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CORPORATE ACCOUNTING

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SYLLABUS

Corporate Accounting

BLOCK I: ISSUES OF SHARES & GOODWILL AND FINAL ACCOUNTING OF COMPANY

Unit 1: Issue of shares: Par, Premium and Discount - Forfeiture - Reissue - Surrender of Shares - Right Issue - Underwriting.	**Unit 1:** Issue of shares **(Pages 1-52);**
Unit 2: Redemption of Preference Shares - Provisions of the companies Act - Debentures - Issue - Treatment of different items relating to debenture in final accounts - Redemption - Methods of redemption of Debenture - Sinking Fund Method - Insurance Policy method.	**Unit 2:** Redemption of Shares and Treatment of Debentures **(Pages 53-92)**
Unit 3: Final Accounts of Companies - Trading Account - Profit and Loss Account - Profit and Loss Appropriation Accounts - Balance sheet - Managerial Remuneration - Remuneration payable to different categories of managerial personnel - Calculation of Managerial remuneration.	**Unit 3:** Final Accounts of Companies **(Pages 93-136);**
Unit 4: Valuation of Goodwill - Need - Methods of valuation of Goodwill - Average Profit method - super profit method - capitalization method.	**Unit 4:** Valuation of Goodwill **(Pages 137-152)**

BLOCK II: LIQUIDATION OF COMPANIES AND AMALGAMATION

Unit 5: Shares - Methods of valuation of Shares - Net asset method - Yield Method - Fair value Method.	**Unit 5:** Valuation of Shares **(Pages 153-170);**
Unit 6: Liquidation of Companies -Modes of Winding up - Statement of Affairs - Deficiency account or Surplus Account.	**Unit 6:** Liquidation of Companies **(Pages 171-190);**
Unit 7: Company Final accounts - Schedule VI Part I and Part II - Profit prior to incorporation - Managerial remuneration - Preparation of profit and loss account and Balance Sheet.	**Unit 7:** Company Final Accounts **(Pages 191-264)**
Unit 8: Amalgamation - Meaning - Advantages - Purchase consideration - Types of amalgamation - Net present value method - Absorption (Excluding inter - company holdings).	**Unit 8:** Amalgamation and Absoprtion **(Pages 265-290)**

BLOCK III: HOLDING COMPANY ACCOUNTS

Unit 9: External reconstruction and Internal reconstruction - Meaning - Accounting treatment - Alteration of share capital - Capital reduction account.	**Unit 9:** External Reconstruction and Internal Reconstruction **(Pages 291-310);**
Unit 10: Holding company accounts excluding inter-company holdings - Mutual Owings - Contingent Liability - Unrealized Profit - Revaluation of Assets.	**Unit 10:** Holding Company Accounts Excluding Inter-Company Holdings **(Pages 311-332);**
Unit 11: Liquidation of companies - Meaning - Reasons for winding up - Liquidator - Preferential creditors - Calculation of liquidator's remunerations - Liquidator's final statement of accounts.	**Unit 11:** Liquidation of Companies II **(Pages 333-358);**

BLOCK IV: BANKING COMPANY ACCOUNTS, HR ACCOUNTING

Unit 12: Accounts for banking companies - Preparation of profit and loss account and balance sheet - Accounts for Insurance Companies - Preparation of profit and loss account and balance sheet.	**Unit 12:** Accounts for Banking Companies and Insurance Companies **(Pages 359-458);**
Unit 13: International Financial Reporting Standards (IFRS) - Meaning - Advantages - Disadvantages.	**Unit 13:** International Financial Reporting Standards (IFRS) **(Pages 459-468);**
Unit 14: Human resource accounting - Characteristic, Applications methods - Principles of Government accounting - Principles of Responsibility accounting.	**Unit 14:** Human Resource Government and Responsibility Accounting **(Pages 469-500)**

CONTENTS

INTRODUCTION

BLOCK I: ISSUES OF SHARES & GOODWILL AND FINAL ACCOUNTING OF COMPANY

UNIT 1 ISSUE OF SHARES 1-52

1.0 Introduction
1.1 Objectives
1.2 Issue of Shares at Par
1.2.1 For Consideration other than Cash; 1.2.2 Issue of Shares for Cash
1.3 Issue of Shares at Premium
1.4 Issue of Shares at Discount
1.5 Forfeiture and Reissue
1.6 Surrender of Shares
1.7 Right Issue
1.7.1 Lien on Shares
1.8 Underwriting
1.9 Answers to Check Your Progress Questions
1.10 Summary
1.11 Key Words
1.12 Self Assessment Questions and Exercises
1.13 Further Readings

UNIT 2 REDEMPTION OF SHARES AND TREATMENT OF DEBENTURES 53-92

2.0 Introduction
2.1 Objectives
2.2 Redemption of Preference Shares and Provisions of the Companies Act
2.3 Issue of Debentures and Treatment of Different Items Relating to Debenture in Final Accounts
2.4 Methods of Redemption of Debenture
2.4.1 Sinking Fund Method; 2.4.2 Insurance Policy Method
2.5 Answers to Check Your Progress Questions
2.6 Summary
2.7 Key Words
2.8 Self Assessment Questions and Exercises
2.9 Further Readings

UNIT 3 FINAL ACCOUNTS OF COMPANIES 93-136

3.0 Introduction
3.1 Objectives
3.2 Trading Account, Profit and Loss Account, Profit and Loss Appropriation Accounts and Balance Sheet
3.2.1 Provisions as to Preparation of Financial Statements
3.2.2 Applicability of Schedule III
3.3 Managerial Remuneration
3.3.1 Remuneration Payable to Different Categories of Managerial Personnel and its calculation
3.4 Answers to Check Your Progress Questions
3.5 Summary
3.6 Key Words

3.7 Self Assessment Questions and Exercises
3.8 Further Readings

UNIT 4 VALUATION OF GOODWILL 137-152
4.0 Introduction
4.1 Objectives
4.2 Valuation of Goodwill: Meaning and Need
4.3 Methods of Valuation of Goodwill:
Average Profit, Super Profit and Capitalization Methods
4.4 Answers to Check Your Progress Questions
4.5 Summary
4.6 Key Words
4.7 Self Assessment Questions and Exercises
4.8 Further Readings

BLOCK II: LIQUIDATION OF COMPANIES AND AMALGAMATION

UNIT 5 VALUATION OF SHARES 153-170
5.0 Introduction
5.1 Objectives
5.2 Valuation of Shares: Meaning and Need
5.3 Methods of Valuation of Shares
5.4 Answers to Check Your Progress Questions
5.5 Summary
5.6 Key Words
5.7 Self Assessment Questions and Exercises
5.8 Further Readings

UNIT 6 LIQUIDATION OF COMPANIES 171-190
6.0 Introduction
6.1 Objectives
6.2 Liquidation: Meaning
6.2.1 Modes and Consequences of Winding Up
6.3 Statement of Affairs and Defciency and Surplus Account
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

UNIT 7 COMPANY FINAL ACCOUNTS 191-264
7.0 Introduction
7.1 Objectives
7.2 Schedule VI: Part I and Part II
7.2.1 Managerial Remuneration
7.3 Acquisition of Business: Preparation of Profit and Loss
Account and Balance Sheet
7.3.1 Profits Prior To Incorporation
7.4 Answers to Check Your Progress Questions
7.5 Summary
7.6 Key Words
7.7 Self Assessment Questions and Exercises
7.8 Further Readings

UNIT 8 AMALGAMATION AND ABSOPRTION 265-290
8.0 Introduction
8.1 Objectives
8.2 Amalgamation and Absorption
8.2.1 Applicability of AS 14 and Amalgamation; 8.2.2 Advantages
8.2.3 Purchase Consideration Including Net Present Value Method
8.2.4 Types of Amalgamation
8.3 Accounting Entries in the Books of Companies
8.4 Journal Entries in the Books of Transferor and Transferee Companies and Revised Balance Sheet
8.5 Answers to Check Your Progress Questions
8.6 Summary
8.7 Key Words
8.8 Self Assessment Questions and Exercises
8.9 Further Readings

BLOCK III: HOLDING COMPANY ACCOUNTS

UNIT 9 EXTERNAL RECONSTRUCTION AND INTERNAL RECONSTRUCTION 291-310
9.0 Introduction
9.1 Objectives
9.2 Meaning of External and Internal Reconstruction
9.3 Internal Reconstruction: Accounting Treatment
9.3.1 Alteration of Share Capital; 9.3.2 Capital Reduction Account
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions and Exercises
9.8 Further Readings

UNIT 10 HOLDING COMPANY ACCOUNTS EXCLUDING INTER-COMPANY HOLDINGS 311-332
10.0 Introduction
10.1 Objectives
10.2 Meaning of Holding Companies
10.3 Some Items to Be Considered in the Consolidated Balance Sheet
10.3.1 Mutual Owings; 10.3.2 Contingent Liability
10.3.3 Unrealized Profit; 10.3.4 Revaluation of Assets
10.4 Answers to Check Your Progress Questions
10.5 Summary
10.6 Key Words
10.7 Self Assessment Questions and Exercises
10.8 Further Readings

UNIT 11 LIQUIDATION OF COMPANIES II 333-358
11.0 Introduction
11.1 Objectives
11.2 Meaning and Reasons for Winding Up
11.2.1 Liquidator
11.2.2 Preferential Creditor
11.3 Calculation of Liquidator's Remununeration

11.4 Liquidator's Final Statement of Accounts
11.5 Answers to Check Your Progress Questions
11.6 Summary
11.7 Key Words
11.8 Self Assessment Questions and Exercises
11.9 Further Readings

BLOCK IV: BANKING COMPANY ACCOUNTS, HR ACCOUNTING

UNIT 12 ACCOUNTS FOR BANKING COMPANIES AND INSURANCE COMPANIES 359-458
12.0 Introduction
12.1 Objectives
12.2 Accounts for Banking Companies
12.3 Preparation of Profit and Loss Account and Balance Sheet of Banking Companies
12.3.1 RBI Disclosure and Comments on Balance Sheet Items
12.4 Accounting Policies for Banking Sector
12.4.1 Accounting Treatment of Transactions of Special Types
12.5 Accounts for Insurance Companies
12.6 Preparation of Profit and Loss Account and Balance Sheet of Insurance Companies
12.6.1 Special Terms
12.6.2 Life Insurance Companies Annual Accounts
12.7 Answers to Check Your Progress Questions
12.8 Summary
12.9 Key Words
12.10 Self Assessment Questions and Exercises
12.11 Further Readings

UNIT 13 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) 459-468
13.0 Introduction
13.1 Objectives
13.2 IFRS: Meaning
13.2.1 Advantages and Disadvantages of IFRS
13.3 Answers to Check Your Progress Questions
13.4 Summary
13.5 Key Words
13.6 Self Assessment Questions and Exercises
13.7 Further Readings

UNIT 14 HUMAN RESOURCE GOVERNMENT AND RESPONSIBILITY ACCOUNTING 469-500
14.0 Introduction
14.1 Objectives
14.2 Characteristics of Human Resource Accounting and Application Methods
14.3 Principles of Government Accounting
14.4 Principles of Responsibility Acccounting
14.4 Answers to Check Your Progress Questions
14.5 Summary
14.6 Key Words
14.7 Self Assessment Questions and Exercises
14.8 Further Readings

INTRODUCTION

NOTES

Accounting has assumed much importance in today's competitive world of business in which corporate organizations have to show the true and fair view of their financial position. Thus, the application of accounting in the business sector has become an indispensable factor. Corporate Accounting is a branch of Financial Accounting that studies the accounting process of those operations that present specific unique features according to the legal status of the figure engaging in the business activity in question. The corporate accounting concepts and procedures are constantly reviewed and revised with the changing times. A clear exposition of such concepts and procedures is a must for students.

Corporate Accounting as a field include several important concepts like issue and redemption of shares and debentures, valuation of shares and goodwill, company final accounts, internal and external reconstruction, etc. It also deals with diverse accounting principles followed in banking and insurance businesses as well as newer innovations of accounting like Human resource accounting, government accounting as well as responsibility accounting.

This book, *Corporate Accounting*, has been designed keeping in mind the self-instruction mode (SIM) format and follows a simple pattern, wherein each unit of the book begins with the Introduction followed by the Objectives for the topic. The content is then presented in a simple and easy-to-understand manner and is interspersed with Check Your Progress questions to reinforce the student's understanding of the topic. A list of Self-Assessment Questions and Exercises is also provided at the end of each unit. The Summary and Key Words further act as useful tools for students and are meant for effective recapitulation of the text.

BLOCK - I
ISSUES OF SHARES & GOODWILL AND FINAL ACCOUNTING OF COMPANY

NOTES

UNIT 1 ISSUE OF SHARES

Structure

1.0 Introduction
1.1 Objectives
1.2 Issue of Shares at Par
1.2.1 For Consideration other than Cash
1.2.2 Issue of Shares for Cash
1.3 Issue of Shares at Premium
1.4 Issue of Shares at Discount
1.5 Forfeiture and Reissue
1.6 Surrender of Shares
1.7 Right Issue
1.7.1 Lien on Shares
1.8 Underwriting
1.9 Answers to Check Your Progress Questions
1.10 Summary
1.11 Key Words
1.12 Self Assessment Questions and Exercises
1.13 Further Readings

1.0 INTRODUCTION

A share is one of the units into which the total share capital of a company is divided. The Companies Act, 2013 defines a share as “share in the share capital of a company and includes stock”. [Sec. 2(84)].

Essential Features

The following are the essential features of a share:

1. A share has a nominal value and bears a distinct number.
2. A share certificate issued under the common seal of the company certifies that the person named herein is a registered holder of a specific number of shares bearing distinct numbers as mentioned in the certificate.
3. A share is an ownership security. In other words, a shareholder is a part-owner of the company.
4. A share is said to be a bundle of rights as well as liabilities. It secures to its owner the right to receive a proportionate part of the profits, if any, and proportionate part of the assets of the company upon liquidation.

On the other hand the shareholder may also be required to pay the full value in winding up.

5. Shares may be issued generally at par or premium and at discount only in certain cases.
6. A share is considered to be a movable property transferable in the manner provided in the articles of the company [Sec. 44].

NOTES

Stocks

Fully paid up share capital may, if the Articles so permit, be converted into stock by an ordinary resolution (a resolution by simple majority) of the members. Stock is the aggregate consolidated holdings of the share capital of a person. It can be divided and transferred in any fractions and sub-divisions without regard to the original face value of the share for the purpose of convenient holding into different parts.

Difference between a Share and a Stock

(1) A share may not be fully paid up, but a stock is always fully paid up.

(2) A share has a nominal value, whereas a stock has no nominal value.

(3) A share cannot be transferred in small fractions, while a stock can be transferred in any fractions.

(4) All shares bear distinct numbers, while stocks disclose the consolidated value of the share capital. Fractions of the stock do not bear any number.

(5) All shares are of equal denomination. Stock may be of unequal amounts.

(6) Unlike shares, stock cannot be directly offered by the company to the public in the first instance. Only fully paid up shares can be converted into stock by the company.

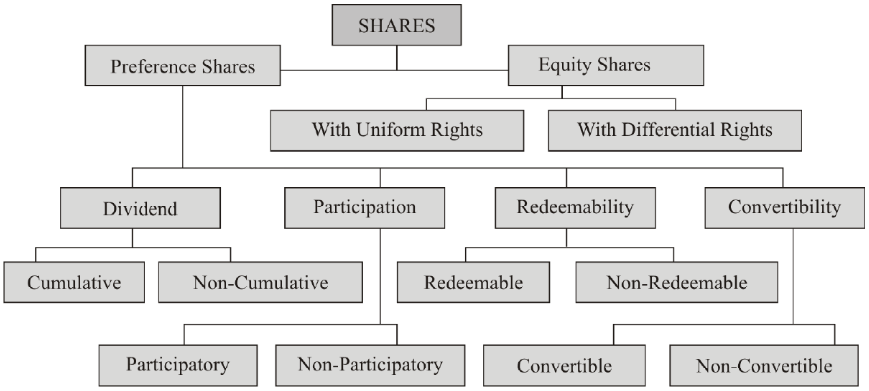
1.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the issues of shares at par, premium and discount
- Describe the forfeiture and reissue of shares
- Explain the surrender of shares
- Examine rights issue
- Describe underwriting of shares

1.2 ISSUE OF SHARES AT PAR

Before, learning about the issue of shares, let’s discuss its types. Shares can be of different types as given in the following chart:


SHARES
Preference Shares
Equity Shares
With Uniform Rights
With Differential Rights
Dividend
Participation
Redeemability
Convertibility
Cumulative
Non-Cumulative
Redeemable
Non-Redeemable
Participatory
Non-Participatory
Convertible
Non-Convertible

Each of the above types of shares are being explained in the following pages.

1. Preference Shares

Preference shares are those which carry the following preferential rights over other classes of shares:

(a) A preferential right in respect of a fixed dividend—it may consist of a fixed amount (say ₹ 30,000 p.a.) or a fixed rate (say 13% p.a.)

(b) A preferential right as to repayment of the capital in the event of company's winding up.

Categorisation and Type of Preference Shares Preference shares can be categorised variously. Their categories and the types under each category are shown below:

On the basis of Dividend

(i) **Cumulative preference shares.** In case of shares, arrears of dividend go on accumulating till they are paid. The accumulated arrears of dividend shall be paid before anything is paid out of profits to the holders of any other class of shares. Preference shares are always cumulative unless otherwise expressly stated in the company's articles.

Example 1: A company has 10,000, 12% preference shares of ₹100 each. The company has not paid dividend to its preference shareholders for the year 2012-13 and 2013-14. In 2014-15 the company earns adequate profits. In this case the company shall pay dividend for 3 years (including arrears of last 2 years) amounting to ₹3,60,000 (₹1,20,000 per annum) before paying any dividend to the equity shareholders.

(ii) **Non-cumulative preference shares**. In case of these shares dividend is not allowed to accumulate. The right to claim dividend will lapse if there are not sufficient profits in a particular year.

Example 2: In Example 1 if the preference shares are non-cumulative the company will pay dividend only for 2014-15 amounting to ₹1,20,000 to its preference shareholders before paying any dividend to its equity shareholders.

On the basis of Participation

(i) **Participating preference shares.** The holders of these shares are entitled to (a) a fixed dividend and (b) a share in the surplus profits, remaining after paying dividend to the equity shareholders up to a certain limit.

Example 3: A company has 10,000, 10% preference shares of ₹100 each and 1,00,000 equity shares of ₹10 each. The Articles provide that after paying a dividend at 15% to the equity shareholders, the remaining profits will be dividend in equally between Preference Shareholders and Equity Shareholders. The company makes a profit of ₹5,00,000 in the year 2014-15. The division of profit among the preference and equity shareholders will be as under:

	₹
Preference Shareholders at 10% on ₹10,00,000	1,00,000
Equity Shareholders at 15% on ₹10,00,000	1,50,000
	2,50,000

The balance of profit of ₹2,50,000 will be divided between Preference and Equity shareholders equally. Thus, the total share of different shareholders in the company's profits for 2014-15 will be as under:

	₹
Preference Shareholders (1,00,000 + 1,25,000)	2,25,000
Equity Shareholders (1,50,000 + 1,25,000)	2,75,000
	5,00,000

(ii) **Non-participating preference shares.** The holders of these shares are entitled to a fixed dividend and not a share in the surplus profits.

Example 4: In Example 3 if the preference shares and non-participating the profit of ₹5,00,000 made by the company during 2014-15 will be divisible between preference shareholders and equity shareholders as under:

	₹
Preference Shareholders at 10%	1,00,000
Equity Shareholders (5,00,000 – 1,00,000)	4,00,000
	5,00,000

On the basis of Convertibility

(i) **Convertible preference shares.** The holders of these shares to get their preference shares converted into equity shares within a certain period.

(ii) **Non-convertible preference shares.** These preference shares do not carry the right of conversion into equity shares.

On the basis of Redemption

(i) **Redeemable preference shares.** The shares which can be redeemed after a fixed period or after giving the prescribed notice, as desired by the company.

(ii) **Irredeemable preference shares.** Shares which cannot be redeemed during the life-time of the company.

NOTES

However, as per the Companies Act, 2013 a company can issue only such preference shares which are redeemable within 20 years from the date of issue. However, Preference Shares which are issued for infrastructure projects can be redeemable after a period exceeding 20 years.

Of course, in no case a company can issue irredeemable preference shares.

It may be noted that preference shares are always taken as cumulative, non-participating, non-convertible and redeemable, unless otherwise specified.

2. Equity Shares

Equity shares are those shares which are not preference shares. Equity shares can be of two types:

(i) With voting rights;

(ii) With differential right as to dividends, voting or otherwise in accordance with the rules and subject to such conditions as may be prescribed. [Sec. 43(a)]

Rules as to Issue of Equity Shares with Differential Rights

The following are the basic rules notified by the Ministry of Corporate Affairs for issue of shares with differential rights:

(a) The articles of association of the company authorizes the issue of shares with differential rights.

(b) The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders.

(c) The shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity.

(d) The company should have consistent track record of distributable profits for the last three years.

(e) The company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or a scheduled bank.

Difference between Equity Shares and Preference Shares

The points of difference between equity shares and preference shares can be put as follows:

(i) **Fixed dividend rate.** In case of equity shares, the dividend rate is not fixed, while in case of preference shares, the dividend rate is fixed.

(ii) **Priority as to payment of dividend.** Preference shares have priority as to payment of dividend over the equity shares. In other words, first dividend is to be paid at fixed rate to the preference shareholders. The balance, if any, can be used for payment of dividend to equity shareholders.

(iii) **Priority as to repayment of capital.** Preference shareholders are entitled to priority as to repayment of capital in the event of the company's winding up, while equity shareholders are not entitled to any such priority.

(iv) **Voting Rights.** Preference shareholders in general have no voting rights at the general meeting of the company, while equity shareholders are entitled to vote at the general meeting of the company. This means preference shareholders are not entitled to participate in the management of the company, while equity shareholders can do so.

(v) **Redemption.** Preference shares are always redeemable. As a matter of fact, according to The Companies Act, 2013, a company can only issue preference share which are redeemable within a period of 20 years from the date of issue except those issued for infrastructure project which may be redeemable for a period exceeding 20 years. However equity share are not redeemable. The money is returned in them only in the event of company's winding up after satisfying the claims of all the persons. Of course, The Companies Act, 2013 permits companies to purchase their own shares subject to certain conditions as provided in Section 68 of the Act.

Share Capital

The sum total of the nominal value of shares of a company is called as its share capital. In case of companies, the terms, 'capital' and 'share capital' have been held to be synonymous. The share capital of a company may be of two kinds:

(a) **Preference share capital:** It is the sum total of the nominal value of preference shares of a company.

(b) **Equity share capital:** It is the sum total of the nominal value of equity shares of a company. According to Section 2 of The Companies Act, 2013, share capital can be classified as under:

   (1) *Authorised Capital or Nominal Capital:* It means such capital as is authorized by the memorandum of a company to be the maximum

amount of share capital of the company [Sec. 2(8)]. It is also termed as "Nominal" or "Registered Capital" of the company.

(2) *Issued Capital:* It means such capital as the company issues from time to time for subscription. [Sec. 2(50)]. It consists of the shares which are offered for subscription within the authorised limit. It is represented by the nominal value of:

(i) The shares allotted for cash.

(ii) The shares allotted for consideration other than cash.

(iii) The shares subscribed for by the signatories to the Company's Memorandum.

(3) *Subscribed Capital:* It means such part of the capital which is for the time being subscribed by the members of a company. [Sec. 2(86)]. It represents that portion of the issued capital which has been subscribed and allotted.

