Rs. 21,10,000)			4,22
Transfer to Reserves (20% of Rs. 21,10,000)			4,22
Balance being Funds for Future Appropriations			12,66
Total (D)			21,10

Schedule 1 – Premium Earned (Net)

Particulars	(₹ '000)
Premium less Reinsurance Premium	57,20

Schedule 2 – Commission Expenses

Particulars	(₹'000)
Commission Paid	2,20

Schedule 3 – Operating Expenses Relating to Insurance Business

Particulars	(₹ '000)
Management Expenses	7,00

Schedule 4 – Benefits Paid

Particulars	(₹'000)
Claims less Reinsurance	34,00
Annuities	50
Surrenders	3,20
	37,70

Illustration 2

The under mentioned balances form part of the Trial Balance of the All People's Assurance Co. Ltd., as on 31st March, 2013 :

Amount of Life Assurance Fund at the beginning of the year, ₹14,70,562 thousand; claims by death ₹76,980 thousand; claims by maturity, ₹ 56,420 thousand; premiums, ₹ 2,10,572 thousand: expenses of management, ₹19,890 thousand; commission, ₹26,541 thousand; consideration for annuities granted ₹10,712 thousand; interests, dividends and rents, ₹52,461 thousand; income tax paid on profits ₹3,060 thousand; surrenders, ₹21,860 thousand; annuities, ₹29,420 thousand; bonus paid in cash, ₹9,450 thousand; bonus paid in reduction of premiums, ₹2,500 thousand; preliminary expenses balance, ₹600 thousand; claims admitted but not paid at the end of year, ₹10,034 thousand; annuities due but not paid, ₹ 2,380 thousand; capital paid up, ₹14,00,000 thousand; Government securities, ₹24,90,890 thousand; Sundry Fixed Assets, ₹4,19,110 thousand.

Prepare Revenue Account and the Balance Sheet after taking into account the following:

(a) Claims covered under reinsurance, ₹ 10,000 thousand

(b) Further claims intimated, ₹ 8,000 thousand by death;

(c) Further bonus utilized in reduction of premium, ₹1,500 thousand

(d) Interest Accrued, ₹15,400 thousand;

(e) Premiums Outstanding, ₹7,400 thousand.

Solution:

All People'sAssurance Co. Ltd.
Revenue Account for the year ended 31st March, 2013

Particulars	*Schedule*	*₹'000*
Premiums earned - net	1	2,19,472
Income from Investments		67,861
Other Income :		
Consideration for Annuities granted		10,712
Total (A)		**2,98,045**
Commission	2	26,541
Operating Expenses related to Insurance Business	3	19,890
Provision for Tax		3,060
Total (B)		**49,491**
Benefits Paid (Net)	4	1,96,130
Total (C)		1,96,130
Surplus (D) = (A) - (B) - (C)		52,424
Balance being Funds for Future Appropriations		52,424
Total (D)		**52,424**

All People'sAssurance Co. Ltd.
Balance Sheet as at 31st March, 2003

Source of Funds	*Schedule*	*₹. '000*
Share Capital	5	13,99,400
Policyholders' Funds		14,70,562
Life Assurance Fund		28,69,962
Funds for Future Appropriations		52,424
Total		**29,22,386**
Application of Funds		
Investments	8	24,90,890
Fixed Assets	10	4,19,110
Current Assets:		
Advances and Other Assets	12	32,800
Sub Total (A)		32,800
Current Liabilities	13	20,414
Sub Total (B)		20,414
Net Current Assets (C) = (A) - (B)		12,386
Total		**29,22,386**
SCHEDULE-1		
Premium		
Premiums earned-net		2,19,472
SCHEDULE-2		
Commission Expenses		26,541
SCHEDULE- 3		
Operating Expenses Related to Insurance Business		19,890
SCHEDULE – 4		
Benefits Paid (Net)		

1. Insurance Claims	
(a) Claims by Death	84,980
(b) Claims by Maturity	56,420
(c) Annuities	29,420
(d) Surrenders	21,860
Bonus in cash	9,450
Bonus in reduction of Premiums	
2. (Amount ceded in reinsurance)	
(a) Claims by Death	10,0000
Total	**1,96,130**
SCHEDULE- 5	
Share Capital	20,00,000
Called up and paid-up Capital	600
Less: Preliminary Expenses	**19,99,400**
Total	
SCHEDULE - 8	
Investments	
Government Securities	24,90,890
Total	**24,90,890**
SCHEDULE-10	
Fixed Assets	4,19,110
Total	**4,19,110**
SCHEDULE-12	
Advances and Other Assets	
Other Assets	
Interest accrued on investments	15,400
Outstanding premiums	7,400
Due from Reinsurers	10,000
Total	**32,800**
SCHEDULE-13	
Current Liabilities	
Claims Outstanding	20,414
Total	**20,414**

Working Notes :

(i) Premiums received	2,10,572
Add Outstanding	7,400
Covered by bonus utilized for reduction of premium	1,500
Premiums earned (net)	**2,19,472**
(ii) Interest dividends and rents	52,461
Add: Interest accrued	15,400
Income from Investments	**67,861**

llustration 3

Getwell Life Assurance Co. Ltd. got its valuation made once in every three years. The life assurance fund on 31st March, 2015 amounted to ₹83,84,000 before providing for ₹.64,000 for the shareholder's dividend for the year 2014-15. Its actuarial valuation on 31st March, 2015 disclosed net liability of ₹.80,80,000 under the triennium ending 31st March, 2015. Prepare statement showing the amount now available as bonus to policyholders.

Solution:

Valuation Balance Sheet of Getwell Life Assurance Co. Ltd as on March 31,2015

	₹		₹
To Net Liability as per actuary's Valuation To Surplus	80,80,000 3,04,000	By Life Assurance Fund as per Balance Sheet	83,84,000
	83,84,000		83,84,000

	₹
Profits made: Surplus as per Valuation Balance Sheet	3,04,000
Add: Interim bonus paid to policy holders	80,000

	3,84,000
Less: Dividend for 2014-15 due to shareholders	64000

Profit for 3years ending March 31,2015	3,20,000

Policyholders will get 95% of ₹.3,20,000 or	3,04,000
Less: amount already paid as interim bonus	80,000

Amount now due to the policyholders	2,24,000

Illustration 4

The Life fund of a Life Insurance Company on 31st March 2013 showed a balance of ₹54,00,000. However, the following items were not taken into account while preparing the Revenue Account for 2012-13.

	₹
(i) Interest and dividends accrued on investments	20,000
(ii) Income tax deducted at source on the above	6,000
(iii) Reinsurance claims recoverable	7,000
(iv) Commission due on reinsurance premium paid	10,000
(v)Bonus in reduction of premiums	3,000

Solution:

Statement Showing True Life Fund of Life Insurance Co. as on 31st March 2013

	Particulars	₹	₹
	Life Assurance fund given		54,00,000
Add:	Interest & Dividend accrued on invest	20,000	
	Less:Income tax Thereon	6,000	

		14,000	
	Reinsurance claims recoverable	7,000	
	Commission due on reinsurance premium Paid	10,000	
	Premium in reduction of bonus	3,000	
		--------	34,000

			54,34,000
Less:	Bonus in reduction of premium		3,000

	True Life Assurance Fund		54,31,000

Note: Bonus in reduction of premium reduces premiums and also bonus. So it has to be added and also substrates from the fund.

Illustration 5

The following balance appeared in the books of the Happy Mutual Life Assurance Society Ltd. As on 31st March, 2012:

Dr. Particulars	₹in Lakhs	Cr. Particulars	₹in Lakhs
Claims less re-insurance paid during the year:		Life Assurance Fund at the beginning of the year	50,000
By Death	2,200	Premiums less re-assurances	15,000
By Maturity	1,500		
Annuities	6	Claims less re-assurances outstanding at the beginning of the year:	
Fumiture and Office Equipment at cost (including ₹40 Lakhs bought during the year)	250	By Death	900
		By Maturity	600
Printing and stationery	77	Credit balances pending adjustment	60

Cash with Bank in Current Account	1,350	Consideration for annuities granted	2
Cash and Stamps in Hand	30	Interests, dividends and Rents	1,800
Surrenders less re-assurances	40	Registration and other fees	2
Commission	250	Sundry deposits	100
Expenses of Management	3,100	Taxation provision	300
Sundry deposits with Electricity Companies, etc.	1	Premium deposits	1,500
Advance Payment of Income-tax	50	Sundry creditors	350
Sundry Debtors	50	Contingency reserve	150
Agents Balances	100	Furniture and office equipment depreciation account	40
Income-tax	450	Building depreciation account	300
Income tax on interest, dividends and rents	500		
Loans and Mortgages	150		
Loans on Policies	3,250		
Investments (₹ 250 Lakhs deposited with the RBI)	52,000		
House Property at cost (Including ₹ 85 Lakhs deposited with the RBI)	5,400		
	70,754		70,754

From the foregoing balances and the following information, prepare Balance Sheet of the Happy Mutual Life Assurance Society Ltd. As on 31st March, 2012 and its Revenue Account for the year ended on that date:

(1) Claims less re-assurances outstanding at the end of the year
By Death: ₹. 600 lakhs; By Maturity: ₹ 400 lakhs.

(2) Expenses outstanding ₹60 lakhs and prepaid ₹15 lakhs.

(3) Provide ₹ 45 lakhs for depreciation on building; ₹15 lakhs for depreciation on furniture and office equipment and ₹110 laksh for taxation.

(4) Premiums outstanding Rs . 2,028 lakhs; Commission thereon ₹65 lakhs.

(5) Interest, dividends and rents outstanding (net) ₹30 lakhs and interest and rest accrued (net) ₹ 250 lakhs.

Solution

Happy Mutual Life Assurance Society Ltd.
Balance Sheet as at 31st March, 2012

Particulars	Schedule		₹ In Lakhs
Sources of funds			
Shareholders Funds			
Share Capital	5	-	
Reserves and Surplus	6	61,759	
Borrowings	7	1,250	63,009
Application of funds			
Investments			
Shareholders	8	56,805	
Loans	9	3,400	
Fixed Assets	10	195	60,400
Current Assets			
Cash and Bank Balances	11	1,380	
Advances and Other Assets	12	2,874	
Sub – total (A)		4,254	
Current Liabilities	13	1,535	
Provisions	14	110	
Sub – total (B)		1,645	
Net Current Assets (C) = (A-B)			2,609
Total			63,009

Happy Mutual Life Assurance Society Ltd.
Revenue Account for the year ended 31st March, 2002

Particulars	Schedule	₹In Lakhs
Premiums earned – net	1	17,028
Income from investments		
Interest, Dividends and Rent – Gross		2,180
Other Income		
Annuities Granted		2
Registration and Other Fees		2
Total (A)		19,212
Commission	2	315
Operating Expenses related to Insurance Business	3	3,282
Provision for tax		760
Total (B)		4,357
Benefits Paid (Net)	4	3,246
Total (C)		3,246
Surplus /(Deficit) (D) = (A) – (B) – (C)		11,609

1. Calculations of Provision for Taxation:

Particulars	₹ in lakhs
Income Tax paid	450
Income tax on interest, dividend and rent	500
Provision for taxation to be made	110
	1060
Less : Existing taxation provision	300
	760