It is possible that all shares offered are not subscribed to and to the extent of unsubscribed portion there will be a difference between shares issued and subscribed. Share capital may not have been allotted because of certain formalities required to be observed by the Shareholder (e.g., in case of right shares). In any case the share capital which could not be finally allotted will be taken as "unissued capital". Thus, ultimately the subscribed capital and issued capital (in terms of number of shares) are the same because if the number of shares subscribed is less than what is offered, the company can allot only the number of shares for which subscription has been received. The shares issued but unsubscribed will again be issued whenever a new issue of capital is made. However, at a particular moment of time Issued Capital and Subscribed Capital may be different.

(4) *Called-up Capital:* It means such part of the capital, which has been called for payment [Sec. 2(15)].

(5) *Paid-up Share Capital or Share Capital Paid-up:* It means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares (e.g., share premium) by whatever name called [Sec. 2(64)].

Example 5: A company is registered with an authorized capital of ₹10,00,000 divided into 50,000 equity shares of ₹10 each and 5,000 Preference Shares of ₹100 each. Its share capital is being held as under as on 31st March, 2014.

(i) 5,000 equity shares of ₹10 each have been subscribed by subscribers to the Company's Memorandum.

(ii) 5,000 fully paid equity shares have been issued to the equity shareholders as bonus shares.

(iii) 30,000 equity shares of ₹10 each and 3,000 preference of ₹100 each have been offered to the public for subscription.

The Company has called up the entire money due on equity shares and preference shares. All shareholders have paid the calls on due dates except one holder of 100 equity share who could not pay the final call of ₹3 per share.

The different classes of share capital will be as under:

		₹
Authorised Capital		
50,000 Equity shares of ₹ 10 each		5,00,000
5,000 Preference share of ₹ 100 each		5,00,000
		10,00,000
Issued Capital		
40,000 Equity shares of ₹ 10 each		4,00,000
3,000 Preference shares of ₹ 100 each		3,00,000
		7,00,000
Subscribed Capital		
35,000 Equity shares of ₹ 10 each		3,50,000
3,000 Preference shares of ₹ 100 each		3.00,000
		6,50,000
Called-up Capital		
35,000 Equity shares of ₹ 10 each fully called up		3,50,000
3,000 Preference shares of ₹ 100 each, fully called up		3,00,000
		6,50,000
Paid-up Capital		
35,000 Equity shares of ₹ 10 each fully called up	3,50,000	
Less: Calls in arrears on 100 shares @ ₹ 3 per share	300	
		3,49,700
3,000 Preference shares of ₹ 100 each fully called and paid up		3,00,000
		6,49,700

Subscribed Capital and Schedule III to The Companies Act, 2013

According to Schedule III to The Companies Act, 2013, the Subscribed Capital has to be shown in the Notes to Balance Sheet under two heads:

(i) Subscribed and fully paid

(ii) Subscribed but not fully paid

This means there will no separate head for Paid-up Capital. Subscribed Capital may not be fully paid because of the following two situations:

(i) The company may not have called up the entire nominal value of a share

(ii) The company may have called up the entire amount but a shareholder(s) may not have paid all the calls.

Example 6: On the basis of the details given regarding Share Capital in Example 5, the details of share capital in the Notes to Accounts may appear as under:

Authorised Share Capital

		₹
50,000 Equity shares of ₹ 10 each		5,00,000
5,000 Preference shares of ₹ 100 each		5,00,000
		10,00,000
Issued Share Capital		
40,000 Equity shares of ₹ 10 each		4,00,000
3,000 Preference shares of ₹ 100 each		3,00,000
		7,00,000
Subscribed Capital		
Subscribed and fully paid up share capital	...	
3,000 Preference shares of ₹ 100 each		3,00,000
Subscribed but not fully paid up		
35,000 Equity shares of ₹ 10 each fully called up		3,50,000
Less: Calls in arrears on 100 shares @ ₹ 3 per share	300	3,49,700
		6,49,700

Schedule III and The Company's Balance Sheet

It may be useful here to give the Form of the Company's Balance Sheet as per Schedule III to the Companies, Act 2013.

PART I — FORM OF BALANCE SHEET

Name of the Company ....

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

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
	1	2	3	4
I	**EQUITY AND LIABILITIES**			
(1)	**Shareholders' 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			

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
	1	2	3	4
(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 and Advances			
	(e) Other Non-current Assets			
(2)	**Current Assets**			
	(a) Current Investments			
	(b) Inventories			
	(c) Trade Receivables			
	(d) Cash and Cash Equivalents			
	(e) Short-term Loans and Advances			
	(f) Other Current Assets			
	TOTAL			

Notes to Accounts (Extracts):

A company shall disclose in the Notes to Accounts Sheet regarding Shareholders' Funds briefly as given below:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) The number and amount of shares authorized;

(b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) Par value per share;

(d) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(e) Calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(f) Forfeited shares (amount originally paid up)

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

(a) Capital reserves;

(b) Securities premium reserve;

(c) Debenture redemption reserve;

(d) Surplus, *i.e.,* balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc. (Additions and deductions since last Balance Sheet to be shown under each of the specified heads).

(ii) A Reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus' after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Illustration 1.1: *X* Ltd. has an authorised capital of ₹ 10,00,000 divided into Equity Shares of ₹ 10 each. The company invited applications for 50,000 shares. Applications for 40,000 shares were received. All calls were made and were dully received except final call of ₹ 2 per share on 1,000 shares. 500 of the share on which final call was not received were forfeited. Show how Share Capital will appear in the Balance Sheet of the company as per Schedule III Part I of the Companies Act, 2013?

Solution:

***X* Ltd.**

Balance Sheet (Extracts)

Particulars	*Note No.*	₹
(i) **Equity & Liabilities**		
Shareholders' Funds:		
Share Capital	1	3,99,000
(ii) **Assets**		3,99,000
Current Assets:		
Cash and Cash Equivalents	2	3,99,000
		3,99,000

Notes to Accounts

	Particulars	₹
1.	**Share Capital**	
	Authorised Capital	
	1,00,000 Equity shares of ₹ 10 each	10,00,000
	Issued Capital	
	40,000 Equity shares of ₹ 10 each	4,00,000
	Subscribed Capital	
	Subscribed & fully paid up	
	39,500 Equity shares of ₹ 10 each	3,95,000
	Forfeited shares	4,000
		3,99,000
2.	**Current Assets**	
	Cash & Cash Equivalents	
	Cash at Bank	3,99,000
		3,99,000

Reserve Capital

It is that portion of the company's uncalled capital, which the company provides by special resolution to be called up only in the event of company's winding up. Conversion of ordinary capital into reserve capital is particularly beneficial to third parties since in the event of company's winding up, they are at least assured of getting this amount.

For example, a company has 10,000 equity shares of ₹ 10 each, ₹ 8 per share called up. The uncalled capital is ₹ 2 per share. The company resolves that out of ₹ 2, ₹ 1 shall be called up only for the purposes of the company's winding up. This amount of ₹ 1 per share or ₹ 10,000 in total will be termed as Reserve Capital.

Difference between Capital Reserve and Reserve Capital

Reserve Capital is different from Capital Reserve. A Capital Reserve is created out of capital profits. Such a reserve can be used for writing off capital losses or for issue of bonus shares. It has, therefore, a much wider use as compared to Reserve Capital.

The following are the points of distinction between Capital Reserve and Reserve Capital:

1. **Meaning.** Reserve Capital is that portion of uncalled capital which can be called up only for the purposes of company's winding up.

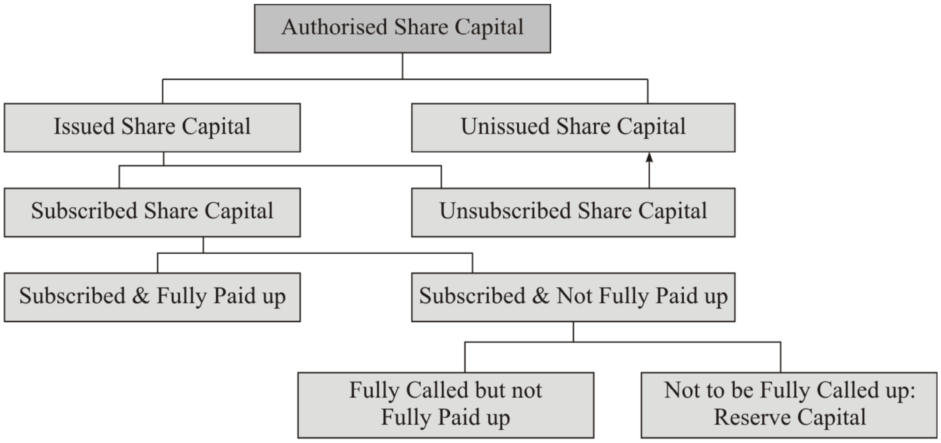
   Capital Reserve is a reserve created out of capital profits. Such reserve cannot be distributed by way of dividend. However, it can be used for writing off capital losses or for issue of bonus shares.

2. **Creation.** It is not mandatory to create reserve capital. It is created by the company by passing a special resolution.

The creation of capital reserve is almost mandatory. For example, profit on re-issue of forfeited shares has to be transferred to capital reserve. Similarly, this is a financially prudent policy to transfer capital profits to capital reserve.

3. **Disclosure in the balance sheet.** Reserve capital is not disclosed in the balance sheet. However, capital reserve is disclosed in the balance sheet under the heading Reserves and Surplus.
4. **Objective.** Reserve Capital is created to protect the interests of creditors since this amount will be available for payment to them in all eventualities. While Capital Reserve is created only as a part the prudent financial policy.
5. **Utility.** Reserve Capital cannot be used for issue of bonus shares, while capital reserve can be utilised for issuing bonus shares.

The kinds of share capital explained in the preceding pages can be presented as under:


Authorised Share Capital
Issued Share Capital
Unissued Share Capital
Subscribed Share Capital
Unsubscribed Share Capital
Subscribed & Fully Paid up
Subscribed & Not Fully Paid up
Fully Called but not Fully Paid up
Not to be Fully Called up: Reserve Capital

Accounting Entries

Shares may be issued by a joint stock company for two different considerations.

1. For consideration other than cash
2. For cash

1.2.1 For Consideration other than Cash

(i) **Issue of Shares to Vendors.** A company, may purchase a running business and pay to the vendors the purchase consideration, in the form of shares. The accounting entries will be as follows:

Sundry assets *Dr.*
(*Dr.* each asset purchased individually)
To Sundry liabilities
(*Cr.* each liability individually)
To Vendors

(Being purchase of assets and liabilities as per agreement dated ....)
Vendors *Dr.*
To Share capital
(Being payment to the vendors)

NOTES

Illustration 1.2: A company issued 15,000 fully paid up shares of ₹ 100 each for purchase of the following assets and liabilities from Mohan Brothers.

	₹
Land & Buildings	6,00,000
Plant	3,50,000
Stock-in-trade	4,50,000
Sundry Creditors	1,00,000

You are required to pass the necessary journal entries.

Solution:

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Land & Buildings	*Dr.*	6,00,000	
	Plant	*Dr.*	3,50,000	
	Stock-in-trade	*Dr.*	4,50,000	
	Goodwill (balancing figure)	*Dr.*	2,00,000	
	To Sundry creditors			1,00,000
	To Mohan Bros.			15,00,000
	(Being purchase of business)			
	Mohan Bros.	*Dr.*	15,00,000	
	To Share capital			15,00,000
	(Being issue of 15,000 shares of ₹ 100 each as payment of the prices of the business)			

(ii) **Issue of shares to the promoters.** A company may allot fully paid shares to the prompters or any other person for providing technical information, engineering services, plan outlay, drawings, etc. The promoters may be compensated for these services by the company by issuing fully paid shares. Such expenditure is of a capital nature and, therefore may appropriately be charged to Goodwill Account.

However, if the promoters have been issued fully paid shares for services connected with the formation of a company *viz*., preparation of the incorporation documents, payment of registration fee, etc. such amount may be debited to Preliminary Expenses Account. The accounting entries in such a case be understood with the help of the following illustration:

Illustration 1.3: A company purchased a running business from Messrs. Maheshwari Brothers for a sum of ₹ 1,50,000, payable as to ₹ 1,20,000 in fully paid shares of ₹ 10 each and balance in cash. The assets and liabilities consisted of the following:

	₹
Plant & Machinery	40,000
Buildings	40,000
Sundry Debtors	30,000
Stock	40,000
Cash	30,000
Sundry Creditors	20,000

You are required to pass the necessary journal entries in the company's books.

Simultaneously, the company also decided to remunerate promoters for getting the formalities completed for the formation of the company and providing technical services after that by issuing fully paid shares of ₹ 10,000 and ₹ 20,000 respectively.

You are required to pass the necessary journal entries in the company's books.

Solution:

Journal Entries

Date	*Particulars*		*Dr.*	*Cr.*
	Plant & Machinery	*Dr.*	40,000	
	Buildings	*Dr.*	40,000	
	Sundry Debtors	*Dr.*	30,000	
	Stock	*Dr.*	40,000	
	Cash	*Dr.*	30,000	
	To Sundry creditors			20,000
	To M/s Maheshwari Brothers			1,50,000
	To Capital reserve (balancing figure)			10,000
	(Being assets and liabilities taken over)			
	M/s Maheshwari Brothers	*Dr.*	1,50,000	
	To Share capital A/c			1,20,000
	To Bank A/c			30,000
	(Being payment to M/s Maheshwari Brothers)			
	Preliminary Expenses A/c	*Dr.*	10,000	
	Goodwill A/c	*Dr.*	20,000	
	To Share capital A/c			30,000
	(Being issue of fully paid shares to the promoters for formation and technical services)			
	Capital Reserve A/c	*Dr.*	10,000	
	To Goodwill A/c			10,000
	(Being writing off a part of goodwill from available capital reserve)			

(iii) **Issue of Sweat Equity Shares.** The expression 'Sweat equity shares' means equity shares issued by a company to its directors or employees at a discount or for consideration other than cash for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called [Sec.

* As amended by the Companies (Amendment) Act 2017.

2(88)]. All the limitations, restrictions and provisions relating to equity shares shall be applicable to such sweat equity shares.

Sweat equity shares can be issued subject to the following conditions:

(i) Such shares should be of a class of shares already issued.

(ii) The issue of sweat equity shares should be authorised by a special resolution passed by the company in the general meeting.

(iii) The resolution authorising the issue should specify the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are issued.

(iv) In case of companies where equity shares are listed on a recognised stock exchange, the sweat equity shares are to be issued as per the guidelines prescribed by *SEBI* in this behalf. In the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are to be issued as per the prescribed rules [Sec. 54].

Illustration 1.4: *Y* Ltd. purchased Intellectual Property Rights costing ₹1,35,000 from Mr. *A,* one of its directors. The payment was made by issue of equity shares of ₹ 10 each at a discount of ₹1 per share. Pass necessary journal entries in the books of *Y* Ltd.

Solution:

***Y* Ltd.**
Journal

Date	*Particulars*	*L.F.*	*Dr.* ₹	*Cr.* ₹
	Intellectual property rights *Dr.*		1,35,000	
	To *A*			1,35,000
	(Being intellectual property rights purchased)			
	A *Dr.*		1,35,000	
	Discount on issue of equity shares A/c *Dr.*		15,000	
	To Equity share capital A/c			1,50,000
	(Being the issue of 15,000 fully paid equity-shares of ₹ 10 each at a discount of ₹ 1 per share)			

Working Note:

Number of equity shares to be issued = $\frac{\text{Purchase Price}}{\text{Issue Price Share}} - \frac{₹\,1,35,00}{₹\,9}$
= 15,000 share

Valuation of Intellectual Property: The valuation of intellectual property rights or of the Knowhow provided or other value addition has to be carried out by a merchant banker. The merchant banker may consult appropriate experts or values for this purpose. The merchant banker shall also obtain a certificate from an independent chartered accountant certifying that valuation of the intellectual property, etc. has been done according to the relevant accounting standards.

Accounting Treatment: Where the sweat equity shares are issued for a non-cash consideration, such non-cash consideration shall be treated in the following manner in the books of account of the company:

(a) Where the non-cash consideration takes the form of a depreciable or amortizable asset, it shall be carried to the balance sheet of the company in accordance with the relevant accounting standards; or

(b) Where clause (a) is not applicable, it shall be expensed as provided in the relevant accounting standards.

Several Equity Shares as Part of Managerial Remuneration: The amount of sweat equity shares issued shall be treated as a part of managerial remuneration for the purposes of section 197 of the Companies Act, 2013 if the following conditions are fulfilled:

(i) The sweat equity shares are issued to any director or manager; and

(ii) They are issued for non-cash consideration, which does not take the form of an asset which can be carried to the balance sheet of the company in accordance with the relevant accounting standards.

1.2.2 Issue of Shares for Cash

Companies generally issue shares for cash. The procedure involved is as follows:

(i) **Applications:** The company issues a prospectus inviting the public to subscribe for its shares. The prospectus contains the details of the amount which the applicants have to pay as application and allotment moneys. The company may demand the full value of share on application itself or it may demand only a part of it. However, as stated earlier, the amount payable on application on every security shall not be less than 5% of the nominal price of the security or such other percentage or amount as may be specified by SEBI.

On receipt of application money, the journal entry will be as follows:

Bank A/c	Dr.
To Share application A/c	

(ii) **Allotment:** After the last of the applications have been received by the due date, the directors of the company will get a detailed list of the applicants, prepared. They will call a directors' meeting and take a decision about the persons to whom the shares have to be allotted and the number of shares to be allotted. Applicants to whom the shares are to be allotted will be issued letters termed as "Letters of Allotment" to that effect. They will also be required to pay allotment money as per terms of the prospectus. The journal entries will be as follows:

Share application A/c *Dr.*
To Share capital
(Amount due on application transferred to Share Capital A/c on allotment of shares as per Board's resolution no…dated….)

Share allotment A/c *Dr.*
To Share capital
(Being money due on allotment as per Board's resolution no…dated…)

Bank A/c *Dr.*
To Share allotment A/c
(Being money received on allotment)

Some companies prefer to have only one account, "Share Application and Allotment Account" in place of two separate accounts as stated above. In such a case the Journal entries will be as follows:

Bank A/c *Dr.*
To Share application and allotment A/c
(For application money received)

Share application and allotment A/c *Dr.*
To Share capital A/c
(For transfer of application money and allotment money becoming due)

Bank A/c *Dr.*
To Share application and allotment A/c
(For receipt of allotment money)

Share application money pending allotment As explained above, the share application money received, in respect of shares allotted, is transferred to share capital account on allotment of shares. However, if the balance sheet of a company is to be prepared after the receipt of the application money but before allotment of shares, it will not be appropriate to show the application money as share capital. In such an event, the share application money as per Schedule III to The Companies Act. 2013, has to be shown under the head a "Share Application Money Pending Allotment" till a final decision regarding allotment of shares is made.

(iii) **Calls** After allotment, whenever the need arises, the directors may demand further money from the shareholders towards payment of the value of the shares purchased by them. Such demands are termed as calls. There can be a maximum of three calls. The journal entries are:

(a) *On making 1st call.*
Share 1st call A/c *Dr.*
To Share capital A/c
(Being 1st call money due as per Board's resolution no…dated….)

(b) *On receipt of money of 1st call.*
Bank A/c *Dr.*
To Share 1st call A/c

(c) *On making 2nd call*
Share 2nd call A/c *Dr.*
To Share capital A/c
(Being money due on second call as per Board's resolution. no…dated…)

(d) Bank A/c *Dr.*
To Share 2nd call
(Being money received on 2nd call)

(e) *On making 3rd or final call*
Share final call A/c *Dr.*
To Share capital A/c
(Being money due on final call as per Board's resolution no…dated…)

(f) On receipt of money on final call
Bank A/c *Dr.*
To Share final call
(Being receipt of money on final call)

NOTES

In case a company decides to collect money on shares on less than three calls, the term "Final Call" is to be used with the call after which no call will be made.

For example if the money is to be collected only on one call, the journal entry will be:

Share 1st & final call *Dr.*
To Share capital account

Illustration 1.5: On 10 January 2016, a company offers 8,000 shares of ₹ 10 each. Applications are received for full 8,000 shares. Money is payable is as follows:

On Application	₹ 3 per share	On 1st Call	₹ 3 per share
On Allotment	₹ 2 per share	On Final Call	₹ 2 per share

The shares were duly allotted, calls made and money realised.

You are required to pass the necessary journal entries.

Solution:

Journal

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
2016	Bank A/c *Dr.*	24,000	
	To Share application A/c		24,000
	(Being application money received on 8,000 shares @ ₹ 3 per share)		
	Share Application A/c *Dr.*	24,000	
	To Share capital A/c		24,000
	(Being application money transferred to share capital account)		
	Share Allotment A/c *Dr.*	16,000	
	To Share capital A/c		16,000

Date	Particulars	Dr. ₹	Cr. ₹
	(Being money due for allotment on 8,000 shares @ ₹ 2 per share)		
	Bank A/c Dr.	16,000	
	To Share allotment A/c		16,000
	(Being money received on allotment)		
	Share 1st call A/c Dr.	24,000	
	To Share capital A/c		24,000
	(Being money due for 1st call on 8,000 shares @ ₹ 3 per share)		
	Bank A/c Dr.	24,000	
	To Share 1st call		24,000
	(Being money received on 1st call)		
	Share Final Call A/c Dr.	16,000	
	To Share capital A/c		16,000
	(Being money due on final call)		
	Bank A/c Dr.	16,000	
	To Share final call A/c		16,000
	(Being money received on final call)		

Check Your Progress

1. What are holders of participating preference shares entitled to?
2. Define reserve capital.

1.3 ISSUE OF SHARES AT PREMIUM

Legal provisions: A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash or for consideration other than cash. The power to issue shares at a premium need not be given in the Articles of Association. However, according to recent guidelines issued by SEBI, a new company set up by the entrepreneurs without a track record can issue capital to the public only at par. According to Section 52 of the Companies Act, the amount of such premium, shall have to be transferred by the company to the Securities Premium Account. The balance in this account is treated with the same sanctity as the paid up Share Capital of the company.

Utilisation of Securities Premium Account

This can be studied under two heads:

(a) **Companies which are not required to follow the accounting standards [Sec. 52(2)].**

These Companies can use the Securities Premium Account for the following purposes.

(i) towards the issue of unissued shares of the company to members of the company as fully paid bonus shares;

(ii) in writing off the preliminary expenses of the company;

(iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(iv) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(v) for the purchase of its own shares or other securities under section 68.

NOTES

(b) **Companies which are required to follow the accounting standards [Sec. 52(3)].**

These companies can use Securities Premium Account only for the following purposes:

(i) in paying up unissued equity shares of the company to be issued to members of the company as fully bonus shares; or

(ii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of equity shares of the company; or

(iii) for the purchase of its own shares or other securities under Section 68.

Note: As stated above according to Section 52 of the Companies Act, 2013 the amount of premium received on shares is to be transferred to the "Securities Premium Account". However, in the Notes to Accounts under Proforma of Balance Sheet as per Schedule III, under the heading "Reserves & Surplus", there is a sub-heading of "Securities Premium Reserve". Hence, some accountants, while making accounting entries, for share premium prefer the term "Securities Premium Reserve Account" in place of "Securities Premium Account". According to us any of the terms, i.e.,"Securities Premium Reserve Account" or "Securities Premium Account" may be used while making entries in respect of Securities premium.

However, in "Notes to Accounts" the Securities Premium will have to be shown as "Securities Premium Reserve" under the heading Reserves & Surplus as required by the Notes to Accounts given in Schedule III.