Schedule 1: Premiums

Particulars	₹ in lakhs
Premium	15,000
Add: Outstanding	2,028
	17,028

Schedule 2: Premiums

Particulars	₹in lakhs
Commission Paid	250
Add: Commission on re-insurance accepted	65
	315

Schedule 3: Operating Expenses

Particulars		₹ in lakhs
Expenses of Management Paid	3,100	
Add: Unpaid	60	
	3,160	
Less: Prepaid	15	3,145
Printing and Stationery		77
Depreciation on:		
Building	45	
Furniture	15	60
		3,282

Schedule 4: Benefits Paid

Particulars		₹ in lakhs
Insurance Claims		
Claims by Death -		
Paid	2,200	
Add: Outstanding at the end	600	
	2,800	
Less: Outstanding at the beginning	900	1,900
Claims by Maturity		
Paid	1,500	
Add: Outstanding at the end	400	
	1,900	
Less: Outstanding at the beginning	600	1,300
Other Benefits		
Annuities		6
Surrender less re-insurance		40
		3,246

Schedule 6: Reserves and Surplus

Particulars	₹ in lakhs
Contingency Reserve	150
Life assurance Fund	61,609
	61,759

Schedule 7: Borrowings

Particulars	₹ in lakhs
Premium Deposits	1,150
Sundry Deposits	100
	1,250

Schedule 8: Investments

Particulars		₹ in lakhs
Sundry Other Investments		51,750
Investments in House Property	5,315	65
Add: Addition	85	
	5400	
Less: Depreciation	345	5,055
		56,805

Schedule 9: Loans

Particulars	₹in lakhs
On Mortgages	150
On Policies	3,250
	3,400

Schedule 10: Fixed Assets

Particulars	(₹'100)
Furniture at Cost less Depreciation	195

Schedule 11: Cash and Bank Balances

Particulars	₹ in lakhs
Cash in Hand including Stamp	30
Cash with Banks on Current Account	1,350
	1,380

Schedule 12: Advances and Other Assets

Particulars	₹in lakhs
Prepaid Expenses	15
Interest, Dividends and Rent Outstanding	30
Interest, Dividends and Rent Accruing	350
Advance Payment on Income Tax	50
Agent's balances	100
Outstanding Premium	2,028
Deposit with RBI	250
Deposit with Electricity Companies	1
Sundry Debtors	50
	2,874

Schedule 13: Current Liabilities

Particulars	₹in lakhs
Sundry Creditors	350

Claims Outstanding	1,000
Credit Balances pending Adjustments	60
Outstanding Expenses	60
Commission Due but not yet Paid	65
	1,535

Schedule 14: Previous

Particulars	₹ in lakhs
Provision for Tax	110

5.2.4.1 Final Accounts of General Insurance Companies

FORM B-RA

Revenue Account for the year Ended 31st March, 20…..

Particulars	*Schedule*	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Premiums Earned (Net) 2. Profit/Loss on sale / redemption investments **3.** Others (to be specified) **4.** Interest, Dividend & Rent - Gross	**1**		
TOTAL (A)			
1. Claims Incurred (Net) 2. Commission 3. Operating Expenses related to insurance business	**2** **3** **4**		
TOTAL (B)			
Operating Profit/ (Loss) from Fire/ Marine/Miscellaneous business *(C)=(A) - (B)*			
APPROPRIATIONS Transfer to Shareholders' Account Transfer to Catastrophe Reserve Transfer to Other Reserves (to be specified)			
TOTAL (C)			

FORM B-PL

Profit & Loss A/c for the year Ended 31st March, 20…..

Particulars	*Schedule*	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Operating Profit/ (Loss) a) Fire Insurance b) Miscellaneous Insurance **2. Income from investments** a) Interest, dividends & rent – Gross b) Profit on sale/redemption of investments *Less*: Loss on sale of investments **Other Income** (to be specified)			

TOTAL (A)			
3. Provisions (other than taxation) d) For diminution in the value of investments e) For Doubtful Debts f) Others (to be specified) **4. OTHER EXPENSES** a) Expenses other than those directly related to the insurance business b) Bad debts written off c) Others (to be specified)			
TOTAL (B)			
Profit before tax Provision for taxation 5. **APPROPRIATIONS** f) Interim dividends paid during the year g) Proposed final dividend h) Dividend Distribution Tax i) Transfer to Reserves or other accounts (to be specified) Balance of Profit/Loss brought forward from last year Balance carried forward to the Balance Sheet			
APPROPRIATIONS Transfer to Shareholders' Account Transfer to Catastrophe Reserve Transfer to Other Reserves (to be specified)			

FORM B-BS

Balance Sheet as at 31st March, 20….

Particulars	*Schedule*	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
SOURCES OF FUNDS			
SHARE CAPITAL	**5**		
RESERVES AND SURPLUS	**6**		
FAIR VALUE CHANGE ACCOUNT			
BORROWINGS	**7**		
TOTAL (A)			
APPLICATION OF FUNDS			
INVESTMENTS	**8**		
LOANS	**9**		
FIXED ASSETS	**10**		
CURRENT ASSETS			
Cash and Bank Balances	**11**		
Advances and Other Assets	**12**		
Sub-Total (A)			
Current Liabilities	**13**		

Provisions	14		
Sub-Total (B)			
NET CURRENT ASSETS (C)=(A)-(B)	15		
MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)			
DEBIT BALANCE IN PROFIT AND LOSS ACCOUNT			
TOTAL			
VII. Partly paid-up investments VIII. Claims, other than against policies, not acknowledged as debts by the company IX. Underwriting commitments outstanding (in respect of shares and securities) X. Guarantees given by or on behalf of the company XI. Statutory demands/liabilities in dispute, not provided for XII. Reinsurance obligations to the extent not provided for in accounts XIII. Others (to be specified)			
TOTAL			