Accounting entries: Generally the amount of premium is payable in a lump sum on allotment. However, a company may require the applicants to pay premium money with application money or with calls. The accounting entries are made as follows:

(i) Where premium money is payable on allotment:

On amount being due:

Shares allotment A/c *Dr.*
To Share capital A/c
To Securities premium A/c
(Share allotment account will be debited with the amount due on account of share capital as well as securities premium).

On receipt of allotment money:

Bank A/c *Dr.*
To Share allotment A/c
(With the amount actually received)

NOTES

(ii) In case premium money is payable on application:

On receipt of application money:

Bank A/c *Dr.*

To Share application A/c

(With money received on account of share capital as well as securities premium)

On transfer of application money:

Share application A/c *Dr.*

To Share capital A/c

To Securities premium A/c

(iii) In case premium is received in parts, say, on application as well as allotment or allotment and first call, entries on the same pattern can be passed. For example, if premium is payable in two installments—on allotment and first call, the following accounting entries will be passed.

For premium due on allotment:

Share allotment A/c *Dr.*

To Share capital A/c

To Securities premium A/c

For receipt of allotment money:

Bank A/c *Dr.*

To Share allotment A/c

For premium due on first call:

Share 1st call A/c *Dr.*

To Share capital A/c

To Securities premium A/c

For receipt of first call money:

Bank A/c *Dr.*

To Share 1st call

Alternative Method

There is an alternative method for treatment of securities premium. No entry is passed for securities premium when it becomes due. However, on receipt of securities premium, the amount of securities premium is credited to Securities Premium Account. For example, if amount is to be received on allotment of 10,000 shares @ ₹ 3 per share (including ₹ 1 per share as premium) and only holders of 9,500 shares pay the allotment money, the following accounting entries will be passed for recording these transactions.

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Allotment A/c	*Dr.*	20,000	
	To Share capital A/c			20,000
	(Being money due on allotment on account of share capital)			
	Bank A/c	*Dr.*	29,500	
	To Share allotment A/c			20,000
	To Securities premium A/c			9,500
	(Being money received on account of share allotment and securities premium)			

The advantage of this method is that the securities premium account will not have to be debited in the event of the forfeiture of shares in case securities premium money has not been received. This has been explained in detail later while explaining forfeiture of shares.

The amount of securities premium is an item of capital gain. It will appear on the liabilities side of the balance sheet under the heading "Reserves and Surplus."

Illustration 1.6: A company offers 10,000 shares of ₹ 10 each to the public for subscription at ₹ 12 per share. Money is payable as follows:

₹ 3 on application,

₹ 4 on allotment (including ₹ 1 as premium)

₹ 5 on call (including ₹ 1 as premium)

Applications are received for 15,000 shares. No allotment is made to applicants for 3,000 shares and their application money is refunded. Rest are allotted shares on a pro rata basis. All allottees pay the money due on shares as and when called up.

Pass necessary journal entries and show how the items will appear in the company's balance sheet.

Solution:

Journal

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bank A/c	*Dr.*	45,000	
	To Share application A/c			45,000
	(Being the application money received on 15,000 shares @ ₹ 3 per share)			
	Share Application A/c	*Dr.*	45,000	
	To Share capital A/c			30,000
	To Bank A/c			9,000
	To Share allotment A/c			6,000
	(Being application money transferred to share capital on 10,000 shares, application money on 3,000 shares refunded and rest transferred to allotment)			
	Share Allotment A/c	*Dr.*	40,000	
	To Share capital A/c			30,000
	To Securities premium A/c			10,000
	(Being money due of allotment of 10,000 shares @ ₹ 4 per share including ₹ 1 as share premium)			
	Bank A/c	*Dr.*	34,000	
	To Share allotment A/c			34,000
	(Being money received on allotment)			
	Share Call A/c	*Dr.*	50,000	
	To Share capital A/c			40,000
	To Securities premium A/c			10,000
	(Being money due to call @ ₹ 5 per share including ₹ 1 as premium)			
	Bank A/c	*Dr.*	50,000	
	To Share call A/c			50,000
	(Being money received on call)			

.... CO. Ltd.
Balance Sheet
as on **.......**

Particulars	*Note No.*	₹
(i) **Equity & Liabilities**		
(a) Shareholders' Funds	1	1,00,000
(b) Reserves & Surplus	2	20,000
		1,20,000
(ii) **Assets**		
Current Assets		
Cash & Cash Equivalents	3	1,20,000
		1,20000

Notes to Accounts

Particulars	₹
1. **Share Capital**	
(a) *Authorised Capital*	
...... Shares of ₹ **......** each	....
Issued Share Capital	
10,000 shares of ₹ l0 each	1,00,000
Subscribed Capital	
Subscribed but not fully paid up	
10,000 shares of ₹ 10 each fully	1,00,000
2. **Reserves & Surplus**	
Securities Premium Reserve	20,000
	1,20,000
3. **Cash & Cash Equivalents**	
Cash at Bank	1,20,000
	1,20,000

1.4 ISSUE OF SHARES AT DISCOUNT

A company now cannot issue shares at a discount (*i.e.,* for a consideration less than the nominal value of the shares) except sweat equity shares. As discussed earlier, sweat equity shares are those shares which have been issued for consideration other than cash, *e.g.,* for intellectual rights or value additions. Section 53 of the Companies Act, 2013 provides as under:

(1) Except as provided in Section 54 (*i.e.,* Sweat Equity Shares), a company shall not issue shares at a discount.

(2) Any share issued by a company at a discount price shall be void.

However, the above provisions (1) and (2) will not be applicable.

(3) Where a company contravenes the provisions of this Section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to

six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Restrictions on the issue of shares at a discount as set out above do not apply in the case of debentures since they do not form the capital fund of the company but are merely creditorship securities.

NOTES

Accounting entries: The entry for discount has to be invariably made with allotment. The accounting entry will be as follows:

Share Allotment A/c	*Dr.*
Discount on Issue of Shares A/c	*Dr.*
To Share Capital A/c	

“Discount on Issue of Shares” will appear on the Assets side of the Balance Sheet as a negative item under the heading other current/non-current assets depending on whether the amount will be amortised in next 12 month or thereafter.

It is an acceptable practice that discount on issue of shares, share issue expenses, etc., should be written off over the period of benefit, *i.e.,* normally 3 to 5 years from profits available for that purpose.

On writing off discount the following entry shall be

Securities Premium */ P & L* Statement/Account*	*Dr.*
To Discount on Issue of Shares A/c	

***Note:** Schedule III to the Companies Act, 2013 gives the format in which a company has to prepare its Balance Sheet and Profit and Loss Statement. All appropriations out of profit have to be made in the Balance Sheet itself under the heading Reserves and Surplus. Hence, for reporting purposes the method given as per Schedule III has to be followed. However, accounting entries for appropriation are to be made as per the traditional procedure that is debiting the *P&L* account and crediting the Respective Appropriation Accounts. The illustration given below will explain this concept.

Illustration 1.7: A company offered 5,000 shares of ₹ 10 each, at a discount of 10%, to the public for subscription. Money was payable as follows:

₹ 4 on application, ₹ 3 on allotment, Balance as and when called up. Applications were received for 4,000 shares. The final call had not yet been made. All applicants paid application and allotment moneys.

During the year the company made a net profit of ₹ 15,000. It decided to write off the discount of ₹ 2,000 out of the profit for the year.

You are requested to prepare the necessary ledger accounts and show how the items would appear in the company’s balance sheet.

Solution:

Bank Account

Particulars	₹	*Particulars*	₹
To Share application A/c	16,000	By Balance c/d	43,000
To Share allotment A/c	12,000		
To Net profit for the year (presuming that it was realised in cash)	15,000		
	43,000		43,000

Share Application Account

Particulars	₹	Particulars	₹
To Share capital A/c	16,000	By Bank	16,000

Share Allotment Account

Particulars	₹	Particulars	₹
To Share capital A/c	12,000	By Bank A/c	12,000

Discount on Issue of Shares Account

Particulars	₹	Particulars	₹
To Share capital A/c	4,000	By P&L A/c	2,000
		By Balance c/d	2,000
	4,000		4,000

Profit & Loss Statement Account

Particulars	₹	Particulars	₹
To Discount on issue of shares A/c	2,000	By Net profit for the year	15,000
To Balance of profit taken to Balance sheet	13000		
	15,000		15,000

Share Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	32,000	By Share application A/c	16,000
		By Share allotment A/c	12,000
		By Discount on issue of shares A/c	4,000
	32,000		32,000

Co. Ltd.
Balance Sheet
as on ....

Particulars	Note No.	₹
(i) **Equity & Liabilities**		
(a) Shareholders' Funds	1	32,000
(b) Reserves & Surplus	2	13,000
		45,000
(ii) **Assets**		
None-current Assets		
Other non-current Assets	3	2,000
Current Assets		43,000
Cash & Cash Equivalents	4	45,000

Notes to Accounts

Particulars	₹
1. **Share Capital**	
Authorised Capital	
..... Shares of ₹ ..... each	....

Issued Share Capital	
4,000 shares of ₹ 10 each	40,000
Subscribed Capital	
Subscribed but not fully paid up	
4,000 shares of ₹ 10 each	
₹ 8 per share called & paid up	32,000
2. **Reserves & Surplus**	
Surplus as per profit & loss statement	15,000
Less: Discount on issue of shares written off	2,000
	13,000
3. **Other Non-current Assets**	
Discount on issue of shares (yet to be written off)	2,000
4. **Cash & Cash Equivalents**	
Cash at Bank	43,000

NOTES

1.5 FORFEITURE AND REISSUE

Legal provisions: Forfeiture of shares may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder. The Companies Act does not contain any specific provision regarding forfeiture of shares. However, Regulation, 28 to 34 of Model Articles of a company limited by shares (as contained in Table *F* of Schedule I of the Companies Act, 2013) make provision forfeiture of shares.

These provisions can be summarized as under.

(i) The power to forfeit shares must be expressly given by the company's Articles.

(ii) The procedure given in the Articles must be followed.

(iii) There should be a default by the shareholder in payment of a valid call.

(iv) A notice of demand, requiring the shareholder to pay calls of a specified amount within 14 days must be given.

(v) The Board of Directors must pass a resolution for forfeiture of shares.

(vi) The power to forfeiture must be exercised in good faith and in the interest of the company.

(vii) Forfeited shares may be sold or otherwise disposed of by the Board, as it deems fit. Board can cancel forfeiture on such terms as it deems fit.

The shareholder, whose shares have been forfeited, shall cease to be the member of the company. If the articles of the company permit, the company can sue him for unpaid calls even after the forfeiture. In such a case the ex-shareholder will be liable as an ordinary debtor and not as a contributory. But where the company goes into liquidation within one year of the forfeiture of shares, the ex-shareholder can be put on "List *B* contributories."

Accounting entries: The following points should be taken into account while passing an accounting entry for forfeiture of shares.

(i) The amount called up on the shares forfeited.

(ii) The amount unpaid on various calls (including allotment) on the shares forfeited.

(iii) The amount received on the shares forfeited.

Forfeiture of shares results in reduction of share capital and therefore the share capital account should be debited with the amount called up on these shares so far. The various unpaid calls account should now be cancelled and therefore they should be credited and the balance representing the amount received on the shares forfeited should be credited to a new account termed as "Forfeited Shares Account."

Share capital A/c *Dr.*
To Unpaid call(s) A/c
To Forfeited shares A/c
(Being forfeiture of…shares as per Board's resolution no…dated…..)

Shares, as explained before, can be issued at par, at premium or at discount. The accounting entries for forfeiture of shares in each of these cases are being explained below:

Forfeiture of shares issued at par The journal entry will be as follows:

Share capital A/c (with the amount called up) *Dr.*
To Unpaid call(s) A/c (with the amount, remaining unpaid)
To Forfeited shares A/c (with the amount received)

Illustration 1.8: A company forfeits 100 shares of ₹ 10 each fully called up on which the shareholder has failed to pay the allotment money of ₹ 2 per share and call money of ₹ 3 per share.

Solution:

The Journal entry for forfeiture will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Share Capital A/c *Dr.*	1,000	
	To Share allotment A/c		200
	To Share call A/c		300
	To Shares forfeited A/c		500

Forfeiture of shares issued at premium: There can be two situations.

(i) The amount of share premium had not been received but it was credited to "Securities Premium Account", when the amount became due. The journal entry for forfeiture will be:

Share capital A/c (with the amount called up) *Dr.*
Securities premium A/c (with the amount of premium called) *Dr.*
To Unpaid calls A/c
To Forfeited shares A/c

Illustration 1.9: A company forfeits 100 shares of ₹ 10 each issued at ₹ 11 per share. The premium was payable on allotment. The shareholder failed to pay allotment money of ₹ 3 per share (including premium) and the call money of ₹ 2 per share.

Solution:

The journal entry for forfeiture will be as follows:

Date	*Particulars*		₹	₹
	Share capital A/c	Dr.	1,000	
	Securities premium A/c	Dr.	100	
	To Share allotment A/c			300
	To Share call A/c			200
	To Forfeited shares A/c			600

(ii) The amount of share premium has either been received or even if not received, the company has given credit to the securities premium account only with the amount of premium received.

The journal entry will be:

Share capital A/c *Dr.*
(with the amount called up on account of share capital)
To Unpaid calls
(with unpaid amount excluding share premium)
To Forfeited shares A/c
(with the amount received)

Share premium once received cannot be cancelled. This is because of Section 52 which provides for the use of share premium received, only for certain specified purposes, as explained before.

Illustration 1.10: A company forfeits the shares held by two shareholders—*A* and *B*.

(i) *A* holds 100 shares of ₹ 10 each on which he has paid ₹ 5 per share (₹ 3 on application and ₹ 2 on allotment including ₹ 1 as premium payable on allotment) as application and allotment moneys but has failed to pay the call of ₹ 6 per share.

(ii) *B* holds 200 shares of ₹ 10 each on which he has paid ₹ 3 per share, as application money. He has failed to pay the allotment and call money.

The company gives credit to securities premium account only when it is received.

Pass necessary journal entries.

Solution:

S. No	*Particulars*		*Dr.* ₹	*Cr.* ₹
(i)	Share Capital A/c	*Dr.*	1,000	
	To Share call A/c			600
	To Shares forfeited A/c			400
	(Being forfeiture of 100 shares held by *A*)			

NOTES

(ii)	Share Capital A/c *Dr.*	2,000	
	To Share allotment A/c		200
	To Share call A/c		1,200
	To Shares forfeited A/c		600
	(Being forfeiture of 200 shares held by *B*)		

Forfeiture of shares issued at discount: In such a case the discount allowed on issue of shares will have to be cancelled. The journal entry will be:

Share Capital A/c *Dr.*
To Unpaid call A/c
To Forfeited shares A/c
To Discount on issue of shares A/c

Illustration 1.11: A company forfeits 100 shares of ₹ 10 each issued at ₹ 9 per share on account of non-payment of final call of ₹ 4 per share by the shareholder.

Solution:

The journal entry for forfeiture will be as follows:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Share capital A/c *Dr.*	1,000	
	To Share final call A/c		400
	To Forfeited Shares A/c		500
	To Discount on issue of shares A/c		100

Reissue of Forfeited Shares

Forfeited shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount. However, in case they are reissued at discount, the amount of discount cannot exceed the amount that had been received on these shares. In other words there cannot be any loss on account of reissue of forfeited shares.

Accounting entries: While passing accounting entries regarding reissue of forfeited shares the following points should be taken into account.

(i) The amount at which they are taken as paid up on reissue.

(ii) The amount that had already been received on the shares forfeited.

(iii) The amount allowed as discount.

The journal entry will be:

Bank A/c (with the amount recd.) *Dr.*
Forfeited Shares A/c (with the discount allowed) *Dr.*
To Share Capital A/c (with the amount taken as paid up)

Illustration 1.12: A company forfeits 100 shares of ₹ 10 each on which ₹ 300 had been received. The company can allow a maximum discount of ₹ 300 on these shares. In case these shares are reissued for ₹ 900 fully paid, pass the necessary journal entries.

Solution:

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bank A/c	*Dr.*	900	
	Forfeited Shares A/c	*Dr.*	100	
	To Share capital A/c			1,000
	(Being reissue of 100 forfeited shares)			

The balance standing to the credit of "forfeited shares account", is a capital profit and therefore, it will be transferred to capital reserve. The journal entry will be:

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Forfeited Shares A/c	*Dr.*	200	
	To Capital reserve			200
	(Being profit on reissue of forfeited shares transferred to capital reserve)			

In case only a part of the forfeited shares have been reissued, only the proportionate profit on reissue of forfeited shares will be transferred to capital reserve.

For example, if in the above case only 60 shares are reissued at ₹ 9 per share, the amount to be transferred to Capital Reserve will be ₹ 120

$$\left(\text{i.e. ₹ } 300\times\frac{60}{100}-\text{₹ } 60\right)$$

Reissue of forfeited shares originally issued at discount: In case the forfeited shares were originally issued at discount, the maximum permissible reissue discount, is the sum received on forfeited shares and original discount.

For example, if a share of ₹ 10 was originally issued at a discount of ₹ 1 is forfeited, and the amount received on it was ₹ 2, the maximum discount on reissue of such a forfeited share can be ₹ 3 (*i.e.,* original discount ₹ 1 + amt. recd. ₹ 2). The Journal entry will be as follows in case the share is reissued for ₹ 7 per share, fully paid up.

	Particulars		₹	₹
	Bank A/c	*Dr.*	7	
	Discount on issue of shares A/c	*Dr.*	1	
	Forfeited shares A/c	*Dr.*	2	
	To Share capital A/c			10

Illustration 1.13: *B* Ltd. forfeited 100 shares of ₹ 10 each, ₹ 8 per share being called up, which were issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share. Of these forfeited shares, 80 shares were reissued subsequently by the company at ₹ 5, as ₹ 8 paid up per share. Give journal entries for the forfeiture and reissue of shares.

NOTES

Solution:

In the Books of *B* Ltd.
Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Share Capital A/c (100 × ₹ 8)	*Dr.*	800	
	To Shares forfeited A/c (100 × ₹ 4)			400
	To Discount on issue of shares A/c (100 × ₹ 1)			100
	To Shares first call A/c (100 × ₹ 3)			300
	(Being forfeiture of 160 shares of ₹ 10 each, ₹ 8 called up issued at a discount of ₹ 1 per share for non-payment of first call of ₹ 3 per share)			
	Bank A/c (80 × ₹ 5)	*Dr.*	400	
	Discount on issue of shares A/c (80 × ₹ 1)	*Dr.*	80	
	Shares Forfeited A/c (80 × ₹ 2)	*Dr.*	160	
	To Share Capital A/c (80 × ₹ 8)			640
	(Being reissue of 80 forfeited shares of ₹ 10 each, ₹ 8 called up, originally issued at a discount of ₹ 1 per share, for ₹ 5 per share, credited as ₹ 8 per share)			
	Shares Forfeited A/c	*Dr.*	160	
	To Capital Reserve A/c			160
	(Being transfer of capital profit proportionate to forfeited shares reissued, *i.e.*, on 80 shares, to capital reserve account)			

Reissue of forfeited shares originally issued at premium: It is not necessary that if the shares were originally issued at premium, their reissue after forfeiture should also be at premium or that the premium should be at the same rate. However, if any premium is received (*i.e.*, over and above the amount taken as paid up on account of share capital), the amount should be credited to the "securities premium account."

Illustration 1.14: A company forfeits 100 shares of ₹ 10 each, originally issued at a premium of ₹ 2 per share. The shareholder paid ₹ 4 per share on application but did not pay the allotment money of ₹ 4 per share (including premium) and call of ₹ 4 per share. The company takes credit for the premium as soon as it becomes due. The shares are subsequently reissued at ₹ 11 per share fully paid up.

Pass journal entries for forfeiture and reissue of forfeited shares.

Solution:

Journal

Date	*Particulars*		₹	₹
	Share Capital A/c	*Dr.*	1,000	
	Securities Premium A/c	*Dr.*	200	
	To Share Allotment A/c			400
	To Share Call A/c			400
	To Shares Forfeited A/c			400
	(Being forfeiture of 100 shares on account of non-payment of allotment and call moneys)			

Date	Particulars		₹	₹
	Bank A/c	Dr.	1,100	
	To Share Capital A/c			1,000
	To Securities Premium A/c			100
	(Being reissue of forfeited shares)			
	Shares Forfeited A/c	Dr.	400	
	To Capital Reserve			400
	(Being transfer of profit on shares forfeited to capital reserve)			

NOTES

Alternative approach Some accountants are of the opinion that securities premium account appearing in the Balance Sheet should have definite relevance with the number of shares actually issued. Hence, in case shares are subsequently issued at a premium at a rate lower than the rate at which they were originally issued and the premium amount had not been received at the time of original issue, the shortfall should be met out of the shares forfeited account. For example, on the basis of the figures given in the previous illustration, the journal entry will be as follows:

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	1,100	
	Shares Forfeited A/c	Dr.	100	
	To Share Capital A/c			1,000
	To Securities premium A/c			200
	(Being reissue of 100 forfeited shares)			

However, such an approach may create problems in cases where forfeited shares account does not have sufficient amount to meet the shortfall on account of share premium. Thus, it is better to follow the first method given before.

1.6 SURRENDER OF SHARES

Surrender of shares means the return of shares voluntarily by the shareholder to the company for cancellation. In this case the shareholder voluntarily abandons the shares in favour of the company.

A company can accept surrender of shares only when it is authorised by its Articles. Moreover, surrender of shares can be accepted only under any of the following two circumstances.

(i) When shares are surrendered in exchange of a new issue of the same nominal value. There would be no reduction of share capital in such a case.

Journal entry for such a surrender of shares will be as follows:

Share Capital A/c (Old) *Dr.*
To Share Capital A/c (New)

NOTES

(ii) When shares are surrendered as a shortcut to forfeiture of shares, when all circumstances for forfeiture have arisen. Reduction of share capital in such a case shall be valid.

Journal entry for such a case will be on the same pattern as in the case of forfeiture of shares.

However, the term "shares surrendered account" will be used instead of "shares forfeited account" wherever necessary.

Pro rata allotment and forfeiture of shares In case of *pro rata* allotment of shares, there may be difficulties in finding out the amount not received on a particular call, if such shares have been forfeited. It will be better to find out the number of shares applied for in such a case on the following basis:

$$\frac{\text{Total shares applied for}}{\text{Total shares allotted}} \times \text{shares alloted to the defaulting shareholder}$$

For example, a company received applications for 18,000 shares against 10,000 shares of ₹ 10 each, offered for subscription. No allotment was made to applicants for 3,000 shares and the rest were allotted shares on *pro rata* basis. Money payable was as follows: ₹ 3 on application, ₹ 4 on allotment and the balance as and when called. A holder of 80 shares failed to pay the allotment money and his shares were subsequently forfeited. While passing entry for forfeiture of shares, it would be necessary to find out the money which this shareholder had not paid on allotment. This could be done as follows:

Shares applied for were: $\frac{15,000}{10,000} \times 80 = 120$

Amount paid as application money: 120 × 3 = 360

Shares allotted are only 100, extra money paid is ₹ 60 (*i.e.*, 360 – 300)

Amount payable on allotment 100 shares × 4	₹	400
Extra paid with application	₹	60
Amount not paid	₹	340

Illustration 1.15: A company offered for public subscription 10,000 shares of ₹ 10 each at ₹ 11 per share. Money was payable as follows:

₹ 3 on application

₹ 4 on allotment

₹ 4 on first and final call.

Applications were received for 12,000 shares and the directors made *pro rata* allotment.

A an applicant for 120 shares, could not pay the allotment and call moneys. *B*, a holder of 200 shares, failed to pay the call. All these shares were later on forfeited.

Out of the forfeited shares, 150 shares (the whole of *A*'s shares being included) were issued at ₹ 9 per share. Pass journal entries for the above transactions.