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE - I

Premium Earned [Net]

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Premium for direct business written Add: Premium on reinsurance accepted Less: premium on reinsurance accepted Net Premium Adjustment for change in reserve for unexpected risks		
Total Premium Earned (Net)		

SCHEDULE -2

Claims Incurred (Net)

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Claims paid Direct Add: Reinsurance accepted Less: Reinsurance ceded Net Claims paid Add: Claims outstanding at the end of the year Less: Claims outstanding at the beginning		
Total Claims Incurred		

SCHEDULE - 3

Commission

Particulars	*Current Year*	*Previous Year*

	(₹.’000)	(₹.’000)
Commission paid Direct Add: Re-insurance Accepted Less: Re-insurance Ceded		
Net Commission		

SCHEDULE – 4

Operating Expenses Related to Insurance Business

Particulars	*Current Year (₹.’000)*	*Previous Year (₹.’000)*
1) Employees’ remuneration & welfare benefits 2) Travel, conveyance and vehicle running expenses 3) Trading Expenses 4) Rent, Rates and Taxes 5) Repairs 6) Printing & stationery 7) Communication expenses 8) Legal & Professional charges 9) Auditors’ fees, expenses etc d. As auditor e. As adviser or in any other capacity, in respect of: iv. Taxation matters v. Insurance matters vi. Management services; and f. In any other capacity 10) Advertisement and publicity 11) Interest & bank charges 12) Others(to be specified) 13) Depreciation		
TOTAL		

SCHEDULE -5 **Share Capital**

Particulars	*Current Year (₹.’000)*	*Previous Year (₹.’000)*
1. Authorised capital Equity shares of Rs…..each		
2. Issued Capital Equity shares of Rs…..each		
3. Subscribed Capital Equity shares of Rs…..each		
4. Called-up Capital Equity shares of Rs…..each Less: Calls unpaid Add: Equity Shares forfeited (Amount originally paid up) Less: Par value of equity shares bought back Less: Preliminary Expenses Expenses including commission or brokerage on underwriting or subscription of shares		
TOTAL		

SCHEDULE – 5A

Share CapitalPattern of Shareholding*[As Certified by the Management]*

Shareholders	*Current Year*		*Previous Year*	
	Number of Shares	*% of Holding*	*Number of Shares*	*% of Holding*
Promoters *Indian *Foreign Others				
TOTAL				

SCHEDULE – 6

Reserve & Surplus

Shareholders	*Current Year (₹'000)*	*Previous Year (₹'000)*
9. Capital Reserve 10. Capital Redemption Reserve 11. Share Premium 12. General Reserves Less: Debit balance in P&L A/c, if any Less: Amount utilized for buy back. 13. Catastrophe Reserve 14. Other Reserves (to be specified) 15. Balance of Profit in P&L A/c		
TOTAL		

SCHEDULE – 7

Borrowings

Shareholders	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Debentures/Bonds 2. Banks 3. Financial Institutions 4. Others (to be specified)		
TOTAL		

SCHEDULE – 8 **Investments**

Shareholders	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
Long –term Investments		
6. Government securities and Government Guaranteed Bonds including treasury bills		
7. Other approved securities		
8. Other investments		
g) Shares		
(aa) Equity		
(bb) Preference		
h) Mutual Funds		
i) Derivative Instruments		
j) Debentures/Bonds		
k) Other securities (to be specified)		
l) Subsidiaries		
m) Investment Properties – Real Estate		
9. Investments in Infrastructure and Social sector		
10. Other than Approved Investments		
Short –term Investments		
6. Government securities and Government Guaranteed Bonds including treasury bills		
7. Other approved securities		
8. Other investments		
g) Shares		
(aa) Equity		
(bb) Preference		
h) Mutual Funds		
i) Derivative Instruments		
j) Debentures/Bonds		
k) Other securities (to be specified)		
l) Subsidiaries		
m) Investment Properties–Real Estate		
9. Investments in Infrastructure and Social sector		
10. Other than Approved Investments		
TOTAL		

SCHEDULE – 9 **Loans**

Shareholders	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
1. Security-wise Classification		
Secured		
e. On mortgage of property		
(aa) In India		
(bb) Outside India		
f. On Shares, Bonds, Govt. Securities, etc.		
g. Loans against Policies		
h. Others (to be specified)		
Unsecured		
TOTAL		

2. Borrower-wise Classification g. Central and State Governments h. Banks and Financial Institutions i. Subsidiaries j. Industrial Undertakings k. Others (to be specified)		
TOTAL		
3. Performance-wise Classification c. Loans classified as standard *(aa)* In India *(bb)* Outside India d. Non-performing loans less provisions *(aa)* In India *(bb)* Outside India		
TOTAL		
4. Maturity-wise Classification c. Short Term d. Long Term		
TOTAL		

CHEDULE – 10

Fixed Assets

Particulars	*Cost/Gross Block*				*Depreciation*				*Net Block*	
	Opening	*Additions*	*Deduction*	*Closing*	*Up to LastYear*	*ForThe Year*	*On Sales/ Adjustments*	*ToDate*	*As atYear End*	*Previous Year*
Goodwill										
Intangibles (specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work-in-progress										
Grand Total										
PREVIOUS YEAR										

SCHEDULE – 11

Cash and Bank Balances

Shareholders	*Current Year (₹'000)*	*Previous Year (₹'000)*
5. Cash (including cheques, drafts and stamps) 6. Bank Balances d. Deposit Accounts (aa) Short-term (due within 12 months) (bb) Others e. Current Accounts f. Others (to be specified) 7. Money at call and short notice c. With banks d. With other institutions 8. Others (to be specified)		
TOTAL		
Balances with non-scheduled banks in 2 and 3 above		

SCHEDULE – 12

Advanced and Other Assets

Shareholders	*Current Year (₹'000)*	*Previous Year (₹'000)*
Advances 7. Reserve deposits with ceding companies 8. Application money for investments 9. Prepayments 10. Advances to Directors/Officers 11. Advance tax paid and taxes deducted at source (Net provision for taxation) 12. Others (to be specified)		
TOTAL(A)		
Other Assets 9. Income accrued on investments 10. Outstanding Premiums 11. Agents' balances 12. Foreign Agencies Balances 13. Due from other entities carrying on insurance business (including reinsurers) 14. Due from subsidiaries/holding company 15. Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938] 16. Others (to be specified)		
TOTAL (B)		
TOTAL (A+B)		

SCHEDULE – 13

Current Liabilities

Shareholders	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
12. Agents' balances 13. Balances due to other insurance companies 14. Deposits held on re-insurance ceded 15. Premiums received in advance 16. Unallocated premium 17. Sundry creditors 18. Due to subsidiaries/holding company 19. Claims outstanding 20. Due to Officers/Directors 21. Others (to be specified)		
TOTAL		

SCHEDULE – 14

Provisions

Shareholders	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
5. Reserve for Unexpired Risk 6. For taxation (less payments and taxes deducted at source) 7. For proposed dividends 8. For dividend distribution tax 9. Others (to be specified)		
TOTAL		

SCHEDULE – 15

Miscellaneous Expenditure

Shareholders	*Current Year (₹.'000)*	*Previous Year (₹.'000)*
3. Discount allowed on issue of shares/debentures 4. Others (to be specified)		
TOTAL		

5.2.4.2 Practical Problems in General Insurance Business

Illustration 6

Zaldi Pay Insurance Co. Ltd. Has furnished the following information for preparation of Revenue Account for fire insurance business for the year ended 31st March, 2015.

	₹
Claims admitted but not paid	42,376
Commission paid	50,000
Commission on reinsurance received	12,000
Share transfer fees	12,000
Expenses of Management	5,000
Bad Debts	78,000
Claims Paid	2,500
Profit and Loss Account Appropriation	15,000
Premiums Received (less Reinsurance)	10,000
Reserve for Unexpired Risks as on 1.4.2014	5,52,000
Claims Outstanding as on 1.4.2014	2,30,000
Dividend on Share Capital	27,000

The following further information has also to be considered:

(i) Premiums outstanding at the end of the year is ₹40,000

(ii) It is the policy of the company of maintain 50% of premium towards reserve for unexpired risks.

Solution

Zaldi Pay Insuracne Co. Ltd.

Fire Revenue Account for the Year ended 31st March, 2015

Particulars		**Schedule**	₹
Premiums earned – net		1	2,96,000
	Total (A)		2,96,000
1. Claims Incurred (Net)		2	30,376
2. Commission		3	38,000
3. Operating Expenses related to Insurance Business			78,000
	Total (B)		1,46,376
Operating Profit/ (Loss) from Fire/ Marine/ Miscellaneous Business C = (A-B)			1,49,624

Schedule 1 – Premium Earned (Net)

Particulars	₹	₹
Premium received (less re-insurance)	5,52,000	
Add: Premium Outstanding	40,000	5,92,000
Adjustment for Changes in Reserve for unexpired risk:		
Opening balance of reserve	40,000	
Less: Closing balance of reserve (Note 1)	2,96,000	(2,56,000)
Total Premium Earned (Net)		2,96,000

Schedule 2 – Claims Incurred (Net)

Particulars	₹₹	
Claims Paid during the Year	15,000	
Add: Claims outstanding at the end of year	42,376	
	57,376	
Less: Outstanding Claims at the beginning of the year	27,000	30,376

Schedule 3 – Commission

Particulars	₹	₹
Commission Paid:		
Direct	50,000	
Add: Re-insurance accepted	-	
	50,000	
Less: Commission on re-insurance ceded	12,000	38,000

Working Note: (1) Reserve for unexpired risk = 50% of ₹5,92,000 = ₹ 2,96, 000.

Tutorial Note: Share transfer fees and bad debts are shown in the Profit and Loss Account.

Illustration 7

From the following figures taken from the books of New Asia Insurance Co. Ltd., doing the underwriting business, prepare the set of Final Accounts for the year 2014 -15.

Particulars	₹	Particulars	₹
Fire Fund (as on	9,30,000	Commission on Direct	
1.4.2014)	4,50,000	Business	2,99,777
General Reserve	36,00,000	Commission on Reinsurance	
Investments	27,01,533	Accepted	60,038
Premium	6,02,815	Outstanding Premium	22,300
Claims Paid		Claims intimated but not	
Share Capital – Divided	9,00,000	paid (1.4.2014)	60,000
into Equity Share of ₹		Expenses on Management	4,31,947
100 each	3,30,000	Audit Fees	36,000
Additional Reserve		Rates and Taxes	5,804
	75,000	Rents	67,500
Profit and Loss A/c (Cr.)	1,12,525	Income from investments	1,53,000
Re-insurance Premium		Sundry Creditors	22,500
Claim Recovered from	21,119	Agents balances (Dr.)	20,000
Re-insurers	48,016	Cash on Hand and Bank	1,82,462
Commission on Re-		Balances	
insurance Ceded	2,50,000		
Advance income – tax			
paid			

The following further information may also be noted:

(a) Expenses of management include survey fees and legal expenses of ₹ 36,000 and ₹20,000 relating to claims;

(b) Claims intimated but not paid on 31st March, 2015 ₹1,04,000.