Solution:

NOTES

Journal

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bank A/c	*Dr.*	36,000	
	To Share Application A/c			36,000
	(Being application money received on 12,000 shares @ ₹ 3 per share)			
	Share Application A/c	*Dr.*	36,000	
	To Share Capital A/c			30,000
	To Share Allotment A/c			6,000
	(Being transfer of application money to Share capital A/c on 10,000 shares and the balance to allotment A/c)			
	Share Allotment A/c	*Dr.*	40,000	
	To Share Capital A/c			30,000
	To Securities Premium A/c			10,000
	(Being money due on allotment @ ₹ 4 per share on 10,000 shares including ₹ 1 on account of share premium)			
	Bank A/c	*Dr.*	33,660	
	To Share Allotment A/c			33,660
	(Being money received on share allotment: *See WN 1*)			
	Share Call A/c	*Dr.*	40,000	
	To Share Capital A/c			40,000
	(Being money due on call on 10,000 shares @ ₹ 4 per share)			
	Bank A/c	*Dr.*	38,800	
	To Share Call A/c			38,800
	(Being call money received on 9,700 shares)			
	Share Capital A/c	*Dr.*	3,000	
	Securities Premium A/c (*See WN 2*)		100	
	To Share Allotment A/c			340
	To Share Call A/c			1,200
	To Shares Forfeited A/c (*See WN 3*)			1,560
	(Being forfeiture of 300 shares)			
	Bank A/c	*Dr.*	1,350	
	Shares Forfeited A/c	*Dr.*	150	
	To Share Capital A/c			1,500
	(Being reissue of 150 forfeited shares)			
	Shares Forfeited A/c	*Dr.*	510	
	To Capital Reserve A/c			510
	(Being profit on forfeiture and reissue of 150 forfeited shares transferred)			

NOTES

Working Notes:

(i) Amount received on allotment has been calculated as follows:

	₹	₹
Total money due		40,000
Less: Amount not paid by an applicant for 120 shares who was allotted only 100 shares	400	
Less: Extra money paid with application 20 × 3 = 60	340	
		39,660
Less: Amount received with application		6,000
		33,660

(ii) Securities Premium Account has been debited only with ₹ 100 relating to *A*'s shares. The premium money has not been received on these shares.
In the case of *B*, since the premium has been received, the securities premium account has not been debited with the amount of premium on these 200 shares though they have been forfeited.

(iii) Shares forfeited account represents the money received on forfeited shares excluding share premium. This can be verified as follows:

	₹
A has paid @ ₹ 3 per share on an application for 120 shares	360
B has paid @ ₹ 6 per share on 200 shares (application and allotment moneys)	1,200
Total amount received	1,560

(iv) Account received from *A* on shares forfeited

₹	
(100 in all which have been reissued)	360
Amount received from *B* on shares forfeited (50 which have been reissued)	300
Total amount received on 150 shares which have been forfeited and now reissued	660
Less: Loss on reissue of forfeited shares	150
	510

Alternative method of treatment of share premium In case the company has followed the alternative method of treatment of share premium (*i.e.*, crediting the securities premium account only when actually received), the journal entries will be the same as stated before except for the following:

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	For money due on allotment:		
	Share Allotment A/c *Dr.*	30,000	
	To Share Capital A/c		30,000
	(Being money due on 10,000 shares @ ₹ 3 per share)		
	For receipt of allotment money:		
	Bank A/c *Dr.*	39,660	
	To Share Allotment A/c		29,760
	To Securities Premium A/c		9,900
	(Being receipt of allotment money on 9,900 shares together with the share premium)		
	For forfeiture of 300 shares:		
	Share Capital A/c *Dr.*	3,000	

	To Share Allotment A/c		240
	To Share Call A/c		1,200
	To Shares Forfeited A/c		1,560
	(Being forfeiture of 300 shares on account of non-payment of allotment and call)		

Illustration 1.16: Vishwas Ltd. with an authorised share capital of ₹ 90,00,000 divided into shares of ₹ 10 each, issued a prospectus inviting applications for 6,00,000 equity shares of ₹ 10 each issued at a premium of ₹ 2 per share payable as to ₹ 3 with application, ₹ 5 on allotment and the balance on first and final call to be made three months after the date of allotment.

Applications were received for 11,00,400 shares. Applications for 400 shares were rejected, full allotment was made on application for 1,00,000 shares while *pro rata* allotment was made on the remaining applications.

All the allottees paid the allotment money due.

The call was made as scheduled. All the shareholders except one shareholder holding 500 shares paid the money on call. These five hundred shares were forfeited and later re-issued as fully paid up shares @ ₹ 13 per share.

Prepare ledger accounts and cash book.

Solution:

Ledger Accounts

Equity Share Application Account

Particulars	₹	*Particulars*	₹
To Bank A/c	1,200	By Bank A/c	
To Equity Share Capital A/c (6,00,000 × 3)	18,00,000	(11,00,400 × 3)	33,01,200
To Equity Share Allotment A/c			
(5,00,000 × 3)	15,00,000		
	33,01,200		33,01,200

Equity Share Allotment Account

Particulars	₹	*Particulars*	₹
To Equity Share Capital A/c		By Equity share application A/c	15,00,000
(6,00,000 × 3)	18,00,000	By Bank A/c	15,00,000
To Share premium A/c	12,00,000		
	30,00,000		30,00,000

Equity Share 1st & Final Call Account

Particulars	₹	*Particulars*	₹
To Equity Share Capital A/c		By Bank A/c	23,98,000
(6,00,000 × 4)	24,00,000	By Equity share capital A/c	2,000
	24,00,000		24,00,000

NOTES

Securities Premium Account

Particulars	₹	*Particulars*	₹
To Balance c/d	12,01,500	By Equity Share Allotment A/c	
		(6,00,000 × 2)	12,00,000
		By Bank A/c (500 × 3)	1,500
	12,01,500		12,01,500

Equity Share Capital Account

Particulars	₹	*Particulars*	₹
To Equity Share 1st & Final		By Equity Share Application A/c	
Call A/c	2,000	(6,00,000 × 3)	18,00,000
To Equity Shares Forfeited A/c	3,000	By Equity Share Allotment A/c	
To Balance c/d	60,00,000	(6,00,000 × 3)	18,00,000
		By Equity Share 1st & Final	
		Call A/c (6,00,000 × 4)	24,00,000
		By Bank A/c	
		(500 × 10)	5,000
	60,05,000		60,05,000

Equity Shares Forfeited Account

Particulars	₹	*Particulars*	₹
To Capital Reserve A/c	3,000	By Equity Share Capital A/c	3,000
	3,000		3,000

Capital Reserve Account

Particulars	₹	*Particulars*	₹
To Balance c/d	3,000	By Equity Shares Forfeited A/c	3,000

Cash Book (Bank Column Only)

Particulars	₹	*Particulars*	₹
To Equity Share application A/c		By Equity Share Application A/c	
(11,00,400 × 3)	33,01,200	(400 × 3)	1,200
To Equity Share Allotment A/c		By Balance c/d	72,04,500
(30,00,000 – 15,00,000)	15,00,000		
To Equity Share 1st & Final Call A/c			
(24,00,000 – 2,000)	23,98,000		
To Equity Share Capital A/c			
(500 × 10)	5,000		
To Securities Premium A/c	1,500		
	72,05,700		72,05,700

Use of cash book In the illustrations explained so far, even cash transactions have been entered through journal entries whereas usually for recording cash transactions like receipts and payments, cash book is used and not the Journal proper.

Check Your Progress

3. Where is the amount of share capital premium transferred to?
4. What is the only condition in which companies can issue shares at discount?
5. State the effect on share capital account in case of forfeiture of shares.

NOTES

1.7 RIGHT ISSUE

Meaning: In case of joint stock companies or corporations, generally the shareholders are given the pre-emptive right either by their Charter or by the Act applicable to them. This pre-emptive right gives holders of common stock (or equity shares) the first option to purchase additional issues of common stock.

A pre-emptive right (popularly termed simply as "right") may therefore be defined as an option to buy a security at a specified price during a specified period. "Right shares" are the shares so issued to the shareholders under such pre-emptive right.

Purpose: Issue of right shares serves two purposes:

(i) It preserves the power of control of the present shareholders. In the absence of such a right, the existing shareholders may be deprived of their controlling power if a large number of shares are offered for subscription to outsiders.

(ii) It prevents loss to the existing shareholders on account of dilution of the value of their shareholdings. For example, a company has a share capital of 1,000 equity shares of ₹ 100 each but having a market value of ₹ 150. The company needs additional funds of ₹ 50,000. It offers to outsiders 500 equity shares at ₹ 100 each. In such a case the total market value of the firm after the new issue would be ₹ 2,00,000 (*i.e.*, 1,50,000 + 50,000) and the value per share would come down to ₹ 133 (*i.e.,* 2,00,000/1,500) each. Thus, offering new equity shares below market value will dilute the value of the equity shares. It will be detrimental to the present equity shareholders but beneficial to those who have purchased the new shares.

Valuation of rights: When a company offers new shares to the existing shareholders, they are generally offered at a much lower price than their market price. This is because of two reasons. First, the company wants to give the existing shareholders some advantage because of their continued association with the company. Secondly, the company wants to make the right issue a success and therefore it takes into account the possible fall in the market value of the company's shares on account of a right issue.

NOTES

On a right issue being made, the existing shareholders have the privilege of either applying for the shares offered within a fixed period (usually 30 days) or to renounce their right to apply for these shares in favour of some other person. Since the right issue is being offered at a concessional price, an existing shareholder can make a profit by selling his right to apply for the new shares. He may sell this right with or without selling his existing shareholding. The price of the shares may therefore be either *cum-right price* or an *ex-right price*. The *cum-right price* gives the buyer, besides the ownership of the shares already held, the right to apply for new shares offered by the company, while the *ex-right price* gives the buyer only the ownership of the existing shares held by the seller and not the right to apply for additional shares offered by the company. *Ex-right price* is quoted either after the right shares have already been allotted by the company or the time to apply for right shares has already expired.

The *cum-right price* is higher than the *ex-right price* of the shares since the former includes the value of the right also. The value of the right can be calculated by applying the following formula:

$$R\frac{M-S}{N+1}$$

where, R = Value of one right

M = Cum-right market price of a share

S = Subscription price for a new share

N = Number of old shares required to purchase one new share

Illustration 1.17: *A* Ltd. has a share capital of 5,000 equity shares of ₹ 100 each, having a market value of ₹ 150 per share. The company wants to raise additional funds of ₹ 1,20,000 and offers to the existing shareholders the right to apply for a new share at ₹ 120 for every five shares held. You are required to calculate the value of a right.

Solution:

$$R\frac{M-S}{N+1}$$

$$R=\frac{150-120}{5+1}=\frac{30}{6}=₹5$$

The value of one right is, therefore, ₹ 5.

Valuation of a share ex-right: The ex-right value of a share can be determined by deducting the value of right from the *cum-right market price* of the share. For example, in the illustration given above, the ex-right value of a share would be ₹ 145 (*i.e.*, ₹ 150 – 5). The same result can be obtained by applying the following formula.

$$P\frac{MV+S}{N+1}$$

where, P = Theoretical market value of a share ex-right

M = Cum-market price

N = Number of old shares entitling purchase one new share

S = Subscription price for a new share.

On the basis of the data given in the above illustration, the theoretical ex-right value of a share will be as follows:

$$P=\frac{150\times5+120}{5+1}=\frac{750+120}{6}=₹145$$

The value of right by this method also comes to ₹ 5 (*i.e.*, 150 – 145)

1.7.1 Lien on Shares

A lien is a right of one person to satisfy a claim against another by holding or retaining the possession of that other's property.

A company can exercise its right of lien on shares held by a shareholder for any debt due by him to the company if such a right has been expressly given by the company's Articles.

The Articles generally provide for a lien on partly paid-up shares but there is nothing in the Companies Act which prevents a company from having a lien on fully paid-up shares as well. Lien is available to the company not only against the shares but also against dividends payable on the shares. Clauses 9 to 12 of Table F (Articles of a Company Ltd. by shares) also provides for this right. The following are the relevant provisions of Table F.

Regulation 9

(i) The company shall have a first and paramount lien:

(a) on every share (not being a fully paid share) for all moneys (whether presently payable or not) called or payable at a fixed time in respect of that share and

(b) on all shares (not being fully paid shares) standing registered in the name of a single person for all moneys presently payable by him or his estate to the company provided that the Board of Directors may at any time declare any share to be wholly or in part exempt from the provisions of this clause.

(ii) The company's lien, if any, on a share shall extend to all dividends payable and bonuses declared from time to time in respect of such shares.

Regulation 10

The company may sell in such manner as the Board think fit, any share on which the company has a lien......

Regulation 12

(i) The proceeds of the sale shall be received by the company and applied in payment of such part of the amount in respect of which lien exists as is presently payable.

(ii) The residue, if any, shall, subject to a like lien for sums not presently payable as existed upon the share before the sale, be paid to the person entitled to the shares at the date of the sale.

Accounting entries The following journal entries are made on enforcement of right of lien by a company:

(i) On sale of shares by a company:

Bank A/c (with sale proceeds)	*Dr.*
To Call A/c (with amount of unpaid call)	
To Shareholder A/c (balancing figure)	

(ii) On payment of surplus to the shareholder:

Shareholder A/c	*Dr.*
To Bank	

Lien Versus Forfeiture of Shares

The differences between Lien and Forfeiture of Shares is as follows:

(i) In case of lien a company cannot retain any profit arising out of sale of shares in enforcing its lien. It has to be refunded to the shareholder. While in the case of forfeiture the company can retain the profit arising out of the forfeiture and reissue of forfeited shares.

(ii) Lien can be exercised in respect of any amount of debt due by a shareholder to the company, while shares can be forfeited only on non-payment of call on shares by the shareholder.

Illustration 1.18: *X* is a holder of 1,000 shares of ₹ 10 each in a company. He has not paid the final call of ₹ 3 per share. *X* is also indebted to the company to the extent of ₹ 2,000 for goods purchased by him on credit. With a view to recover the money due by *X* the company exercised its right of lien and sold shares held by *X* in the company for ₹ 6,000. You are required to pass necessary journal entries in the books of the company.

Journal Entries

Date	*Particulars*		₹	₹
	Bank A/c	*Dr.*	6,000	
	To Share final call A/c			3000
	To *X*			3,000
	(Being sale of 1,000 shares of *X* in exercise of right of lien)			
	X	*Dr.*	1,000	
	To Bank A/c			1,000
	(Being payment of ₹ 1,000 to *X* after adjusting the amount of ₹ 2,000 due by him to the company)			

1.8 UNDERWRITING

The term underwriting in relation to companies means undertaking responsibility that the shares or debentures offered to the public for subscription will be fully subscribed for and in the event of any failure, the underwriter will subscribe for unsubscribed shares or debentures. The underwriter is paid commission for this service, which cannot exceed 5% of the issue price in case of shares and 2.5% of the issue price in case of debentures.

An underwriter may appoint several underwriters to work under him. Such underwriters are termed as sub-underwriters. They have no privity of contract with the company. They get their remuneration from the underwriter and are also responsible to him.

An underwriter is different from a broker. A broker does not guarantee the subscription for a company's shares or debentures. He simply agrees to procure subscription for the shares or debentures without any responsibility attached to it. He is paid commission on the shares or debentures subscribed through him subject to the overall limit as given above.

According to the guidelines issued by the SEBI, underwriting is now not mandatory. It is for the issuer to decide whether the issue is to be underwritten or not. However, where the issue is not underwritten and the minimum subscription of 90% of the offer to the public is not received, the entire amount received as subscription has to be refunded in full.

Marked applications

Underwriters or brokers issue application forms to the general public for subscribing to the shares or debentures of the company. Such application forms bear the stamp of the particular underwriter or broker who has issued such forms. This helps in identifying the applications received through various underwriters or brokers. This information is also relevant for ascertaining the amount of commission payable to each underwriter or broker as well as fixing up the liability of different underwriters for unsubscribed shares or debentures. The forms bearing the stamp of the underwriters or brokers are termed as marked application forms. The forms without any stamp of a broker or underwriter are termed as unmarked forms/applications. Of course, if there is a sole underwriter who has underwritten the whole issue, the distinction between marked and unmarked forms in not of much significance.

Joint underwriting

In case the number of underwriters, underwriting an issue is more than one, the underwriting is termed as 'joint underwriting' and the underwriters as joint underwriters. For example, if *A* and *B* underwrite an issue of 10,000 shares of a company in the ratio of 6:4 (*i.e*., 6,000 by *A* and 4,000 by *B*), the underwriting will be termed as a joint underwriting. In such a case, underwriters will be first given the benefit of unmarked forms in the ratio of their gross liability (*i.e.,* 6:4). Each underwriter will then be given the benefit of forms marked in his favour. In case there is a surplus in respect of an underwriter, the benefit of such surplus will be given to the other underwriters in the ratio of their gross liability.

Illustration 1.19: Albert Ltd. issued 50,00,000 equity shares of ₹ 10 each. The whole issue was underwritten by *A*, *B* and *C* as below:

A	15,00,000 shares
B	25,00,000 shares
C	10,00,000 shares

Applications were received for 48,50,000 shares of which the marked applications were as follows:

A	12,00,000 shares
B	25,00,000 shares
C	8,50,000 shares

Calculate the number of shares to be taken up by the underwritters.

Solution:

Number of Shares

Particulars	A	B	C
Gross Liability (3 : 5 : 2)	15,00,000	25,00,000	10,00,000
Less: Marked applications	12,00,000	25,00,000	8,50,000
	3,00,000	Nil	1,50,000
Less : Unmarked applications in 3 : 5 : 2 ratio	90,000	1,50,000	60,000
	2,10,000	(1,50,000)	90,000
Less: Surplus of *B* allocated to *A* & *C* in 3 : 2 ratio	90,000	1,50,000	60,000
Number of shares to be taken up by the underwriters	1,20,000	Nil	30,000

Firm Underwriting

Firm underwriting refers to a definite commitment by the underwriter or underwriters to take up a specified number of shares or debentures of a company irrespective of the number of shares or debentures subscribed for by the public.

For example *A*, *B* & *C* underwrite 6,000, 2,500 and 1,500 shares which includes a firm underwriting of 800 shares, 300 shares and 1,000 shares respectively. This means that only 7,900 shares will be available to the general public for subscription. In case the applications are for 8,500 shares, the public will be allotted only 7,900 shares. In other words in case of firm underwriting even if the issue is oversubscribed the underwriters are liable to take up the agreed number of shares or debentures.

While computing the individual liability of the underwriters the shares *underwritten firm* can be dealt in any of the following manner in the absence of any specific instructions in the question.

(i) The shares underwritten firm may be allowed to be adjusted against the individual liability of each underwriter separately or by including them in the marked forms.

In such a case, the statement of liability of underwriters will appear as follows:

Statement of Liability of Underwriters

Particulars	A	B	C
Gross liability (total shares underwritten)	...	...	...
Less: Firm underwriting	...	...	...
	...	...	...
Less: Unmarked forms (in the ratio of gross liability)	...	...	...
Less: Marked forms	...	...	...
Net liability for unsubscribed shares	...	...	...
Add: Firm underwriting	...	...	...
Total shares to be subscribed by the underwriters	...	...	...

(ii) The benefit of shares *underwritten firm* may be shared by all underwriters. In such a case shares underwritten firm will be included in the unmarked forms. In such a case, the Statement of Liability of underwriters will appear as shown above except that the shares underwritten firm by each underwriter will not be specifically adjusted against his individual liability but will be included in the *total unmarked forms* to be distributed amongst all underwriters in the ratio of their gross liability.

NOTES

Illustration 1.20: *ABC* Ltd. issued 10,000 shares of ₹ 100 each at a premium of ₹ 20 per share. The entire issue was underwritten by underwriters *A*, *B* and *C* as follows:

A	5,000 shares	(Firm underwriting	1,000 shares)
B	3,000 shares	(Firm underwriting	500 shares)
C	2,000 shares	(Firm underwriting	500 shares)

Shares applied for were 9,000 — the following being the marked forms (including firm underwriting):

A	3,500 shares
B	1,400 shares
C	1,600 shares

Money payable was as follows:

On application	₹ 30
On allotment	₹ 50

Balance on call, which was duly made and all allottees including the underwriters paid the money.

Calculate the liability of each underwriter and the commission each will get, assuming it is the maximum allowed by law. Pass necessary journal entries recording the above transactions.

Solution:

Statement of Liability of Underwriters

Particulars	A	B	C
Gross Liability	5,000	3,000	2,000
Less: Unmarked Forms (2,500 in ratio of 5: 3 : 2)	1,250	750	500
	3,750	2,250	1,500
Less: Marked Forms (including firm underwriting)	3,500	1,400	1,600
	250	850	–100
Credit for *C*'s oversubscription to *A* and *B* in the ratio of 5 : 3	63	37	+ 100
Net Liability	187	813	–
Add: Firm Underwriting	1,000	500	500
Total Liability	1,187	1,313	500

Commission will be @ 5% of the issue price of shares underwritten as calculated below:

A 5,000 × 120 × 5/100 = ₹ 30,000

B 3,000 × 120 × 5/100 = ₹ 18,000

C 2,000 × 120 × 5/100 = ₹ 12,000

Journal

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Bank A/c	*Dr.*	2,70,000	
	To Share application A/c			2,70,000

Date	Particulars	Dr. ₹	Cr. ₹
	(Being application money received on 9,000 shares @ ₹ 30 per share)		
	Share Application A/c Dr.	2,70,000	
	To Share capital A/c		2,70,000
	(Being transfer of share application money to share capital account)		
	Share Allotment A/c Dr.	4,50,000	
	To Share capital A/c		2,70,000
	To Securities premium A/c		1,80,000
	(Being allotment money due on 9,000 shares @ ₹ 50 per share including premium of ₹ 20)		
	A Dr.	14,960	
	B Dr.	65,040	
	To Share capital A/c		60,000
	To Securities premium A/c		20,000
	(Being application and allotment money due by underwriters on 187 and 813 shares respectively)		
	Underwriting Commission A/c Dr.	60,000	
	To *A*		30,000
	To *B*		18,000
	To *C*		12,000
	(Being underwriting commission due)		
	Bank A/c Dr.	4,50,000	
	To Share allotment A/c		4,50,000
	(Being receipt of allotment money)		
	Bank A/c Dr.	47,040	
	To *B*		47,040
	(Being receipt of application and allotment money from *B* after adjustment of underwriting commission *i.e.,*₹ 65,040 – ₹ 18,000)		
	A (₹ 30,000 – ₹ 14,960) Dr.	15,040	
	C Dr.	12,000	
	To Bank		27,040
	(Being underwriting commission paid after adjusting money due on account of share application and allotment)		
	Share Final Call A/c Dr.	4,00,000	
	To Share capital A/c		4,00,000
	(Being call money due on 10,000 shares)		
	Bank A/c Dr.	4,00,000	
	To Share final call		4,00,000
	(Being final call money received)		

Note: It has been assumed that underwriters are entitled to underwriting commission soon after allotment of shares. It can also be presumed that underwriters will get their commission only after they have paid call money on their shares. In such a case the underwriting commission will be adjusted against the money due on call and not against money due on allotment.

Illustration 1.21: *A* Ltd. came out with an issue of 45,00,000 equity shares of ₹ 10 each at a premium of ₹ 2 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by *X, Y* and *Z*. Each underwriter took firm underwriting of 1,00,000 shares. Subscriptions for 31,00,000 equity shares were received with marked applications for the underwriters as given below.

Underwriter		No. of shares
X	—	7,25,000
Y	—	8,40,000
Z	—	13,10,000
		28,75,000

The underwriters are eligible for a commission of 5% on face value of shares. The entire amount towards shares subscription has to be paid along with application.