(c) Income – Tax to be provided at 35%.

(d) Transfer of ₹ 2,00,000 to be made from current profits to General Reserve.

Solution

New Asia Insurance Co. Ltd.,

Fire Revenue Account for the year ended 31st March, 2015

Particulars		**Schedule**	**₹**
Premiums earned – net		1	22,24,504
	Total (A)		22,24,504
1. Claims Incurred (Net)		2	6,81,696
2. Commission		3	3,11,799
3. Operating Expenses related to Insurance Business			4,85,251
	Total (B)		14,78,746
Operating Profit/ (Loss) from Fire/ Marine/ Miscellaneous Business C= (A-B)			7,45,758

Profit and Loss Account for the year ended 31st March, 2015

Particulars	Schedule	₹
1. Operating Profit/(Loss)		
(a) Fire Insurance		7,45,758
(b) Marine Insurance		-
(c) Miscellaneous Insurance		1,53,000
2. Income from investments		1,53,000
3. Other Income (to be specified)		-
Total (A)		8,98,758
4. Previous (other than taxation)		-
5. Other Expenses		-
Total (B)		-
Profit Before Tax		8,98,758
Provision for Taxation		3,14,565
Appropriations		
Transfer to general reserve		2,00,000
Balance of profit/ loss brought forward from last year		75,000
Balance carried forward to Balance Sheet		4,59,193

New Asia Insurance Co. Ltd.

Balance Sheet as at 31st March, 2015

Particulars	**Schedule**	**₹**
Sources of Funds		
Share Capital	5	9,00,000
Reserves and Surplus	6	11,09,193
Sub total		20,19,193
Application of Funds		
Investments		36,00
Loans	9	-
Fixed Assets	10	-
Current Assets		
Cash and Bank Balances	11	1,82,462
Advances and Other Assets	12	42,300

Sub – total (A)		2,24,762
Current Liabilities Provisions	13 14	1,26,500 16,89,069
Sub – total (B)		18,15,549
Net current Assets (C) = (A-B) Miscellaneous Expenditure (to the extent not written off or adjusted) Debit Balance in Profit and Loss Account (Shareholder's Account)	 15	(15,90,807) - -
Total		20,19,193

Schedule 1 – Premium Earned (Net)

Particulars	₹	₹
Premium	27,01,533	
Less: Re-insurance	1,25,525	25,89,008
Adjustment for Changes in Reserve for unexpired risk:		
Opening balance of reserve (₹9,30,000 + 3,30,000)	12,60,000	
Less: Closing balance of reserve (₹12,94,504 + 3,30,000)	16,24,504	(3,64,504)
Total Premium Earned (Net)		22,24,504

Schedule 2 – Claims Incurred (Net)

Particulars	₹	₹
Claims Paid during the year		
Direct	6,02,815	
Add: Survey fees	36,000	
Legal Expenses	20,000	6,58,815
Less: Received from re-insurance		21,119
		6,37,696
Add: Claims outstanding at the end of the year		1,04,000
		7,41,696
Less: Outstanding Claims at the beginning of the year		60,000
		6,81,696

Schedule 3 – Commission

Particulars	₹	₹
Commission Paid		
Direct	2,99,777	
Add: Re-insurance accepted	60,038	
	3,59,815	
Less: Commission on re-insurance ceded	48,016	3,11,799

Schedule 4 – Operating Expenses Related to Insurance Business

Particulars	₹	₹
Expenses on Management	4,31,947	
Rates and Taxes	5,804	
Rent	67,500	
Audit Fees	36,000	5,41,251

Less: Survey fees relating to claims	36,000	
Legal expenses relating to claims	20,000	56,000
		4,85,251

Schedule 5 – Share Capital

Particulars	₹	₹
9,000 Equity Shares of ₹100 each fully paid-up		9,00,000

Schedule 6 – Reserves and Surplus

Particulars	₹	₹
General Reserve:		
Opening balance	4,50,000	
Add: Addition during the year	2,00,000	6,50,000
Balance of Profit and Loss Account		4,59,193
		11,09,193

Schedule 12 – Advances and Other Assets

Particulars	₹	₹.
Premium Outstanding		22,300
Agent's Balance		20,000
		42,230

Schedule 13 – Current Liabilities

Particulars	₹	₹
Sundry Creditors		22,500
Claims intimated but not paid		1,04,000
		1,26,500

Schedule 14 – Provision

Particulars	₹	₹.
Reserve for Unexpired Risk		16,24,504
Provision for Taxation	3,14,565	
Less: Payment of Advance Tax	2,50,000	64,565
		16,89,069

Working Notes;

(1) Reserve for expired risk = 50% of ₹ 25,89,008 = ₹ 12,94,504.
Assuming that the additional reserve will be maintained at the same level, the total closing balance of reserve for unexpired risk will be: ₹ 12,94,508 + ₹3,30,000 = ₹ 16,24, 504.

(2) Provision for Taxation to be created @ 35%. The amount of provision for income tax = 35% of ₹8,98,758 – ₹3,14, 565.

(3) No adjustment is required in Premium Account in respect of outstanding premium because it has already been done and that is why Outstanding Premium Account is appeared in the Trial Balance.

5.2.5 Self Test Questions

Theory

1. Explain the method followed for arriving at rift in the life inusurance business.
2. Explain what do you understand by Life Fund. Where does it appear in the final Accounts?
3. How is profit or loss determined in Fire insurance Business?

4. What important points should be kept in mind in preparing the annual accounts of general Insurance companies?
5. Point out the main features of Accounts of General Insurance Companies. What statutory boos are required to be maintained by a general Insurance Company under the Insurance Act.
6. Explain how the profit or loss from general insurance business is ascertained and prepare a firm Revenue Account with imaginary figures.
7. Explain in brief disclosure forming part of financial statements.