You are required to —

(i) Compute each underwriter's liability (number of shares); and

(ii) Compute the amount payable or due to underwriters.

Pass necessary journal entries in the books of *A* Ltd. relating to underwriting.

Solution:

Computation of Liability of Underwriters

(*No. of shares*)

Particulars	*X*	*Y*	*Z*
Gross liability	12,00,000	12,00,000	12,00,000
Less: firm underwriting	(1,00,000)	(1,00,000)	(1,00,000)
	11,00,000	11,00,000	11,00,000
Less: marked application	(7,25,000)	(8,40,000)	13,10,000)
	3,75,000	2,60,000	2,10,000)
Less: unmarked application	(1,12,500)	(1,12,500)	Nil
	2,62,500	1,47,500	2,10,000)
Less: Z's surplus distributed to *X* and *Y*	(1,05,000)	(1,05,000)	2,10,000
	1,57,500	42,500	Nil
Add: firm underwriting	1,00,000	1,00,000	1,00,000
Liability of Underwriters (in shares)	2,57,500	1,42,500	1,00,000

Amount Payable to Underwriters

(*in* ₹)

	X	*Y*	*Z*
Liability of shares	30,90,000	17,10,000	12,00,000
Less: commission @ 5%	6,00,000	6,00,000	6,00,000
Net amount paid by underwriters	24,90,000	11,10,000	6,00,000

Journal Entries

Underwriting commission A/c	*Dr.*	18,00,000	
To X a/c			6,00,000
To Y a/c			6,00,000
To Z a/c			6,00,000
(Being underwriting commission due)			
X	Dr.	30,90,000	
Y	Dr.	17,10,000	
Z	*Dr.*	12,00,000	
To Equity share capital a/c			50,00,000
To Securities premium a/c			10,00,000
(Being shares allotted)			
Bank A/c	*Dr.*	42,00,000	
To *X*			24,90,000
To *Y*			11,10,000
To *Z*			6,00,000
(Being amount received towards share allocated)			

Partial underwriting

A company may not get its total issue underwritten by the underwriters. For example, out of a issue of 10,000 shares to the public only 8,000 may be underwritten by different underwriters. This means that for 2,000 shares, the company itself is an underwriter. Such underwriting is termed as "Partial underwriting." In such a case the benefit of unmarked forms will first go to the company. In case there is a surplus, such surplus will be distributed among the other underwriters in the ratio of their gross liability.

Check Your Progress

6. What are cum-right and ex-right price?
7. How are brokers and underwriters different?

1.9 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Holders of participating preference shares entitled to (a) a fixed share of dividend and (b) a share in the surplus profits.
2. Reserve capital is that portion of a company's uncalled capital, which the company provides by special resolution to be called up only in the event of company's winding up.
3. According to the companies act, the amount of premium in case of issue of shares at premium is transferred by the company to the Securities Premium Account.
4. Companies now cannot issue shares at discount (i.e. for a consideration less than the nominal value of the shares) except sweat equity shares.

5. Forfeiture of shares results in reduction of share capital and therefore, the share capital account should be debited with the amount called up on these shares so far.
6. The cum-right price gives the buyer, besides the ownership of the shares already held, the right to apply for new shares offered by the company, while the ex-right price gives the buyer only the ownership of the existing shares held by the seller and not the right to apply for additional shares offered.
7. An underwriter is different from a broker. A broker does not guarantee the subscription for a company's shares or debentures.

1.10 SUMMARY

- A share is one of the units into which the total share capital of a company is divided.
- Shares are majorly divided into preference and equity shares.
- The sum total of the nominal value of shares of a company is called the share capital.
- Equity share capital may be classified as authorised, issued, subscribed, called-up and paid-up capital.
- Shares may be issued by a joint stock company for two different considerations like consideration other than cash and for cash.
- The procedure involved in issue of shares for cash: applications, allotment, calls etc.
- A company can issue its shares at a premium (i.e., for a value higher than the face value of the shares) whether for cash or for considerations other than cash.
- A company now cannot issue shares at a discount (i.e., for a consideration less than the nominal value of the shares) except sweat equity shares.
- The Companies Act does not contain any provisions regarding forfeiture of shares.
- Forfeiture shares become the property of the company and the company can always reissue them at its convenience. They can be reissued at par, premium or discount.
- Surrender of shares means the return of shares voluntarily by the shareholder to the company for cancellation. In this case, the shareholder voluntarily abandons the shares in favour of the company.
- In case of joint stock companies, generally the shareholders are given the pre-emptive rights either by their Charter or by the Act applicable to them.

- Undertaking the responsibility that the shares or debentures offered to the public for subscription will be fully subscribed for and in the event of any failure, the underwriter will subscribe for unsubscribed shares or debentures.
- According to the guidelines issued by the SEBI, underwriting is now not mandatory.

1.11 KEY WORDS

- **Share:** It is one of the units into which the total share capital of a company is divided.
- **Share capital:** It is the sum total of the nominal value of shares of a company.
- **Forfeiture of shares:** It may be defined as termination of membership and taking away of the shares because of default in payment of allotment and/or call money by a shareholder.
- **Surrender of shares:** It means the return of shares voluntarily by the shareholder to the company for cancellation.
- **Pre-emptive right:** It may be defined as an option to buy security at a specified price during a specified period.
- **Underwriting:** It refers to undertaking the responsibility that the shares or debentures offered to the public for subscription will be fully subscribed for and in the event of any failure, the underwriter will subscribe for unsubscribed shares or debentures.

1.12 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the rights preference shares carry over other category of shares?
2. Differentiate between preference and equity shares.
3. Write a short note on issue of shares for cash.
4. List the accounting entries for issue of shares at premium.
5. What are the entries to be passed for issue of shares at discount?
6. Mention the circumstances under which surrender of shares is authorized.
7. Briefly explain the purpose and valuation of rights shares.

Long Answer Questions

1. Discuss different types of preference shares.
2. Explain the categorization of share capital as per the Companies Act 2013.
3. Discuss accounting entries for consideration other than cash.
4. Examine the accounting treatment in case of forfeiture and reissue of forfeiture of shares.
5. Describe the concept and types of underwriting of shares and debentures.

1.13 FURTHER READINGS

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NOTES

UNIT 2 REDEMPTION OF SHARES AND TREATMENT OF DEBENTURES

Structure

2.0 Introduction
2.1 Objectives
2.2 Redemption of Preference Shares and Provisions of the Companies Act
2.3 Issue of Debentures and Treatment of Different Items Relating to Debenture in Final Accounts
2.4 Methods of Redemption of Debenture
2.4.1 Sinking Fund Method
2.4.2 Insurance Policy Method
2.5 Answers to Check Your Progress Questions
2.6 Summary
2.7 Key Words
2.8 Self Assessment Questions and Exercises
2.9 Further Readings

2.0 INTRODUCTION

A company cannot return its share capital to its shareholders during its lifetime except as provided under provisions The Companies Act (e.g. buy-back of shares). However, a company can issue a special category of shares termed as Redeemable Preference Shares, which the company can redeem during its lifetime as per the provisions of Section 55 of the Companies Act, 2013. These provisions have been framed keeping in view the fact that the interest of the third parties are not adversely affected on account of return of share capital to the shareholders.

Companies require money from time to time. This requirement is met by the company partly by raising share capital and partly by depending on public borrowings. One form of such public borrowings is to raise money by issue of debentures. Debentures help the companies in borrowing money from a large section of the general public.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the redemption of preference shares
- Explain the provisions of the companies act in reference to redemption of preference shares

- Examine the issue of debentures and treatment in the final accounts
- Describe the methods of redemption of debentures

2.2 REDEMPTION OF PREFERENCE SHARES AND PROVISIONS OF THE COMPANIES ACT

The legal provisions are as follows:

(i) The issue of redeemable preference shares must be authorised by the Articles of Association. Shares already issued cannot be converted into redeemable preference shares.

(ii) A company can issue preference shares which are liable to be redeemed within a period not exceeding twenty years from the date of their issue subject to such conditions as may be prescribed: Provided that a company may issue preference shares for a period exceeding twenty years for infrastructure projects, subject to the redemption of such percentage of shares as may be prescribed on an annual basis at the option of such preferential shareholders.

(iii) Such shares cannot be redeemed unless they are fully paid.

(iv) These shares can be redeemed subject to the terms and manners laid down in the Articles and only (a) out of the profits of the company which would otherwise be available for dividend or (b) out of the proceeds of a fresh issue of shares made for the purpose of redemption.

It is to be noted that amount in the securities premium account or development rebate reserve account or capital reserve etc., is not available for distribution by way of dividend, and, therefore, such funds cannot be used for redemption of preference shares. Similarly, the term "proceeds of fresh issue' does not include the amount received by way of securities premium since Section 52 does not permit use of securities premium for the redemption of preference share capital. However, if the shares are issued at a discount, the net amount received should be taken into consideration for calculating the "proceeds of the fresh issue."

(v) Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, the company must out of the profits which would have been otherwise available for dividend, transfer to 'Capital Redemption Reserve Account' a sum equivalent to the nominal amount of shares redeemed. 'Capital Redemption Reserve Account' may subsequently be utilised for the purpose of issuing fully paid bonus shares to the members of the company.

In the case of a capital reduction scheme, the capital redemption reserve account can be reduced in the same way as paid up share capital of the company.

The effect of the provisions given in clauses (iv) and (v) above is the replacement of redeemable preference share capital by fresh share capital or by Capital Redemption Reserve Account. Capital Redemption Reserve Account can be used only for issuing fully paid bonus shares. The intention of the law, therefore, is to keep intact even redeemable preference share capital by replacing such share capital by share capital issued for cash or issued out of profits as bonus shares.

(vi) Where any shares are redeemed out of the proceeds of the fresh issue, the premium, if any, payable on redemption must be provided for out of the profits of the company or out of the balance in the Securities Premium Account.

(vii) Where a company is not in a position to redeem any preference shares or to pay dividend, if any, on such shares in accordance with the terms of issue (such shares hereinafter referred to as unredeemed preference shares), it may, with the consent of the holders of three-fourths in value of such preference shares and with the approval of the Company Law Tribunal on a petition made by it in this behalf, issue further redeemable preference shares equal to the amount due, including the dividend thereon, in respect of the unredeemed preference shares. On the issue of such further redeemable preference shares, the unredeemed preference shares shall be deemed to have been redeemed.

(viii) Company must notify the fact of the redemption of shares to the Registrar of Joint Stock Companies within one month of such redemption.

Accounting entries The following are the accounting entries to be passed in the books of a company which wants to redeem its redeemable preference share capital.

(i) For making partly paid up shares fully paid up:

(a) Redeemable preference share final call A/c *Dr.*
    To Redeemable preference share capital A/c
(For final call being made)

(b) Bank A/c *Dr.*
    To Redeemable preference share final call A/c
(For money realised on final call)

(ii) For redeeming out of profits:

Profit & Loss A/c/Revenue reserves A/c *Dr.*
    To Capital redemption reserve A/c

(iii) For a fresh issue of shares:
Bank A/c *Dr.*
To Share capital A/c
(In case of issue of shares at premium or discount, the relevant account should be credited or debited)

(iv) Making provision for payment of premium on redemption of preference shares:
Securities premium/Profit and Loss/Revenue or Capital reserve A/c *Dr.*
To Premium on redemption of preference share A/c

(v) For money due to redeemable preference shareholders:
Redeemable preference share capital A/c *Dr.*
Premium on redemption of preference shares A/c *Dr.*
To Redeemable preference shareholders/preference shares redemption A/c

(vi) For payment of redeemable preference shareholders:
Redemable preference shareholders/preference share redeemable A/c
To Bank A/c

(vii) For issue of bonus shares:
(a) redemption reserve/Share premium/Revenue reserve A/c *Dr.*
To Bonus payable A/c
(b) Bonus payable A/c *Dr.*
To Share capital A/c

Tutorial Notes: The following points are worth noting:

(i) **Calls in Arrears.** In case calls are in arrear in respect of certain redeemable preference shares, such preference shares can be redeemed only when the calls are paid by the shareholders concerned. While attempting an examination problem, the students should not redeem these preference shares till the calls are paid. The amount of such preference capital not redeemed because of unpaid calls may be allowed to remain as Redeemable Preference Share Capital. Alternatively the amount of such capital may be transferred to Redeemable Preference Share Capital Suspense Account till a final decision (whether to forfeit or not) is taken. The Red. Pref. Share Capital Suspense Account may be shown under the heading Share Capital in the balance sheet. However, if a fresh issue is to be made for redemption of the preference shares, such issue should be made presuming that the shareholders holding preference shares against which calls are in arrears will also make payment of such calls.

In case preference shares are to be redeemed out of profits, an amount equivalent to the nominal value of the preference shares against which calls are in arrears should be allowed to remain in the Profit and Loss Account or the Revenue Reserve Account. On redemption of these shares, such amount should be transferred to Capital Redemption Reserve Account.

Alternatively, the amount may be transferred to Preference Shares Redemption Suspense Account. On redemption of these shares the amount may be transferred to Capital Redemption Reserve Account.

Any premium payable on redemption of preference shares may also be put to Preference Shares Redemption Suspense Account. On redemption of preference shares, such account will be debited with the amount of premium paid.

(ii) **Sale of Assets.** In case certain assets are sold for raising the necessary liquid resources, selling of such assets will not in any way affect transferring of the amount to the capital redemption reserve account or issue of new shares for redemption as per the requirements of law. Any profit or loss on sale of such assets (unless it is a capital profit) should preferably be transferred to the profit and loss account.

(iii) **Unpaid Amount.** In case certain Redeemable Preference shareholders could not be paid the amount due to them due to change of their addresses or their being untraceable, the amount due to them should be allowed to remain in the "Redeemable Preference Shareholders Account or Preference Shares Redemption Account." In the Balance Sheet the amount due to them can be shown under the heading Current Liabilities and Provisions.

The process of making necessary accounting entries, in case of redemption of preference shares can be very well understood with the help of the illustrations given below.

Illustration 2.1: Pioneer Construction Co. Ltd. decided to redeem their preference shares as on 31st March, 2017 on which date the position was as under.

Pioneer Construction Ltd.
Balance Sheet as at 31 March, 2017

	Particulars	*As at 31 March, 2017*
		₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued Subscribed & Paid up Capital:	
	4,000 Equity shares of ₹100 each	4,00,000
	4,000 Redeemable preference shares of ₹50 each, ₹25 Paid up	1,00,000
	2,000 Redeemable preference shares of ₹ 100 each Fully paid	2,00,000
	(b) Reserves and Surplus	
	Securities Premium Account	10,000
	Capital Redemption Reserve	90,000
	Dividend Equalisation Reserve	1,10,000
	(c) money Received Against Share Warrants	–
		9,10,000
2.	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–

	Particulars	*As at 31 March, 2017* ₹
4.	Current Liabilities	–
	(a) Short-term Borrowings	–
	(b) Trade Payables	90,000
		90,000
	Total (l) + (2) + (3) + (4)	10,00,000
B	Assets	
1.	Non-current Assets	–
2.	Current Assets	
	(a) Current Anvestments	–
	(b) Inventories	–
	(c) Trade Receivables	–
	(d) Cash and Cash Equivalents	1,40,000
	(e) Short-term loans and Advances	–
	(a) Other Current Assets	8,60,000
	Total (1) + (2)	10,00,000

The redemption was to be at a premium of 5 per cent. The Capital Redemption Reserve appearing in the balance sheet is the reserve brought into being as a result of a redemption which took place in 2000. To enable the redemption to be carried out the company decides to issue, after carrying out the necessary formalities required under law, sufficient number of new equity shares at a discount of 10 per cent. The redemption is duly carried out. Show journal entries relating to the redemption and new issue and also the balance sheet after redemption. Ignore the question of dividend upto the date of redemption.

Solution:

Tutorial Notes:

(i) Amount to be paid to preference shareholders:

As Share capital	₹ 2,00,000
As Premium on redemption	10,000
	2,10,000

Please note that only preference shares fully called and paid up are to be redeemed. No redemption can be carried out of 4,000 redeemable preference shares which are partly called and paid up.

(ii) Arrangement for redemption:

(a) ₹ 10,000 premium on redemption can be provided out of Securities Premium Account already appearing in the Balance Sheet (*See entry No. 5*).

(b) Preference Capital of ₹ 2,00,000 has to be redeemed. The number of new shares to be issued has not been given. However, in the absence of any specific amount in the question, their number has to be minimum. A sum of ₹ 1,10,000 is lying in the Dividend Equalisation Reserve. Redemption can be carried out of profits to this extent. The amount has therefore been transferred to Capital Redemption Reserve (*See entry No. 2*).

The balance has been redeemed by issuing new shares. Since the new shares are being issued at a discount, the number of new shares required to be issued to collect the necessary proceeds would amount to 90,000/9 = 10,000 (*See entry No. 3*).

Pioneer Construction Co. Ltd
Journal

S. No.	*Particulars*		*Dr.* ₹	*Cr.* ₹
(1)	Preference Share Capital A/c(fully paid)	*Dr.*	2,00,000	
	Premium on redemption of pref. shares A/c	*Dr.*	10,000	
	To Sundry preference shareholders A/c			2,10,000
	(Being amount due to preference shareholders on redemption, including premium at 5%)			
(2)	Dividend Equalisation Reserve	*Dr.*	1,10,000	
	To Capital redemption reserve A/c			1,10,000
	(Being transfer to the latter account as required by law, to the extent the redemption has been from distributable profits)			
(3)	Bank A/c	*Dr.*	. 90,000	
	Discount on Issue of Share A/c	*Dr.*	10,000	
	To Equity share capital A/c			
	(Being issue of new equity shares @ 10 per cent discount for the purpose of redemption of preference shares to the extent required)			1,00,000
(4)	Sundry preference Shareholders A/c	*Dr.*	2,10,000	
	To Bank			2,10,000
	(Being payment made to preference shareholders)			
(5)	Securities Premium A/c	*Dr.*	10,000	
	To Premium on redemption of preference shares			10,000
	(Being writing off premium on redemption of preference shares from share premium)			

Pioneer Construction Ltd.
Balance Sheet as at 31 March, 2017
(*Summarised balance sheet after redemption***)**

	Particulars	₹
A	**Equity and Liabilitie**s	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued Capital: 5,000 Equity Shares of ₹ 100 each	5,00,000
	4,000 Redeemable Preference Shares of ₹50 each, ₹25 Paid up	1,00,000
	(b) Reserves and Surplus	
	Capital Redemption Reserve	2,00,000
	Discount on Issue of Shares	(10,000)
	(c) money Received against Share Warrants	
		7,90,000
2	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	–
	(a) Short-term Borrowings	–
	(b) Trade Payables	90,000

	Particulars	₹
		90,000
	Total (l) + (2) + (3) + (4)	8,80,000
B	Assets	
1.	Non-current Assets	–
2.	Current Assets	
	(a) Current Investments	–
	(b) Inventories	–
	(c) Trade Receivables	–
	(d) Cash and Cash Equivalents	20,000
	(e) Short-term Loans and Advances	–
	(f) Other Current Assets	8,60,000
	Total (l) + (2)	8,80,000

Use of Mathematical Equation

Sometimes the use of a mathematical equation becomes necessary to find out the number of new shares to be issued. This particularly happens when a minimum new issue is to be made at premium or discount, the preference shares are to be redeemed at premium and the existing amount of divisible profits and share premium are not sufficient to redeem the preference shares in full.

The algebraic equation taking the new issue as *x* can be put as follows:

Red. Pref. Share Capital + Premium on Redemption	=	Premium in Balance Sheet	+	Divisible Profits in Balance Sheet	+	*x i.e.*, New Issue	+	Premium on *x* (or less Discount)

Illustration 2.2: Prosperous Ltd. has 12% preference share capital of ₹ 1 lac consisting of ₹ 100 shares fully called and paid up. The company wants to redeem them at 10% premium. The ledger accounts show the following balances:

Profits & loss A/c	₹ 20,000
Securities premium	4,000

The directors desire to make a minimum fresh issue of equity shares of ₹ 10 each at 5% premium for redemption of the preference shares.

You are required to ascertain the amount of such fresh issue to be made by the directors and pass the requisite journal entries.

Solution:

Since, the new issue of equity shares is to be made at a premium of an amount which is the minimum for redeeming preference shares, a mathematical equation will have to be used.

Let the new issue be of ₹ *x*

Redeemable Preference Share Capital + Premium on redemption	=	Share Premium as given + *P.* & *L.* A/c balance + Proceeds of fresh issue + Premium on fresh issue.

$$
\begin{aligned}
& & = 1,00,000 + 10,000 &= 4,000 + 20,000 + x + x/20 \\
&\text{or} & 1,10,000 &= 24,000 + 21x/20 \\
&\text{or} & -21x/20 &= -1,10,000 + 24,000 \\
&\text{or} & -21x/20 &= -86,000 \\
&\text{or} & 21x &= 86,000 \times 20 = 17,20,000 \\
& & x &= 17,20,000/21 \\
&\text{or} & &= 81,905
\end{aligned}
$$

Thus, a minimum new issue of ₹ 81,905 will have to be made for redemption of preference shares.

Verification In case each share is of ₹ 10, face value, 8,191 shares will be issued. The amount realised would be as under:

Share Capital	8,191 × 10	= ₹	81,910.00
Share Premium	8,191 × 0.50		4,095.50
			86,005.50
Total amount required for redemption:			
Red. Preference share capital			1,00,000
Premium on Redemption			10,0000
			1,10,000
Amount Available for redemption:			
Share Premium (4,000 + 4,095.50)		= ₹	8,095.50
Profit & Loss A/c balance			20,000.00
Proceeds from new Issue			81,910.00
			1,10,005.50

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Redeemable Preference Share Capital A/c	*Dr.*	1,00,000	
	Premium on Redemption of Pref. Shares	*Dr.*	10,000	
	To Redeemable pref. shareholders A/c			1,10,000
	(Being amount due to preference shareholders including 10% premium)			
	P&L A/c	*Dr.*	1,904.50	
	Share premium A/c	*Dr.*	8,095.50	
	To Premium on redemption of pref. shares			10,000
	(Being providing for premium on redemption)			
	P&L A/c	*Dr.*	18,095.50	
	To Capital redemptional reserve			18,095.50
	(Being transfer of balance in P. & L. A/c to Capital redemption reserve to provide for redemption of preference shares)			
	Bank A/c	*Dr.*	86,005.50	
	To Equity share capital A/c			81,910.00
	To Securities Premium A/c			4,095.50

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	(Being issue of 8,191 shares of ₹ 10 each at 10% premium)		
	Redeemable pref. shareholders A/c *Dr.*	1,10,000	
	To Bank A/c		1,10,000
	(Being money paid to preference shareholders on redemption)		

Illustration 2.3: Continuing with the data given in illustration 2.2 above, compute the amount of fresh issue if it is to be made at 10% discount.

Solution:

Let the new issue be *x*.

Red. Pref. Capital + Premium on Redemption	=	Share Premium as given	+	*P & L* A/c Balance	+	Net Proceeds from fresh issue

$$= 1{,}10{,}000 = 4{,}000 + 20{,}000 + x - (x/10)$$

$$= \quad 9/10x = 86{,}000$$

or $$x = 86{,}000 \times (10/9) = ₹\ 95{,}556$$

New issue has therefore to be of ₹ 95,556. Alternatively, the amount of new issue can be computed as follows:

	₹
P & L A/c (as given)	20,000
Less: Premium on redemption of pref. share out of profit (10,000 – 4,000)	6,000
Profits available for redemption	14,000
Amount of Pref. share capital to be redeemed	1,00,000
Less: Profit available for redemption	14,000
Net Proceeds required for redemption	86,000

New issue is to be made at 10% discount. Hence, the amount of new issue should be:

86,000 × 10/9 = ₹ 95,556.

Illustration 2.4: The following balances were extracted from the books of Redemption Limited as on 30 June, 2016.

	2,000, 8% Redeemable preference shares of ₹ 100 each fully called up	₹ 2,00,000
Less:	Calls in arrear at ₹ 20 per share on 300 shares	₹ 6,000
		1,94,000
	General reserve	₹ 50,000
	Capital reserve	₹ 10,000

The preference shares were redeemed on 1 July, 2016 at a premium of ₹ 5 per share. The company issued such further equity shares of ₹ 10 each—as were necessary for the purpose of redeeming the preference shares—which were fully subscribed and duly allotted.

You are required to show the journal entries showing the transactions relating to the redemption of shares and the relevant extracts in the liabilities side of the Balance Sheet, after such redemption.

Solution:

Redemption Ltd.
Journal Entries

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	General Reserve *Dr.*	10,000	
	To Premium on redemption of pref. shares A/c		8,500
	To Preference shares redemption suspense A/c*		1,500
	(Being the premium of ₹ 5 per share payable on redemption of 1,700 shares, that on 300 shares not yet redeemable put to suspense to be used later when necessary)		
	Bank A/c *Dr.*	1,60,000	
	To Equity share capital A/c		1,60,000
	(Being the amount received on issue of equity shares of 10 each)		
	General Reserve *Dr.*	40,000	
	To Pref. shares redemption suspense A/c*		30,000
	To Capital redemption reserve A/c		10,000
	(Being the amount of profit utilised for redemption of preference shares transferred to capital redemption reserve A/c and that relating to 300 shares not yet redeemable put to suspense A/c to be used when necessary)		
	8% Redeemable preference share capital A/c *Dr.*	1,70,000	
	Premium on red. of pref. shares A/c *Dr.*	8,500	
	To Pref. shares redemption A/c		1,78,500
	(Being the amount of preference share capital due to be redeemed)		
	Pref. shares redemption A/c *Dr.*	1,78,500	
	To Bank		1,78,500
	(Amount due to preference shareholders on redemption paid)		

* Alternatively, the amount of ₹ 31,500 could have been allowed to remain in the General Reserve.

Redemption Ltd.
Balance Sheet (Extracts)
(after redemption on 1st July 2016)

Equity & Liabilities	₹	₹
Shareholders' Funds		
1. Share Capital:		
Issued, Subscribed and paid-up		
300, 8% Redeemable preference shares of ₹ 100 each fully called up	30,000	
Less: Calls in arrear	6,000	24,000
(redeemable as soon as the calls in arrear are collected)		
16,000 Equity Shares of ₹ 10 each fully called up		1,60,000
		1,84,000
2. Reserve & Surplus:		
Capital Reserve	10,000	

Equity & Liabilities	₹	₹
Capital Redemption Reserve	10,000	20,000
3. Current Liabilities:		
Other Current Liabilities		
Preference Shares Redemption Suspense A/c		31,500

Note:

(i) Capital Reserve has not been used to provide for premium on redemption as it may include unrealised appreciation in fixed assets.

(ii) Since 300 shares not yet redeemed because of calls in arrear. They would be redeemable as soon as the calls are collected so, it has been considered prudent to transfer ₹ 31,500 from General Reserve to Preference Shares Redemption Suspense account. On redemption of such preference shares ₹ 30,000 would be transferred to Capital Redemption Reserve. Balance of ₹ 1,500 represents the premium payable on redemption of such shares.

Alternatively, the company could have provided only for redemption of 1,700 shares. However, it would not be a sound and safe policy.

(iii) The amount in respect of 300 Preference Shares is being shown as "Redeemable Preference Share Capital." Alternatively the amount could have been transferred to "Red. Pref. Share Capital Suspense Account." Of course it would have continued to be shown under the head "Share capital" in the Balance Sheet.

Illustration 2.5: The summarised Balance Sheet of Nipa Ltd. on March 31, 2017 was as follows:

Nipal Ltd.

Balance Sheet as at 31 March, 2017

(Summarised balance sheet after redemption)

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued Capital: 40,000 equity shares of ₹ 100 each	4,00,000
	20,000,6% Redeemable preference shares of ₹ 10 each	2,00,000
	(b) Reserves and Surplus	
	Profit and Loss A/c	2,50,000
	Discount on Debentures	(12,000)
	(c) Money received against share warrants	–
		838,000
2.	Share application money pending allotment	–
3.	Non-current Liabilities	
	Long-term Borrowings: 5% debentures	3,00,000
		3,00,000
4.	Current Liabilities	
	(a) Short-term Borrowings: Bank loan	50,000
	(b) Trade Payables	89,000
		1,39,000
	TOTAL (1) +(2)+ (3)+ (4)	12,77,000
B	**Assets**	
1.	Non-current Assets	
	(a) Fixed Assets	
	(i) Tangible Assets	4,12,000
	(ii) Intangible Assets	2,00,000

	Particulars	₹
		6,12,000
		6,12,000
2.	Current assets	
	(a) Current Investments	–
	(b) Inventories	4,50,000
	(c) Trade Receivables	2,15,000
	(d) Cash and Cash Equivalents	–
	(e) Short-term Loans and Advances	–
		6,65,000
	TOTAL (1) + (2)	12,77,000

NOTES

Wanting to redeem the preference shares and debentures the company offered to the Redeemable Preference Shareholders and Debenture Holders the option to convert their holding into equity shares to be issued at a premium of ₹ 2.50 per share. Half of the Preference Shareholders and one-third of the Debenture Holders agreed to do this. The company issued 30000 equity share at ₹ 12.50 to the public for cash and with the funds available paid off the bank loan and redeemed the remaining redeemable preference shares and debentures.

Journalise the transaction and show how the balance sheet will appear after the transactions have been completed.

Solution:

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
	6% Redeemable preference share capital A/c	*Dr.*	1,00,000	
	To Equity share capital (8,000 × ₹ 10)			80,000
	To Securities premium A/c (8,000 × ₹ 2.50)			20,000
	(Being 50% of redeemable preference shares converted into Equity shares @ 10 each with premium, ₹ 2.50 each.)			
	5% Debentures A/c	*Dr.*	1,00,000	
	To Equity share capital A/c (8,000 × ₹ 10)			80,000
	To Securities premium A/c (8,000 × ₹ 2.50)			20,000
	(Being 1/3rd debenture converted into equity share @ ₹ 10 each with premium of ₹ 2.50 each.)			
	Bank A/c (30,000 × ₹ 12.50)	*Dr.*	3,75,000	
	To Equity share capital A/c (30,000 × ₹ 10)			3,00,000
	To Securities premium A/c (30,000 × ₹ 2.50)			75,000
	(Being 30,000 Equity shares @ ₹ 10 with premium ₹ 2.50 each issued for cash as per Board resolution No. ... Dt. ...)			
	6% Redeemable preference share capital A/c	*Dr.*	1,00,000	
	5% Debentures A/c	*Dr.*	2,00,000	
	To Preference share holders A/c			1,00,000
	To Debenture holders A/c			2,00,000
	(Being the balance amount of redeemable preference share and debentures redeemable.)			

NOTES

Date	Particulars		Dr. (₹)	Cr. (₹)
	Preference Shareholders A/c	Dr.	1,00,000	
	Debenture holders A/c	Dr.	2,00,000	
	Bank loan A/c	Dr.	50,000	
	To Bank A/c			3,50,000
	(Being the amount paid to Shareholders and Debenture Holders in full and Bank loan repaid.)			
	Share Premium A/c	Dr.	12,000	
	To Discount on debenture A/c			12,000
	(Being the amount of discount on debenture is written off after utilising the amount of Share Premium Account)			

Nipa Ltd.
Balance Sheet as at 31 March, 2017
(Summarised Balance Sheet after Redemption)

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued Capital: 86,000 equity shares of ₹ 100 each	8,60,000
	(b) Reserves and Surplus	
	Profit and Loss A/c	2,50,000
	Securities Premium A/c	1,03,000
	(c) Money received against share warrants	–
		12,13,000
2.	Share application money pending allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	
	(a Short-term Borrowings	–
	(b) Trade Payables	89,000
		89,000
	TOTAL (1) + (2) + (3) + (4)	13,02,000
B	**Assets**	
1.	Non-current Assets	
	Fixed Assets	
	(i) Tangible Assets	4,12,000
	(ii) Intangible Assets	2,00,000
		6,12,000
		6,12,000
2.	Current Assets	
	(a) Current Investments	–
	(b) Inventories	4,50,000
	(c) Trade Receivables	2,15,000
	(d) Cash and Cash Equivalents	25,000
	(e) Short-term Loans and Advances	–
	(f) Other Current Assets	–

	Particulars	₹
		6,90,000
	TOTAL(1) + (2)	13,02,000

Check Your Progress

1. What should the issue of redeemable preference shares by?
2. Where the unpaid amount on redeemable preference shareholder shown in the Balance Sheet?

2.3 ISSUE OF DEBENTURES AND TREATMENT OF DIFFERENT ITEMS RELATING TO DEBENTURE IN FINAL ACCOUNTS

A debenture is of a small denomination (usually of ₹ 100) and, therefore, can be purchased even by persons of small means. For example, if a company needs a sum of ₹ 1,00,000 it can offer to the public for subscription 1,000 debentures of ₹ 100 each. It may be difficult for one person to lend a sum of ₹ 1,00,000 to the company but he can conveniently purchase a certain number of debentures, thus helping the company in raising the required funds.

Meaning of Debentures

Debenture may be defined as a certificate issued by a company under its seal acknowledging debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness.

According to the Companies Act, 2013 the term debenture includes “debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not”. [Sec. 2(30)]

The term “debenture stock” is similar to “share stock”. It is the aggregate and consolidated amount of borrowings on account of debentures by a company. Fully paid debentures can only be converted into debenture stock. Such stock can be divided and transferred in any convenient parts.

A company cannot issue debentures carrying any voting rights [Sec. 71(2)].

Bonds and Debentures

Bonds are a form of long term debt and can be referred as a debt security. Bond may be defined as a debt security in which the issuer (borrower) of the bond owes the holder (lender), a debt and depending on the terms of the bond is obliged to pay interest on the amount borrowed and repay the principal at maturity. In other words, the bond is a formal contract to repay the borrowed money with interest at fixed intervals.

A bond is similar to a debenture. A debenture, as stated before may be defined, a certificate issued by a company acknowledging the debt due by it to its holder. The most essential characteristic of a debenture is the admission or record of indebtedness. Debentures may be both, secured or unsecured.

In some countries, e.g., in U.S.A., a difference is made between a debenture and a bond. The term debenture is used for a debt instrument which is unsecured or which does not have a charge against some specific property of the borrower. Moreover, a bond has a longer maturity, period as compared to a debenture.

In India, no such difference is made between a debenture and a bond. They are used as interchangeable terms. Of course, the term bond is generally used in India for a debt security issued by Government or a Public Institution. Both debentures and bonds are debt securities issued for long term borrowings, i.e., borrowings for more than a year.

Accounting for Issue of Debentures

The entries for issue of debentures are made on the same pattern as for issue of shares. They can also be issued at par, premium or discount. However, the legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are not applicable to debentures. The accounting entries are being given below:

Issue of Debentures for Consideration Other than Cash

(i) **On acquisition of assets:**

Assets A/c (with value of assets)	*Dr.*
To Vendors (with purchase price)	

In case the value of assets is more than the purchase price, the balance is credited to Capital Reserve. In a reverse case, *i.e.,* where the purchase price is more than the value of assets purchased, the balance is debited to Goodwill Account.

(ii) **On allotment of debentures:**

Vendors	*Dr.*
To Debentures A/c	

In case debentures are issued at a discount, the 'Debenture Discount Account' will be debited with the amount of discount allowed. In case issue of debentures is at premium, the "Debenture Premium Account" will be credited with the amount of premium.

Issue of debentures for cash

(i) **For receipt of application money:**

Bank A/c	*Dr.*
To Debenture application A/c	

NOTES

(ii) **On allotment of debentures:**

Debenture application A/c *Dr.*
To Debentures A/c
(For transfer of debenture application money)
Debenture allotment A/c *Dr.*
To Debentures A/c
(For allotment money due)
Bank A/c *Dr.*
To Debenture allotment A/c
(For receipt of allotment money)

In case allotment is made at premium and premium is to be received on allotment, the entry for amount due on allotment will be:

Debenture allotment A/c *Dr.*
To Debentures A/c
To Debenture premium A/c

In case allotment is made at discount, the entry will be:

Debenture allotment A/c *Dr.*
Discount on issue of debentures A/c *Dr.*
To Debentures A/c

(iii) **On first/second/final call:**

Debentures first/second/final call A/c *Dr.*
To Debentures A/c
(For first/second/final call due)
Bank A/c *Dr.*
To Debenture first/second/final call A/c
(For first/second/final call money received)

(iv) **If money is received in one instalment:**

If issued at par:

Bank A/c *Dr.*
To Debentures A/c

If issued at discount:

Bank A/c *Dr.*
Discount on issue of Debentures A/c *Dr.*
To Debentures A/c

If issued at premium:

Bank A/c *Dr.*
To Debentures A/c
To Debentures Premium A/c

(v) **For payment of interest of debentures:**

Debenture interest A/c *Dr.*
To Bank
To Tax deducted at source

Notes:

(a) It is customary to prefix the rate of interest payable on debentures with the "debentures Account". For example if the rate of interest payable on debentures is 10%, debentures account will be termed as, "10% debentures Account".

(b) Income tax is to be deducted at source at prescribed rates by the company paying interest on debentures. Tax so deducted is deposited by the company on behalf of debentureholders with the Central Government. The debentureholder can get credit for the tax deducted on the basis of Tax deduction certificate issued by the company (for more details please refer to the next chapter "Company Final Accounts").

Illustration 2.6: In February 2016 A Ltd., offered for subscription 1,000 14% debentures of ₹ 1,000 each at the issue price of 94%, payable ₹ 50 per debenture on application, ₹ 500 on allotment and the balance on 1 May, 2016. Interest was payable half yearly on 30 June and 31 December. The first coupon payable on 30 June 2016, being for 5%. The issue was fully taken up.

Rate of Tax Deducted at source is 10%. Journalise the transactions and show how they would appear in the Company's Balance Sheet as on 31st Dec. 2016.

Solution:

***A* Ltd.**

Journal

Date	*Particulars*	Dr. ₹	Cr. ₹
2016 Feb.	Bank A/c *Dr.* To 14% Deb. application A/c (Being application money received on 1,000 debentures @ ₹ 50 each)	50,000	50,000
	14% Debenture application A/c *Dr.* To 14% Debentures A/c (Being transfer of application money to 14% debentures account on allotment vide Board's Resolution No. ..... dated ......)	50,000	50,000
	14% Debenture allotment A/c *Dr.* Discount on issue of deb. A/c *Dr.* To 14% Debentures A/c (Being money due on allotment vide Board's Resolution No......dated.....)	5,00,000 60,000	5,60,000
	Bank A/c *Dr.* To 14% Debenture allotment A/c (Receipt of allotment money)	5,00,000	5,00,000
1 May	14% Debenture first & final call A/c *Dr.* To 14% Debentures A/c (Being first and final call due on 1,000 debentures @ ₹ 390 per debenture)	3,90,000	3,90,000

Date	Particulars		Dr. ₹	Cr. ₹
	Bank A/c	Dr.	3,90,000	
	To 14% Debenture first & final call A/c			3,90,000
	(Being receipt of first and final call money)			
30 June	Debenture interest A/c[*]	Dr.	50,000	
	To Bank			45,000
	To Tax deducted at source			5,000
	(Interest paid on debentures for half year @ 5 per cent on ₹ 10,00,000 after deduction of tax)			
31 Dec.	Debenture interest A/c	Dr.	70,000	
	To Bank			63,000
	To Tax deducted at source			7,000
	(Payment of debenture interest for half-year ended 31 Dec. 2016)			
31 Dec.	Profit and Loss A/c	Dr.	1,20,000	
	To Debenture interest A/c			1,20,000
	(Being transfer of debenture interest to Profit & Loss A/c)			

[*] The money was received on debentures on different dates. Instead of calculating interest on different amounts received on different dates, the question provides for a flat rate of interest of 5% on the entire amount for the first six months.

***A* Ltd.**

Balance Sheet as on 31st Dec. 2016

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	(a) Share Capital	
	Issued & Paid-up Capital _ equity shares of _ each	
	(*b*) Reserves and Surplus	....
	Profit and Loss A/c	(1,20,000)
	Discount on Issue of Debentures	(60,000)
	(c) Money Received Against Share Warrants	–
		(1,80,000)
2	Share Application money Pending Allotment	–
3	Non-current Liabilities	
	(a) Long-term Borrowings: 14% debentures	10,00,000
	(b) Deferred tax Liabilities (net)	
	(c) Other Long-term Liabilities	
	(d) Long-term Provisions	
		10,00,000
4	Current Liabilities	
	(a) Short-term Borrowings	–
	(b) Trade Payables	–
	(c) Other Current Liabilities	12,000

NOTES

	Particulars	₹
	(d) Short-term Provisions: Tax deducted at source	–
		12,000
	TOTAL (1) + (2) + (3) + (4)	8,32,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(a) Current Investments	–
	(b) Inventories	–
	(c) Trade Receivables	–
	(d) Cash and Cash Equivalents	8,32,000
	(e) Short-term Loans and Advances	–
	(f) Other Current Assets	–
		8,32,000
	TOTAL (1) + (2)	8,32,000

Note: Separate notes for various items of Balance Sheet have not been made in the absence of detailed information.

Different Terms of Issue of Debentures

A company may issue debentures on different terms. These terms may not only relate to issue but also to redemption. Such terms can be as follows:

Debentures issued at par and payable at par: They are ordinary type of debentures and accounting entries are the same as discussed earlier.

On issue of debentures

Bank A/c *Dr.*
To Debentures A/c

Some accountants prefer to pass two accounting entries even when amount of debentures is received in one instalment.

Bank A/c *Dr.*
To Debenture application & allotment A/c
(For application money received)
Debenture application & allotment A/c *Dr.*
To Debentures A/c
(For transfer of application money to debentures Account)

Passing of two entries may be useful in case of oversubscription since surplus money can be retained in and returned out of Debenture application & allotment account. In the normal course the students may pass only one entry.

On payment

Debentures A/c *Dr.*
To Bank A/c

In case money is received in different instalments, say on application, allotment, first call etc., entries will be made in the manner already discussed in the previous pages.

Debentures issued at discount and payable at par, e.g., a debenture of ₹ 100 is being issued at ₹ 90 and is payable at ₹ 100.

On issue of debentures

Bank A/c	*Dr.*	90
Discount on issue of debentures A/c	*Dr.*	10
To Debentures A/c		100

In case money is received in instalments, the entry for discount will be made with money due on allotment.

Debenture allotment	*Dr.*
Discount on issue of debenture A/c	*Dr.*
To Debentures A/c	

On payment:

Debentures A/c	*Dr.*	100
To Bank A/c		100

Debentures issued at premium payable at par e.g., a debenture of ₹ 100 is being issued at 110, but is payable at ₹ 100.

On issue of debentures

Bank A/c	*Dr.*	110
To Debentures A/c		100
To Premium on issue of debentures A/c	10	

In case money is received in instalments, the entry for premium, will be made with money due on allotment unless otherwise stated:

Debenture allotment A/c	*Dr.*
To Debentures A/c	
To Premium on issue of Debentures A/c	

At the end of the accounting year, the amount of Debenture premium may be transferred to Capital Reserve. Alternatively, it may be shown as a separate item “Premium on issue of debentures” under the heading “Reserves & Surplus” in the balance sheet of the company.

On payment:

Debentures A/c	*Dr.*	100
To Bank A/c		100

Debentures issued at par, payable at premium, *e.g.*, a debenture of ₹ 100 is payable at ₹ 110.

On issue of debentures

Bank A/c	*Dr.*	100
Loss on issue of debentures A/c	*Dr.*	10
To Debentures A/c		100
To Premium on Redemption of debentures A/c		10

In the Balance Sheet, the items will appear as follows:

***A* Ltd.**
Balance Sheet as at 31 March, 2017

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	Share Capital	
	Reserve & Surplus	......
	Loss on Issue of Debentures	(10)
2.	Share Application Money Pending Allotment	......
3.	Non-current liabilities	
	(a) Long-term Borrowings: Debentures	100
	Premium on Redemption of Debentures	10
		110
4.	Current Liabilities	_
	TOTAL (1) + (2) + (3) + (4)	100
B	**Assets**	......
1.	Non-current Assets	
2.	Current Assets	
	(a) Current Investments	
	(b) Inventories	
	(c) Trade Receivables	
	(d) Cash and Cash Equivalents	100
	(e) Short-term Loans and Advances	
		100
	TOTAL (1) + (2)	100

In case the money is received on debentures in instalments, the entry for the amount of premium payable on redemption, will be made for money due on allotment.

Debenture allotment A/c	*Dr.*	
Loss on issue of debentures A/c	*Dr.*	
To Debentures A/c		
To Premium on redemption of debentures A/c		

On payment:

Debentures A/c	*Dr.*	100
Premium on redemption of debentures A/c	*Dr.*	10
To Bank A/c		110

Debentures issued at discount, payable at premium, *e.g.*, a debenture of ₹ 100 is issued for ₹ 90 but is payable at ₹ 110.

On issue of debentures:

Bank A/c	*Dr.*	90
Loss on issue of debentures A/c (₹ 10 + ₹ 10)	*Dr.*	20
To Debentures A/c		100
To Premium on redemption of debentures A/c		10

In case money on debentures is received in instalments, the entry for loss on issue will be made with allotment as in case of point (4).

On payment:

The entry on payment will also be the same as indicated in point (4).

There is no practice of issuing debentures at par/premium/discount but payable at discount or issuing debentures at premium and also payable at premium. However, if such issue is made, the accounting entries will be as follows:

Debentures issued at par and payable at discount, e.g., a debenture of ` 100 is issued at ₹ 100 but is payable at ₹ 95.

On issue of debentures:

Bank A/c	*Dr.*	100
To Debentures A/c		100

On payment:

Debentures A/c	*Dr.*	100
To Bank		95
To Profit on redemption of debentures		5

It may be noted that discount receivable on redemption should be recorded only on redemption of debentures and not on issue of debentures. This is as per the accounting convention of conservatism according to which expected losses are to be taken into account but not expected profits.

Debentures issued at discount and redeemable at discount, e.g., a debenture of ₹ 100 is issued at 95 but is payable at ₹ 98.

On issue of debentures:

Bank A/c	*Dr.*	95
Discount on issue of debentures A/c	*Dr.*	5
To Debentures A/c		100

On payment:

Debentures A/c	*Dr.*	100
To Bank		98
To Profit on redemption of debentures		2

debentures issued at premium and redeemable at discount, e.g., a debenture of ₹ 100 is issued at ₹ 105 but is payable at ₹ 95.

On issue of debentures:

Bank A/c	*Dr.*	105
To Debentures A/c		100
To Premium on issue of debentures A/c		5

On redemption of debentures:

Debentures A/c	*Dr.*	100
To Bank		95
To Profit on redemption of debentures A/c		5

debentures issued at premium and payable at premium, e.g., a debenture of ₹ 100 is issued at ₹ 105 but is payable at ₹ 110.