Problems

1. The New India assurance company Ltd. had paid up capital of ₹ 2,50,000 divided into 25,000 shares of ₹10 each. Its net liability on all contracts in force on 31st March, 2014 was ₹22,50,000. From the following figures extracted from its books for the year ended 31st March, 2014, prepare Revenue Account and a Valuation Balance Sheet. The company had paid an interim bonus of ₹1,03,806 and 25% of the surplus is to allocated to shareholders and 70% to the policyholders.

	₹		₹
Interest, dividend and rents	7,50,000	Life fund	24,50,000
Premium	13,80,000	Fines and fees	720
Surplus on revaluation of reversions	4,800	Bonus in cash	1,58,400
Reassurance recoverable	1,250	Income-tax	1,16,500
Claims	8,90,000	Management expenses	1,75,000
Consider for annuities granted	45,000	Bonus in reduction of premium	1,976
Surrenders	85,200	Commission	54,000

2. The life insurance fund of an insurance company was on 31.03.2014 ₹60 lakhs before providing dividend of ₹ 20,000 for the year 2013-2014. While ascertaining the above fund figure, the following items were omitted:

1. Interest received on investments ₹ 63,000 after deduction for tax at source 10%.
2. Bonus utilized for reduction of premium ₹ 14,000.
3. Death claim intimated, but not yet admitted ₹ 36,000.
4. Death claim covered under re-insurance ₹ 12,000.
5. Consideration for annuities granted ₹ 9,000.

Interim bonus for the valuation period paid was ₹ 80,000.
Net liabilities as per valuation were ₹ 50 lakhs. It is now proposed to carry forward ₹ 2,70,000. The company declared a reversionary bonus of ₹ 12 per ₹ 1,000 and gave the policy holders an option to get the bonus in cash for ₹1,000. Total business of the company is ₹ 1 crore, 40% of the policyholders decide to get bonus in cash.
Prepare:

1. Valuation balance sheet as on 31.03.2014.
2. Distribution statement showing the amount due to the policyholders.

Also give journal Entries relating to reversionary bonus.

3. The following Trial balance was extracted from the books of Bharat Life Assurance Co. Ltd. as on 31 March, 2013:

Particulars	*Dr.* ₹	*Cr.* ₹
Share Capital (shares of ₹ 10 each)		1,60,000
Life assurance fund as on 1st April, 2012		29,72,300
Dividends paid	15,000	
Bonus to policy holders	31,500	
Premium received		1,01,500
Claims paid	1,97,000	
Commission paid	9,300	
Management expenses	32,300	
Mortgage in India	4,92,200	
Interest and dividends received		1,12,700
Agents' balances	9,300	
Freehold premises	40,000	
Investments	23,05,000	
Loan on company's policies	1,73,600	
Cash on deposit	27,000	
Cash in hand and on current A/c	7,300	
Surrenders	7,000	
	33,46,500	33,46,500

You are required to prepare the company's Revenue Account for the year ended 31st March, 2013 and its balance sheet as on that date after taking the following matters into consideration:

a) Claims admitted but not paid ₹ 9,300
b) Management Expenses due ₹ 200
c) Interest accrued ₹19,300
d) Premium outstanding ₹12,000

4. Prepare a revenue Account for fire business from the following details for the year 2013-14:

	₹
Reserve for unexpected risk on 1.4.2013 @ 50%	1,80,000
Additional reserves	36,000
Estimated liability for claims intimidated on 1.4.2013	31,000
Estimated liability for claims intimidated on 31.3.2014	42,000
Claims paid	3,65,000
Legal expenses	6,000

Reinsurance recoveries	32,000
Medical expenses	4,000
Bad debts	800
Premium recovered	4,86,000
Premium on re-insurance accepted	32,000
Premium on re-insurance cede	43,000
Commission on direct business	48,000
Commission on reinsurance accepted	1,600
Commission on reinsurance cede	2,150
Expenses of management	90,000
Interest, dividend and rent	24,000
Profit on sale of investments	3,000

Create reserve on 31.12.2001 to the same extent as on 31.3.2014.

5. From the following balances of Safety Insurance Co. Ltd. as on 31 March, 2015 prepare (1) Fire Revenue A/c, (2) Marine Revenue A/c, and (3) P&L A/c.

Particulars	₹	Particulars	₹
Bad debts (fire)	10,000	Depreciation	70,000
Bad debts (marine)	24,000	Interest, dividend received	28,000
Auditor's fees	6,000	Difference in exchange(Cr.)	600
Director's fees	6,400	Miscellaneous receipts	10,000
Share transfer fees	1,600	Profit on sale of land	1,20,000
Bad debts recovered	2,400	Fire premium less reinsurance	12,00,000
Revenue (Fire as on 1 April,2014)	5,00,000	Management expenses(fire)	21,60,000
Revenue (Marine as on 1	16,40,000	Management expenses	
April,2014)	3,80,000	(marine)	2,90,000
Claims paid outstanding (fire)		Commission earned on	
Claims paid outstanding (marine)	7,60,000	reinsurance cede(fire)	8,00,000
Commission paid (fire)	1,80,000	Commission earned on	
Commission paid (marine)	2,16,000	reinsurance cede(marine)	60,000
Additional reserve (fire as on 1			
April,2014)	1,00,000		1,20,000

In addition to the usual reserve, additional reserve in case of fire insurance is to be increased by 5% of net premium.

6. New Insurance Co. Ltd., is doing composite insurance business. The following balances pertaining to its marine business as on 31st March, 2014 are submitted to you for preparing the Revenue A/c for the year ended on that date in the prescribed form:

	(₹)
Commission on re-insurance accepted	1,86,000
Commission on direct business	1,95,000

Commission on re-insurance cede	3,42,000
Depreciation	7,000
Loss on sale of motor car	12,000
General Managers' Salary	48,000
Rent	62,500
Postage, telegram and telephones	10,000
Staff salary and bonus	1,50,000
Travelling expenses	25,600
Motor expenses	85,000
Printing, Stationery and periodicals	49,000
Law charges	25,000
Electricity charges	11,000
Contribution to staff provident fund	10,900
Audit fees	4,000
Bad debts	1,200
Miscellaneous expenses	2,5000
Claims under policies paid during the year	6,53,000
Reserve for unexpired as on 1st April, 2013	13,67,000
Additional reserve for unexpired risks as on 1st April, 2013	46,000
Premium received for less re-insurances	9,90,000

(1) Gross Premium written direct in India was ₹ 12,23,000.
(2) No premium was written outside India and as such no business was transacted outside India during 2015-14.
(3) Total estimated liability in respect of claims due or intimated as on 1st April, 2013 and 31st March, 2014, were Rs 1,200 and Rs 6,300, respectively.
(4) The general Manager's salary pertaining to Marine Department was Rs 24,000.
(5) Make an additional reserve of 10% of the premium received in addition to the usual reserve required to be maintained as per the code of conduct in respect of unexpired risks as on 31st March, 2014.

7. The following figures are from the books of Varuna Fire Insurance Co. Ltd. at the end of their financial year ended 31st March, 2014:

	(Rs)		*(Rs)*
Fire fund	6,20,000	Share capital	6,00,000
General reserve	3,00,000	Additions al reserves	2,20,000
Investments	20,00,000	Profit and Loss A/c	50,000
Premiums	18,01,022	Re-insurance premium	75,017
Claims paid	4,01,877	Claims recovered from re-insurance	14,079
Commission on re-insurance ceded			32,011
Commission on direct business			1,99,777
Commission on re-insurance accepted			40,100
Outstanding premiums			14,865

Claims intimated but not paid (1st April, 2013)	40,000
Expenses of management	2,87,965
Audit fees	12,000
Directors' fees	12,000
Rates and taxes	3,869
Rents	45,000
Income from investments	1,00,000
Share transfer fees	2,000
Loans (Dr.)	4,00,000
Sundry creditors	15,000
Agents balances (Dr.)	1,80,000
Cash in hand	20,155
Cash at bank	1,01,487

From the above, you are required to prepare Fire Revenue Account, Profit and Loss Account, Profit and Loss Apportion Account an Balance Sheet of the Company, after taking into account the following:

(i) Income tax to be provided Rs 2,50,000
(ii) Transfer to General Reserve Rs 1,00,000
(iii) Proposed Dividend 12%
(iv) Claims intimated but not paid as on 31st March, 2014, Rs 60,000.

8 From the following balances of Hi-Fi General Insurance Co. Ltd. as on 31st March 2013, prepare

(i) Fire Revenue A/c;
(ii) Marine Revenue A/c; and
(iii)Profit & Loss A/c.

Particulars	*Rs*	*Particulars*	*Rs*
Survey expenses (fire)	10,000	Commission earned on	
Additional reserve-opening (fire)	50,000	reinsurance ceded(marine)	60,000
Commission paid (marine)	1,08,000	Commission earned on	
Commission paid (fire)	90,000	reinsurance ceded(fire)	30,000
Claims paid and outstanding		Management expenses (fire)	1,45,000
(marine)	3,80,000	Management expenses	4,00,000
Claims paid and outstanding (fire)	1,80,000	(marine)	
Fire fund-opening	2,50,000	Marine premium	10,80,000
Marine fund-opening	8,20,000	*Less:* Reinsurances	
Bad debts recovered	1,200	Fire Premium	6,00,000
Share transfer fee	800	*Less:* Reinsurances	60,000
Director's fees	5,000	Profit on sale of land	5,000
Auditor's fees	1,200	Miscellaneous receipts	300
Bad debts (marine)	12,000	Differences in exchange (cr.)	14,000
Bad debts (fire)	5,000	Interest, dividends, etc,	35,000

		received Depreciation	

In addition to usual reserves, additional reserve in case of fire insurance is to be increased by 5% of the net premium.

9. From the following details, prepare the Revenue A/C, Profit and Loss Account and Balance sheet of Moon shine Insurance Co. Ltd. carrying on Marine Insurance business, for the year ended 31.3.2015.

	₹ '000		₹ '000
Agents balance (Dr.)	1,46,400	Share capital	15,00,000
Interest accrued but not due	8,200	Balance of marine fund	
Furniture & fixtures (cost	8,400	(1.4.2014)	7,60,000
Rs.12,600)		Unclaimed dividends	2,400
Stock of stationery	2,500	P & L a/c (Cr.)	2,40,000
Expenses of management	2,20,000	Sundry creditors	12,600
Foreign taxes & Insurance	12,300	Due to reinsurers	60,000
Outstanding premium	21,200	Premium less	12,40,000
Donations paid	8,600	reinsurance	
Advance income tax payments	62,000	Interest & Dividends	2,40,000
Sundry debtors	9,200	Transfer fees received	600
Govt. of India securities	9,20,000		
Debenture of public bodies	1,80,000		
Shares in limited companies	3,60,000		
State govt. securities	8,80,000		
Claims less re insurance	10,60,000		
Commission paid	62,400		
Cash & Bank balance	94,400		

Outstanding claims on 31.3.15 were Rs.1,40,000 thousands. Depreciation on furniture to be provided at 20% per annum.