On issue of debentures:

Bank A/c	*Dr.*	105
Loss on issue of debentures A/c	*Dr.*	10
To Debentures A/c		100
To Premium on issue of debentures A/c		5
To Premium on redemption of debentures A/c		10

On payment:

Debentures A/c	*Dr.*	100
Premium on redemption of debentures A/c	*Dr.*	10
To Bank		110

Issue of debentures as collateral security: A company may borrow money from a bank or any other person and may give debentures of the company as an additional security besides other property of the company. These debentures are given to the lender with the understanding that in case the company pays the loan, they will be returned back to the company but in case it fails to pay the loan, the lender will become a debentureholder to the extent of debentures so held and will have all rights which are available to the debentureholders of that class.

There are two ways of dealing with such debentures in the accounts of the company.

(i) No entry, whatsoever, is made in the books of the company. A note is given in the Balance Sheet regarding depositing of the debentures as collateral security. For example if *A* Ltd. obtains a loan of ₹ 30,000 from its bankers giving debentures of ₹ 40,000 as collateral security, the Balance sheet will appear as follows:

Equity & Liabilities	₹
Non-current Liabilities	
Bank Loan (collaterally secured by an issue of ₹ 40.000 debentures)	30,000

(ii) The transaction may be recorded in the books of the company by the following entry:

Debenture suspense A/c	*Dr.*
To Debentures A/c	

Taking the details given in the above example, the items will appear as follows in the company's Balance Sheet.

***A* Ltd.**
Balance Sheet as at 31st March, 2017

	Particulars	₹
A	**Equity and Liabilities**	
1..	Shareholders' Funds	–
2..	Share application money pending allotment	–
3..	Non-current Liabilities	–
	(a) Long-term Borrowings:	
	Bank Loan (secured by debentures of ₹40,000 issued as collateral security)	30,000

	Particulars	₹
	Debentures (Issued as collateral security as per contra)	40,000
	(b) Deferred Tax Liabilities (net)	
	(c) Other long-term Liabilities	–
	(d) Long-term Provisions	–
		70,000
4.	Current Liabilities	–
	TOTAL (1) + (2) + (3) + (4)	70,000
B.	**Assets**	
1.	Non-current Assets	
	Other Non-current Assets	40,000
	Debenture Suspense A/c (as per contract)	40,000
2.	Current Assets	
	(a) Current Investments	–
	(b) Inventories	
	(c) Trade Receivables	–
	(d) Cash and Cash Equivalents	30,000
	(e) Short-term Loans and Advances	–
		30,000
	TOTAL (1)+ (2)	70,000

On repayment of the bank loan the entry will be reversed:

Debentures A/c	*Dr.*	40,000
To Debentures suspense A/c		40,000

In case the company fails to pay the loan, the debentures issued as collateral security will become active. The following journal entry will be passed:

Bank loan A/c	*Dr.*	30,000
Loss on issue of debentures A/c	*Dr.*	10,000
To Debentures A/c		40,000

Illustration 2.7: Journalise the following transactions:

(i) 950, 14% Debentures of ₹ 100 each, issued at par and redeemable at par, were converted into equity shares of ₹ 10 each issued at par.

(ii) 950, 14% Debentures of ₹ 100 each, issued at par and redeemable at par, were converted into equity shares of ₹ 10 each issued at a discount of 5%.

(iii) ₹ 95,000 14% debentures of ₹ 100 each, issued at par and redeemable at par, were converted into equity shares of ₹10 each issued at ₹ 9.50 paid up. (*PCEI, ICAI, May 2008*)

Solution:

Journal Entries

S. No.	*Particulars*		*Dr.* ₹	*Cr.* ₹
(i)	*Common for entry all cases* :			
	14% Debentures A/c	*Dr.*	95,000	
	To Debentureholders A/c			95,000
	(Being the amount due to debentureholders)			
(ii)	*Additional entry for case of* (i)			
	Debentureholders' A/c	*Dr.*	95,000	
	To Equity share capital A/c			95,000
	(Being the issue of 9,500 equity shares of ₹ 10 each at par on conversion of 950 debentures)			
(iii)	*Additional entry for case* (ii)			
	Debentureholders' A/c	*Dr.*	95,000	
	Discount on Issue of shares A/c	*Dr.*	5,000	
	To Equity share capital A/c			1,00,000
	(Being the issue of 10,000 equity shares of ₹ 10 each at 5% discount on conversion of 950 debentures)			
(iv)	*Additional entry for* case (iii)			
	Debentureholders' A/c	*Dr.*	95,000	
	To Equity share capital A/c			95,000
	(Being the issue of 10,000 equity shares of ₹ 10 each at ₹ 9.50 paid up on conversion of 950 debentures)			

Writing off Loss on Issue of Debentures

The loss on issue of debentures (*e.g.*, discount on issue of debentures or premium payable on redemption etc.) appears on the 'Assets side' of the Balance Sheet. However, it is a fictitious asset which must be written off as soon as possible. The loss can be written off from any capital profit (including securities premium) or revenue profit. The entry for writing off the loss will be as follows:

Capital reserve/P.&L. A/c *Dr*.
To Loss (Discount) on issue of debentures A/c

It is to be noted that writing off loss on issue of debentures is not a legal necessity. However, sound financial principles require that such loss should be written off as soon as possible but in any case before the debentures are completely redeemed.

In case such loss is written off from Profit & Loss Account as a deferred revenue expenditure, the amount to be written off each year will be calculated as follows:

Where debentures are to be redeemed after a fixed period: The amount of loss or discount on issue of debentures is written off evenly over the years after which the debentures will be redeemed. This is because in every year there has been an even benefit of the funds raised on account of issue of debentures. For example, if the debentures are to be redeemed after 10 years in lump sum and the loss on issue of debentures is a sum of ` 20,000, every year ` 2,000 should be written off from the Profit & Loss Account.

Where the debentures are to be redeemed in instalments: The funds for use each year go on diminishing and therefore the loss on issue of debentures is also divided over different years in the ratio of amount of debentures outstanding at the beginning of each year.

Illustration 2.8: *R* Ltd. issued debentures at 94% for ₹ 1,00,000 on 1 July 2012, repayable by five equal annual drawing of ₹ 20,000 each. The company closes its accounts on 31st March each year. Indicate the amount of discount to be written off every accounting year assuming that the company decides to write off the debenture discount during the life of the debentures.

Solution:

Amount of Debenture Capital Utilized in Various Years

Year ended				*Equivalent annual amount*
31 March 2013	₹	1,00,000	for 9 months	75,000
31 March 2014	₹	1,00,000	for 3 months	85,000
	₹	80,000	for 9 months	
31 March 2015	₹	80,000	for 3 months	65,000
	₹	60,000	for 9 months	
31 March 2016	₹	60,000	for 3 months	45,000
	₹	40,000	for 9 months	
31 March 2017	₹	40,000	for 3 months	25,000
	₹	20,000	for 9 months	
31 March 2017	₹	20,000	for 3 months	5,000

The amount of discount on issue of debentures will be charged to profit and loss account in the ratio of effective utilization of funds which is as follows:

Year	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Ratio	15	17 :	13 :	9 :	5 :	1

The amount to be written off in various years, therefore, is as follows:

2012-2013	₹ 1,500	2015-2016	₹ 900
2013-2014	₹ 1,700	2016-2017	₹ 500
2014-2015	₹ 1,300	2017-2018	₹ 100

Check Your Progress

3. Do debentures have voting rights?
4. Mention the journal entry in case of money is received in instalments for debentures issued at premium.

2.4 METHODS OF REDEMPTION OF DEBENTURE

A company can redeem its debentures by any of the following methods:

1. Redemption in Instalments

A company may redeem its debentures in instalments as per the terms of the issue of debentures. the terms may be in any of the following forms:

Redemption of a fixed sum of debentures: The terms of issue may provide that from a particular year the company will be redeeming debentures of a fixed amount. For example, a company which has issued debentures of ₹ 1,00,000 may provide by the terms of issue, that beginning with the 5th year of issue of debentures, at the end of each accounting year debentures of ₹ 10,000 will be redeemed. The decision about the debenture holders whose money has to be returned can be taken either by (i) lottery method or by (ii) serial number of debentures. For example, if in the above case debentures are of ₹ 100 each, holders of 100 debentures have to be selected for payment. In order to decide who has to be paid off, either chits bearing number of debentures outstanding are put in a drum and 100 chits taken out or the debentures having first one hundred serial numbers of debentures outstanding may be paid off.

A company may adopt any of the following two options for redeeming debentures of a fixed sum:

(i) Redemption out of profits. In this case, the company withholds a part of divisible profits for redeeming debentures. The amount of profit is reduced to the extent of the debentures to be redeemed and hence not available for distribution by way of dividends among the shareholders. The payment to debenture holders in such a case is out of profits earned in the course of the business and therefore it is termed as "Redemption out of profits."

(ii) Redemption out of capital: In case of this method, no amount out of divisible profits is set aside for redeeming debentures. The divisible profit is therefore not reduced and may go to the shareholders by way of dividends. Thus, the payment to debenture holders is not out of the profits earned in the course of the business. Hence, it is termed as redemption out of capital.

Taking the figures given in the above example, the following accounting entry will be passed if the debentures are redeemed as per this method:

Debentures A/c	*Dr.*	10,000	
To Bank A/c			10,000
(For redemption of debentures)			

This method results in depletion of the liquid resources available to the company. The company may therefore adopt this method only when it has got sufficient surplus funds.

Alternatively the following two options are also available with the company:

(iii) Conversion of debentures to be redeemed into new debentures or shares: This is called redemption by conversions.

NOTES

(iv) Issue of new shares or debentures: The company may offer to the general public for subscription, shares or debentures and redeem the debentures out of the funds so raised.

Strictly speaking, redemption under the above two alternative methods is also of "redemption out of capital" since the debentures are redeemed not out of profits earned in the course of business but by raising new capital.

According to section 71(4) (c) of the Companies Act, a company which issues debentures is required to create debenture redemption reserve for the redemption of such debentures to which adequate amounts are to be credited out of the profits of the company every year until such debentures are redeemed. The amounts credited to debenture redemption reserve are not to be utilised by the company except for the purpose of redemption of debentures. This aspect has already been discussed in the preceding pages.The company has to pay interest and redeem the debentures in accordance with the provisions and conditions of their issue.

As a result of the above provision, redemption of debentures out of capital is not possible under the Companies Act.

Redemption by purchase of debentures in the open market: A company may reserve for itself the right to purchase its own debentures in the open market. The advantage of such an option is that the company can redeem the debentures at its convenience, whenever it has surplus funds.

Redemption by Conversion

As mentroned earler, the terms of issue may give an option to the debentureholders to get their existing debentures converted into shares or new debentures. Even if the terms of issue do not provide, the company can also give such an option to its debentureholders. In case, the debentureholders exercise their option, the journal entry will be as follows:

Debentures (old) A/c	*Dr.*
To Debentures (new)/or Share capital A/c.	

The conversion of debentures is to be made as per terms of issue of debentures. However, the following points are important in this respect:

(a) Conversion before redemption due date: Conversion of debentures into shares in such a case must not be such as to amount to an unauthorised issue of shares at a discount. It is prohibited by Section 53 of the Companies Act 2013. For example, if a debenture of ₹ 100 is issued at 10 % discount and later on converted into a share of ₹ 100, it virtually amounts to issue of shares at discount and such conversion will be illegal. Of course, there is nothing to prevent the company from converting such debenture taking its nominal value as ₹ 90. In other words, where the debentures are originally issued at discount, the actual amount realised on account of them should be considered while determining the number of shares to be issued.

(b) Conversion when due for redemption: In such a case conversion of debentures into shares may be made on the basis of terms and conditions mutually agreed upon by the concerned parties, i.e., the company and the debenture holder for redemption either at the time of issue or at the time of redemption.

2. Redemption in a Lump Sum after the Expiry of a Fixed Period

The company may redeem the debentures in a lump sum after the expiry of a fixed period as per terms of issue. Redemption in a lump sum involves huge funds and, therefore, it will be appropriate for the company to make adequate provision for the funds for redemption right from the very beginning. There can be two alternative methods of such provision:

(i) Creation of Sinking Fund or Debenture Redemption Fund.

(ii) Taking of an Insurance Policy.

In the following section, we will only be discusing sinking fund and insurable policy methods.

2.4.1 Sinking Fund Method

In case of Sinking Fund Method, every year a fixed amount is taken from the Profit & Loss Appropriation Account (Statement of P & L in Balance Sheet). This amount is invested outside the business in certain good securities. When the time for redemption of debentures comes, securities are realised and the sale proceeds are used for redeeming debentures. The sinking fund can also be of two types:

(i) **Cumulative Sinking Fund.** In case of this fund the amount received as interest on securities of sinking fund is also reinvested. Thus, the company earns compound interest.

(ii) **Non-Cumulative Sinking Fund.** In case of this fund, the amount received as interest on securities is not reinvested but taken as a revenue profit of the business.

The method of recording transactions in both the cases is the same, except that in case of the latter, the entries for interest will not be posted to the sinking fund account.

The companies usually follow cumulative sinking fund method for redemption of debentures.

The amount to be appropriated every year for cumulative sinking fund purposes can be ascertained with the help of any of the following techniques:

(a) *Sinking Fund Table.* This table helps in finding out the amount which should be taken out of Profit & Loss Appropriation Account which if invested together with interest in securities earning a fixed rate of interest, will amount to the sum required for redemption of debentures after the expiry of a fixed period. This can be understood with the help of the following extracts from a sinking fund table.

Sinking Fund Table

Periodic deposit that will amount to ₹ 1

Period in years	*Rates of Interest*		
	3%	*4%*	*5%*
1	1.000000	1.000000	1.000000
2	.492611	.490196	.487805
3	.323530	.320348	.317209
4	.239027	.235490	.232012
5	.188355	.184627	.180975

The above table shows that if investments earn 5%, to get ₹ 1 at the end of 5 years, one has to invest ₹ 0.180975 every year together with interest that will be earned for that period. This means that if ₹ 1,10,000 (say ₹ 1,00,000 for debentures + 10% premium on redemption) are required for redemption of debentures after 5 years then every year ₹ 19,907.25 (*i.e.,* ₹ 1,10,000 × 0.180975) together with interest earned should be invested in securities carrying interest at 5% per annum.

(b) *Annuity Table.* The table giving the compound value of an annuity of ₹ 1 per period at the end of '*n*' periods can also be used for this purpose. This can be understood from the following extracts of this table

Annuity Table

Periods	*5%*	*10%*	*15%*
1	1.0000	1.0000	1.0000
2	2.0500	2.1000	2.1400
3	3.1525	3.3100	3.4396
4	4.3101	4.6410	4.9211
5	5.5256	6.1051	6.6101

The table (based on Appendix I given at the end of this book) shows the value of an annuity of ₹ 1 at the end of a period at a particular rate of interest. For example if there is annual investment of ₹ 1 at 5% compound interest, at the end of 5 years, the accumulated sum would be ₹ 5.5256. In case one needs ₹ 1,10,000, at the end of five years, the annual instalment should be 1,10,000/5.5256 = ₹ 19,907.34.

(c) *Mathematical Formula*. The annual instalment required can also be computed by the following mathematical formula.

$$P - A \times \left[\frac{(1+r)^h - 1}{r} \right]$$

where, P = Total amount to be paid
A = Annual Instalment
r = rate of interest per rupee
n = time period

For example, taking the figures given above, the annual instalment will be computed as follows:

$$1,10,000 = A\times\left[\frac{(1+.05)^5-1}{.05}\right]$$

$$\text{or}\quad 1,10,000 = A\times\left[\frac{.2762815}{.05}\right]$$

$$\text{or}\quad 1,10,000 = 5.52563\,A$$

$$\text{or}\quad A = ₹\ 19,907.23$$

Thus, the amount of annual instalment is almost the same in all cases:

Accounting Entries

At the end of the first year

(i) Profit & loss appropriation A/c *Dr.*
To Debenture sinking fund A/c
(For setting aside the amount for investment)

(ii) Debentures sinking fund investment A/c *Dr.*
To Bank A/c
(For investing the amount set aside)

At the end of the second and subsequent years

(i) Bank A/c *Dr.*
To Interest on sinking fund investment A/c
(For interest received on sinking fund investments)

(ii) Interest on sinking fund investment A/c *Dr.*
To Debenture sinking fund A/c
(For transfer of interest on sinking fund investments to sinking fund account)

A single entry may also be passed in place of (i) and (ii) stated above:

Bank A/c *Dr.*
To Debentures sinking fund A/c

(iii) Profit & loss appropriation A/c *Dr.*
To Debenture sinking fund A/c
(For setting aside amount for investment)

(iv) Debenture sinking fund investment A/c *Dr.*
To Bank
(For investing the amount set aside and interest received)

At the end of the last year

(i) Bank A/c *Dr.*
To Interest on sinking fund investment A/c
(For receipt of interest)

(ii) Interest on sinking fund investment A/c *Dr.*
To Debenture sinking fund A/c
(For transfer of interest of sinking fund)

(iii) Profit & loss appropriation A/c *Dr.*
To Debenture sinking fund A/c
(Being setting aside the amount for investment)

(iv) There will be no investment. Investments already held will be sold away. The entry will be:
Bank A/c *Dr.*

To Debenture sinking fund investment A/c

Profit or loss on sale of investment will be transferred to Debenture sinking fund. Entries will be:

In case of profit:

Debenture sinking fund A/c Dr.
To Debenture sinking fund investment A/c

In case of loss:

Debenture sinking fund A/c Dr.
To Debenture sinking fund investment A/c

(v) Debentures will be redeemed. The entry for redemption will be:
Debentures A/c
To Bank Dr.

(vi) The amount standing credit to the Debenture Sinking Fund will be transferred to General Reserve. The entry will be:
Debentures sinking fund A/c Dr.
To General reserve A/c

In case only a part of the debenture are redeemed, an amount equivalent to the paid up value of debentures redeemed will only be transferred to General Reserve.

Illustration 2.9: On 1 April 2014, a limited company issued 10,000 14% debentures of ₹ 10 each repayable after 3 years. It has been decided to establish a Sinking Fund for their redemption. The annuity table shows that the annuity of ₹ 1 for three years at 10% interest amounts to ₹ 3.3100. The investment yields 10% interest. The investment is to be made in nearest ten rupees.

Prepare necessary accounts for three years. ending 31st March each year

Solution:

The annual sinking fund instalment amounts to 1,00,000/3.3100 = ₹ 30,211.48 or (say) ₹ 30,210.

Debenture Sinking Fund Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2015			2015		
31 March	To Balance c/d	30,210	31 March	By P. & L. Appropriation A/c	30,2010
		30,210			30,210
2016			2016		
31 March	To Balance c/d	63,441	1 April	By Balance b/d	30,210
			31 Dec.	By Bank (Interest)	3,021
				By P. & L. Appropriation A/c	30,210
		63,441			63,441
2017			2017		
March	To General Reserve	1,00,000	1 April	By Balance b/d	63,441
			31 March	By Bank (Interest)	6,344
				By P. & L. Appropriation A/c	30,215
		1,00,000			1,00,000

Debenture Sinking Fund Investments Account

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
March	To Bank	30,210	March	By Balance c/d	30,210
		30,210			30,210
2016			2016		
1 April	To Balance b/d	30,210	31 March	By Balance c/d	63,440
31 March	To Bank	33,230			
		63,440			63,440
2017			2017		
1 April	To Balance b/d	63,440	31 March	By Bank (sale of investments)	63,440
		63,440			63,440

14 Per Cent Debentures Account

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
31 March	To Balance c/d	1,00,000	1 April	By Bank	1,00,000
		1,00,000			1,00,000
2016			2016		
31 March	To Balance c/d	1,00,000	April	By Balance b/d	1,00,000
		1,00,000			1,00,000
2017			2017		
31 March	To Bank	1,00,000	April	By Balance b/d	1,00,000
		1,00,000			1,00,000

Illustration 2.10: The Balance Sheet of Suneel Brothers Ltd. disclosed the following information on 31 March, 2014.

	₹
15% Debentures	15,00,000
Debenture redemption fund	11,63,600
Debenture redemption fund investments:	
10% Government securities	11,63,600

The contribution to the Debenture redemption fund was ₹ 1,30,800 per annum for the year 2014-15 and 2015-2016. Debentures fell due for payment on 31 March, 2016. Prepare the above accounts in the books of the company assuming that securities were realised on 31 March, 2016 for a sum of ₹ 13,52,000 and interest on securities on 31 December, was immediately invested.

Solution:

15 Per Cent Debentures Account

Date	Particulars	₹	Date	Particulars	₹
2015			2014		
31 March	To Balance c/d	15,00,000	1 April	By Balance b/d	15,00,000
		15,00,000			15,00,000
2016			2015		

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31 March	To Bank	15,00,000	1 April	By Balance b/d	15,00,000
		15,00,000			15,00,000

Debenture Redemption Fund Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2015 31 March	To Balance c/d	14,10,760	2014 1 April	By Balance b/d	11,63,600
			2015 31 March	By Bank (Interest)	1,16,360
				By P. and L. Appropriation A/c	1,30,800
		14,10,760			14,10,760
2016 31 March	To Deb. Red. Fund Investment A/c	58,760	2015 1 April	By Balance b/d	14,10,760
			2016 31 March	By Bank (Interest)	1,41,076
31 March	To General Reserve	16,23,876		By P. & L. Appropriation A/c	1,30,800
		16,82,636			16,82,636

Debenture Redemption Fund Investment Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014 1 April	To Balance b/d	11,63,600	2015 31 March	By Balance c/d	14,10,760
31 Dec.	To Bank	2,47,160			
		14,10,760			14,10,760
2015 1 April	To Balance b/d	14,10,760	2016 31 March	By Bank	13,52,000
			31 March	By Deb. Red. Fund A/c	58,760
		14,10,760			14,10,760

2.4.2 Insurance Policy Method

The company may take an insurance policy for redemption of debentures in place of purchasing investments. The policy will be taken for a period which will enable the company to get the required money on the required date. The amount of premium will have to be paid in the beginning of the year. The question of getting interest does not arise at all and therefore, there will be no entry for interest.

Accounting Entries

In the first and subsequent accounting years

(i) On payment of premium:

Insurance policy A/c *Dr.*
To Bank A/c

At the end of the accounting year:

(ii) For setting aside the amount of premium:

P & L appropriation A/c *Dr.*
To Debenture redemption fund A/c

In the last year

(i) On payment of premium:

Insurance policy A/c *Dr.*
To Bank A/c

(ii) For setting aside the amount of premium:

P & L appropriation A/c *Dr.*
To Debenture redemption fund A/c

(iii) On realising the amount of policy:

Bank A/c *Dr.*
To Insurance policy A/c

(iv) For transfer of any profit on realisation of policy:

Insurance policy A/c *Dr.*
To Debenture redemption fund A/c

(v) On payment of debentures:

Debentures A/c *Dr.*
To Bank A/c

(vi) On transfer of debenture redemption fund to general reserve:

Debenture redemption fund A/c *Dr.*
To General reserve A/c

Illustration 2.11: A company issued debentures of ₹ 3,00,000 on 1 January, 2012 and decided to provide for their redemption by means of an insurance policy of ₹ 3,00,000. The annual premium was ₹ 95,000.

Prepare the necessary ledger accounts assuming that accounting year ends on 31st December and the amount of policy was duly realised and debentures were paid.

Solution:

Debentures Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2012		
31 Dec.	To Balance c/d	3,00,000	1 Jan.	By Bank	3,00,000
		3,00,000			3,00,000
2013			2013		
31 Dec.	To Balance c/d	3,00,000	1 Jan.	By Balance b/d	3,00,000
		3,00,000			3,00,000
2014			2014		
31 Dec.	To Bank	3,00,000	1 Jan.	By Balance b/d	3,00,000
		3,00,000			3,00,000

NOTES

Debenture Redemption Fund Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2012		
31 Dec.	To Balance c/d	95,000	31 Dec.	By P. & L. Appropriation A/c	95,000
		95,000			95,000
2013			2013		
31 Dec.	To Balance c/d	1,90,000	1 Jan.	By Balance b/d	95,000
			31 Dec.	By P. & L. Appropriation A/c	95,000
		1,90,000			1,90,000
2014			2014		
31 Dec.	To General reserve	3,00,000	1 Jan.	By Balance b/d	1,90,000
			31 Dec.	By P. & L. Appropriation A/c	95,000
				By Insurance policy A/c	15,000
		3,00,000			3,00,000

Insurance Policy Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2012		
1 Jan.	To Bank	95,000	31 Dec.	By Balance c/d	95,000
		95,000			95,000
2013			2013		
1 Jan.	To Balance b/d	95,000	31 Dec.	By Balance c/d	1,90,000
1 Jan.	To Bank	95,000			
		1,90,000			1,90,000
2014			2014		
1 Jan.	To Balance b/d	1,90,000	31 Dec.	By Bank	3,00,000
1 Jan.	To Bank	95,000			
31 Dec.	To Debs. red. fund A/c	15,000			
		3,00,000			3,00,000

Check Your Progress

5. What are the purposes for which the amounts credited to the debenture Redemption Reserve can be utilised?
6. Define non-cumulative sinking fund.

2.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The issue of redeemable preference shares must be authorized by the Articles of Association. Shares already issued cannot be converted into redeemable preference shares.
2. The unpaid amount on redeemable preference shareholder is shown in the Balance Sheet under the heading Current Liabilities and Provisions.
3. A company cannot issue debentures carrying any voting rights as per Section 71(2) of the Companies Act 2013.
4. The journal entry in case of money is received in instalments for debentures issued at premium is:

Debenture Allotment A/c	Dr.
To Debenture A/c	
To Premium on Issue of Debentures A/c	

5. The amounts credited to the Debenture Redemption Reserve are not to be utilised by the company except for the purpose of redemption of debentures.
6. In non-cumulative sinking fund, the amount received as interest on securities is not reinvested but taken as revenue profit of the business.

2.6 SUMMARY

- The provisions related to the redeemable preference shares is mentioned in Section 55 of the Companies Act 2013.
- According to the Companies Act 2013, the term debenture includes "debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not.".
- The entries for issue of debentures are made on the same pattern as for issue of shares. They can be issued at par, premium or discount. However, the legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are note applicable to debentures.
- The loss on issue of debentures appears on the Asset side of the Balance Sheet.
- A company may adopt any of the following two options for redeeming debentures of a fixed sum: (i) redemption out of profits and (ii) redemption out of capital. Alternatively, conversion of debentures into new debentures and issue of new debentures methods can also be used.

- Redemptions of debentures may be done by purchase in the open market, by conversion, and redemption in a lump sum after the expiry of a fixed period.
- Redemption in a lump sum after the expiry of a fixed period may be done by two alternative methods like creation of sinking fund or by taking of an insurance policy.

2.7 KEY WORDS

- **Redeemable preference shares:** It refers to the shares which can be redeemed after a fixed period or after giving the prescribed notice, as desired by the company.
- **Debentures:** It is a certificate issued by a company under its seal acknowledging debt due by it to its holder.

2.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What is the difference between bonds and debentures?
2. What are the ways of issuing debentures as collateral security?
3. Briefly mention the categories of methods of redemption of debentures.
4. Write a short note on the insurance policy method of redemption of debentures.

Long Answer Questions

1. Discuss the accounting entries in case of redeemable of preference shares along with important points to be noted in this regard.
2. Describe the accounting entries in case of issue of debentures under different conditions.
3. Explain the different terms of redemption of debentures.
4. Assess the sinking fund method of redemption of debentures.

2.9 FURTHER READINGS

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UNIT 3 FINAL ACCOUNTS OF COMPANIES

NOTES

Structure

3.0 Introduction
3.1 Objectives
3.2 Trading Account, Profit and Loss Account, Profit and Loss Appropriation Accounts and Balance Sheet
3.2.1 Provisions as to Preparation of Financial Statements
3.2.2 Applicability of Schedule III
3.3 Managerial Remuneration
3.3.1 Remuneration Payable to Different Categories of Managerial Personnel and its calculation
3.4 Answers to Check Your Progress Questions
3.5 Summary
3.6 Key Words
3.7 Self Assessment Questions and Exercises
3.8 Further Readings

3.0 INTRODUCTION

The Accuracy of the books of accounts is determined by means of preparing a trial balance. having determined the accuracy of the books of accounts every businessman is interested in knowing about two more facts. they are: (i) whether he has earned a profit or suffered a loss during the period covered by the trial balance, (ii) where does he stand now? in other words, what is his financial position? The determination of the profit or loss is done by preparing a trading and profit and loss account (or an income statement). while the financial position is judged by means of preparing a balance sheet of the business. the two statements together, i.e., income statement and the balance sheet, are termed as final accounts. In this unit, we will be concerning ourselves with the Companies Act provisions related to the financial statements.

At every annual general meeting of a company, the Board of Directors of the company shall lay before such meeting financial statements for the financial year. The term Financial Statement has been defined under the Companies Act, 2013

Financial Statement

According to Section 2(40), the term financial statement in relation to a company includes:

(i) A balance sheet as at the end of the financial year;

(ii) 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;

(iii) Cash flow statement for the financial year;

(iv) A statement of changes in equity, if applicable; and

(v) Any explanatory note annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, and small company and dormant company, may not include the cash flow statement.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the preparation of trading and profit and loss account as per the Companies Act
- Describe the preparation of the balance sheet as per the Companies Act 2013
- Explain the concept and categories of remuneration payable to managers
- Examine the calculation of managerial remuneration

3.2 TRADING ACCOUNT, PROFIT AND LOSS ACCOUNT, PROFIT AND LOSS APPROPRIATION ACCOUNTS AND BALANCE SHEET

Trading Account gives the overall result of trading, i.e., purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has proved to be profitable for the business or not. It takes into account on the one hand the cost of goods sold and on the other the value for which they have been sold away. In case the sales value is higher than the cost of goods sold, there will be a profit, while in a reverse case, there will be a loss. The profit disclosed by the Trading Account is termed as Gross Profit, similarly the loss disclosed by the Trading Account is termed as Gross Loss.

This will be clear with the help of the following example.

Example. The following figures have been taken from the Trial Balance of a trader:

	₹
Purchases	30,000
Purchases Returns	5,000

Sales	40,000
Sales Returns	5,000

Calculate the amount of profit or loss made by the trader.

Solution:

The profit or loss made by the trader can be found out by comparing the cost of goods sold with sales value. This has been done as follows:

Particulars	Amount ₹	Amount ₹
Sales	40,000	
Less: Sales Returns	5,000	35,000
Purchases	30,000	
Less: Purchases Returns	5,000	25,000
Gross Profit		10,000

Profit and Loss Appropriation Account

The Profit and Loss Appropriation Account is an extension of Profit and Loss Account which shows the allocation or distribution of net profit among partners, dividends and reserves. In case of a partnership, the amount of profit to be distributed is arrived at after making adjustments for interest on capital, interest on drawings, salaries to partners, distribution of profits, etc.

As mentioned in the introduction, in this unit, we will be following the provisions of the Companies Act with regards to the preparation of the Financial statements. Therefore, only Profit and Loss Account and Balance Sheet preparation are being discussed.

As per the definition given in the Companies Act the term financial statement in relation to a company includes the following:

1. **Balance Sheet:** It is Statement of financial position of a business at a specified moment of time. It represents all assets owned by the business at a particular moment of time and the claims (or equities) of the owners and outsiders against those assets at that time. It is in a way snapshot of the financial condition of the business at that time.
2. **Income Statement:** The income statement (also termed as profit and loss account statement) is generally considered to be the most useful of all financial statements. It explains what has happened to a business as a result of operations between two balance sheet dates. For this purpose it matches the revenues and costs incurred in the process of earning revenues and shows the net profit earned or loss suffered during a particular period. The Balance Sheet and Income Statement (or Statement of Profit & Loss) are to be prepared as per the provision of Schedule III to the Companies Act 2013, given later in this unit.
3. **Cash Flow Statement:** It is a statement depicting change in cash and cash equivalents position from one period to another. For example, if the cash

balance of a business is shown by its balance sheet on 31 March, 2015 at ₹ 20,000 while the cash balance as per its balance sheet on 31 March, 2016 is 30,000, there has been an inflow of cash of ₹ 10,000 in the year 2016 as compared to the year 2015. The cash flow statement explains the reasons for such inflows or outflows of cash, as the cash might be Schedule III does not give the format of cash flow statement. It is to be prepared as per Accounting Standard 3 (Revised) issued by the Institute of Chartered Accountants of India.

4. **Statement of Changes in Equity:** The Companies Act, 2013 introduced for the first time, in the accounting history, a Statement of Changes in Equity as part of financial statements, In India this concept has been brought in from *IFRS* wherein as per International Accounting Standard 1: Presentation of Financial Statements, preparation of Statement of Changes in Equity is required. Schedule III does not give the format of Statement of Changes in Equity, In general the Statement of Changes in Equity explains the movement in various equity accounts namely Equity Share Capital Account, Securities Premium Account, General Reserve Account, Profit and Loss Account, Capital Reserve, Debenture Redemption Reserve, Capital Redemption Reserve, Tax Reserve, Revaluation Reserve Account etc.

The format of statement of changes in equity with imaginary figures is shown below:

ABC Ltd.
Statement of Changes in Equity

S. No.	*Particulars*	*Share Capital* ₹	*Securities Premium* ₹	*Retained Earnings* ₹	*Other Reserves or Components of Equity* ₹	*Total Equity for Equity Shareholders* ₹
1.	Balance as on April 1, 2014	5,00,000	1,00,000	50,000	1,00,000	7,50,000
2.	Issue of New Shares as on 30th June, 2014	1,00,000	–	–	–	1,00,000
3.	Dividend Paid at the end of the year	–	–	(20,000)	–	(20,000)
4.	Profit on Revaluation of Assets during the year	–	–	–	30,000	30,000
5.	Profit due to exchange difference at the end of the year	–	–	–	10,000	10,000
6.	Bonus Shares Issued out of Retained Earnings during the year	20,000	–	(20,000)	–	–
	Balance as on 31st March, 2015	6,20,000	1,00,000	10,000	1,40,000	8,70,000

3.2.1 Provisions as to Preparation of Financial Statements

1. Basic Provisions

Section 129 provides as under for preparation of financial statements:

(1) The financial statements shall give a true and fair view of the state of affairs of the company and comply with the accounting standards notified. They shall be in the form as may be provided for different class or classes of companies in Schedule III to the Act.

(2) Where a company has one or more subsidiaries, it shall, in addition to financial statements provided under para (1) above, prepare a consolidated financial statement of the company and of all the subsidiaries/associate company in the same form and manner as that of its own. They shall also be laid before the annual general meeting of the company along with the laying of its financial statement [Para (1) above].

Provided that the company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or associate company in such form as may be prescribed:

Provided further that the Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed:

(3) Where the financial statements of a company do not comply with the accounting standards referred to in para (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

(4) The Central Government may, exempt any class or classes of companies from complying with any of the requirements of this section or the rules made thereunder, if it considers necessary in public interest.

(5) If a company contravenes the provisions of this section, the managing director, the whole-time director in charge of finance, the Chief Financial Officer or any other person charged by the Board with this duty, and in the absence of any of the officers mentioned above, all the directors shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

2. Authentication of Financial Statements [Sec. 134(1)]

(1) The financial statements, including consolidated financial statement, if any, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company or by two directors out of which one shall be the managing director, the Chief Financial Officer and the Company Secretary of the company, wherever they are appointed.

(2) In the case of a One Person Company, they shall be signed only by one director, for submission to the auditor for his report thereon.

3. Auditors' Report [Sec. (134(2)]

The auditor's report shall be attached thereto the financial statement(s). Sections 139 to 148 of the Companies Act make various provisions regarding audit and auditors of companies registered under the Act.

4. Financial Year

According to Section 2(41) the financial year, in relation to any company or body corporate, means the period ending on the 31st day of March every year.

(a) This requirement in case of a company or body corporate, existing on the commencement of 2013 Act, is to be compiled within a period of 2 years from commencement of 2013 Act.

(b) Where a company has been incorporated on or after the 1st day of January of a year, the period ending on the 31st day of March of the following year, in respect whereof financial statement of the company or body corporate is made up.

A company or body corporate, which is a holding company or a subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, the *NCLT* may allow any period as its *FY*, whether or not that period is a year.

5. Companies Act, 2013 and Accounting Standards

The Companies Act, 2013 gives importance to compliance of accounting standards by companies, Section 129(1) of the Act specifies that financial statements shall comply with the accounting standards. According to section 133 of the Companies act 2013, "Accounting Standards" means such standards prescribed by the Central Government as recommended by the Institute of Chartered Accountants of India (ICAI) in consultation with over after examination of the recommendation made by National Financial Reporting Authority, as explained below.

6. National Financial Reporting Authority

NOTES

Section 132 of the Companies Act, 2013 provides for constitution of National Financial Authority. The relevant provisions are as under:

(1) The Central Government may, by notification, constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards under this Act.

(2) The National Financial Reporting Authority shall—

(a) Make recommendations to the Central Government on the formulation and laying down of accounting and auditing policies and standards;

(b) Monitor and enforce the compliance with accounting standards and auditing standards;

(c) Oversee the quality of service of the professions associated with ensuring compliance with such standards, and suggest measures required for improvement in quality of service and such other related matters.

(3) The National Financial Reporting Authority shall —

(a) Have the power to investigate, into the matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the Chartered Accountants Act, 1949.

(b) Have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying the suit.

(c) Where professional or other misconduct is proved, have the power to make order for—

(A) Imposing penalty of —

(I) Not less than one lakh rupees, but which may extend to five times of the fees received, in case of individuals; and

(II) Not less than ten lakh rupees, but which may extend to ten times of the fees received, in case of firms;

(B) Debarring the member of the firm from engaging himself or itself from practicing as member of the Institute of Chartered Accountants of India for a minimum period of six months or for such higher period not exceeding ten years as may be decided by the National Financial Reporting Authority.

(4) Any person aggrieved by any order of the National Financial Reporting Authority issued under clause (c) of para (3), may prefer an appeal before the Appellate Authority constituted and notified by the Central Government.

7. Board of Directors' Report [Sec. 134(3)]

There shall be attached to statements laid before a company in a general meeting, a report by its Board of Directors, which shall include the following:

(a) The extract of the annual return containing particulars as per Section 92 as given earlier;

(b) Number of meetings of the Board;

(c) Directors' Responsibility Statement containing details as given later;

(d) A statement on declaration given by independent directors;

(e) In case of a listed company or such class of companies as may be prescribed, company's policy on directors' appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director and other matters;

(f) Explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made-

(i) By the auditor in his report; and

(ii) By the company secretary in practice in his secretarial audit report.

(g) Particulars of loans, guarantees or investments under section 186;

(h) Particulars of contracts or arrangements with related parties;

(i) The amounts, if any, which it proposes to carry to any reserves;

(j) The amount, if any, which it recommends should be paid by way of dividend;

(k) Material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the financial statements relate and the date of the report;

(l) The conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed;

(m) Such other matters as may be prescribed.

Rule 5 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, prescribes that the following disclosures in Boards' Report have to be made by every listed company.

(i) The ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year;

(ii) The percentage increase in remuneration of each director, CFO, CEO, Company Secretary or Manager, if any, in the financial year;

(iii) The percentage increase in the median remuneration of employees in the financial year;

NOTES

(iv) The number of permanent employees on the rolls of company;

(v) Comparison of the remuneration of the KMP against the performance of the company;

(vi) A statement showing the name and prescribed of every employee of the company, who particularly is in receipt of remuneration of ₹ 5 lakh per month or more.

Note: "Median" means the numerical value separating the higher half of a population from the lower half and the median of a finite list of numbers may be found by arranging all the observations from lowest value to highest value and picking the middle one;

If there is an even number of observations, the median shall be average of the two middle values.

8. The Directors' Responsibility Statement [Sec. 134(4)]

As stated before Board of Directors Report has to include Directors' Responsibility Statement. The Statement shall contain following details:

(a) In the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(b) The directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;

(c) The directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(d) The directors had prepared the annual accounts on a going concern basis; and

(e) The directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

(f) The directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

The Board's report and any annexure thereto shall be signed by its chairperson of the company if he is authorized by the Board and where he is not so authorized, shall be signed by at least two directors, one of whom shall be a managing director, or by the director where there is one director.

Penalty: If a company contravenes the provisions of this Section 134, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees, or with both.

A copy of Financial Statements including consolidated financial statements if any and report musts be sent not less than 21 days before the date of the meeting to every member of the company, every debenture-holder and every trustee for the debenture-holders. A copy of the financial statements and reports must also be filed with the Registrar within thirty days from the date on which they were so laid in the meeting. If the annual general meeting of a company before which the accounts, as aforesaid, are laid does not adopt them or the meeting is adjourned without adopting them or if the annual general meeting could not be held, a statement of that fact with reasons should be annexed to the financial statements and documents should be filed with the Registrar (Sec. 137). In case the annual general meeting is not held on account of any reasons, the financial statements etc., have still to be filed within thirty days after the date on which the meeting should have been held.

Thus, it has now been made obligatory for a company to file copies of financial statements and documents with the Registrar of Companies even where the annual general meeting of the company has not been held.

A One Person Company (OPC) shall file a copy of the financial statements duly adopted by its member along with all documents required within 180 days from the close of the financial year.

Penalty: If a company fails to file the copy of the financial statements with the Registrar within the prescribed time, the company shall be punishable with fine of one thousand rupees for every day during which the failure continues but which shall not be more than ten lakh rupees. Moreover, the Managing Director and the Chief Financial Officer of the company, if any, and in the absence of the managing director and the Chief Financial Officer, any other director who is charged by the Board with this responsibility of complying, and, in the absence of any such director, all the directors of the company, shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both [Sec. 136(3)].

3.2.2 Applicability of Schedule III

Schedule III is applicable to all the financial statements to be prepared for the financial year commencing on or after 1st April, 2014. It may be noted that Schedule III, as stated before, does not provide for the formats of a Cash Flow Statement and Statement of Changes in Equity.

It is important to note here that all Companies whether public or private and irrespective of level of operations are required to prepare their financial statements, in the manner provided in Schedule III.

However, the requirements of the Schedule III, do not 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 financial statement has been specified in or under any other Act governing such class of company.

The provisions of Schedule III regarding presentation of Balance Sheet and Statement of Profit & Loss are given below—

Schedule III
(See Section 129)
General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a Company

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 or sub-head or any changes, *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.
2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. 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. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregations of items recognised in those statements; and (b) information about items that do not qualify for recognition in those statements.

   (ii) 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 important information as a result of too much aggregation.

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

Turnover	*Rounding off*
(a) Less than one hundred crore rupees	To the nearest hundreds, thousands, lakh or millions, or decimals thereof.
(b) One hundred crore rupees or more	To the nearest lakh, millions or crores, or decimals thereof.

   (ii) Once a unit of measurement is used, it shall 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.

Note:—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
BALANCE SHEET

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

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

Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of the previous reporting period*
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) **Shareholders' 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			

Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of the previous reporting period*
(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			
Non-current Assets			
(1) (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 and Advances			
(e) Other Non-current Assets			
Current Assets			
(1) (a) Current Investments			
(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.

Notes

General Instructions for Preparation of Balance Sheet

1. An asset shall be classified as current when it satisfies any of the following criteria:—

   (a) It is expected to be realised in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) It is held primarily for the purpose of being traded;

   (c) It is expected to be realised within twelve months after the reporting date; or

   (d) It is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

   All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of twelve months.
3. A liability shall be classified as current when it satisfies any of the following criteria:—
   (a) It is expected to be settled in the company's normal operating cycle;
   (b) It is held primarily for the purpose of being traded;
   (c) It is due to be settled within twelve months after the reporting date; or
   (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

   All other liabilities shall be classified as non-current.
4. A receivable shall be classified as a "trade receivable" if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a "trade payable" if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A company shall disclose the following in the notes to accounts.

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately);

(a) The number and amount of shares authorised;

(b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) Par value per share;

(d) A reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) The rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) Shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) Shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held;

(h) Shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

(A) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.

(B) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.

(C) Aggregate number and class of shares bought back.

(j) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(l) Forfeited shares (amount originally paid-up).

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

(a) Capital reserves;

(b) Capital redemption reserve;

(c) Securities premium reserve;

(d) Debenture redemption reserve;

(e) Revaluation reserve;

(f) Share options outstanding account;

(g) Other reserves (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus, *i.e.*, balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.;

(Additions and deductions since last balance sheet to be shown under each of the specified heads);

(ii) A reserve specifically represented by earmarked investments shall be termed as a “fund”.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

C. Long-term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/Debentures;

(b) Term loans:

(A) from banks

(B) from other parties.

(c) Deferred payment liabilities;

(d) Deposits;

(e) Loans and advances from related parties;

(f) Long term maturities of finance lease obligations;

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be staled in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long-term Liabilities

Other long-term liabilities shall be classified as:

(a) Trade payables;

(b) Others.

E. Long-term Provisions

The amounts shall be classified as;

(a) Provision for employee benefits;

(b) Others (specify nature).

F. Short-term Borrowings

(i) Short-term borrowings shall be classified as:

  (a) Loans repayable on demand:

    (A) from banks

    (B) from other parties.

  (b) Loans and advances from related parties;

  (c) Deposits;

  (d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

G. Other Current Liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends;

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities";

(h) Unpaid matured deposits and interest accrued thereon;

(i) Unpaid matured debentures and interest accrued thereon;

(j) Other payables (specify nature).

H. Short-term Provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible Assets

(i) Classification shall be given as:

- (a) Land;
- (b) Buildings;
- (c) Plant and Equipment;
- (d) Furniture and Fixtures;
- (e) Vehicles;
- (f) Office Equipment;
- (g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible Assets

(i) Classification shall be given as:

(a) Goodwill;

(b) Brands/Trademarks;

(c) Computer software;

(d) Mastheads and publishing titles;

(e) Mining rights;

(f) Copyrights, and patents and other intellectual property rights, services and operating rights;

(g) Recipes, formulae, models, designs and prototypes;

(h) Licences and franchise;

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current Investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property,

(b) Investments in equity instruments;

(c) Investments in preference shares;

(d) Investments in government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in mutual funds;

(g) Investments in partnership firms;

(h) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital) of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof;

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term Loans and Advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other Non-current Assets

Other non-current assets shall be classified as:

(i) Long-term trade receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature);

(iii) Long term trade receivables, shall be sub-classified as:

(a) (A) Secured, considered good;

(B) Unsecured, considered good;

(C) Doubtful.

(b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be-separately stated.

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares;

(c) Investments in Government or trust securities;

(d) Investments in Debentures or Bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are: (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments;

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and Cash Equivalents

(i) Cash and Cash equivalents shall be classified as:

(a) Balances with Banks;

(b) Cheques, Drafts on Hand;

(c) Cash on Hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than twelve months maturity shall be disclosed separately.

R. Short-term Loans and Advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other Current Assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent Liabilities and Commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable.

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid;

(c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

NOTES

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II
STATEMENT OF PROFIT AND LOSS

Name of the Company...............
Profit and Loss Statement for the year ended.............. **(***Rupees in* **................)**

Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of the previous reporting period*
1	2	3	4
I. Revenue from Operations		xxx	xxx
II. Other Income		xxx	xxx
III. Total Revenue (I + II)		xxx	xxx
IV. Expenses:			
Cost of Materials Consumed			
Purchases of Stock-in Trade			
Changes in Inventories of			
Finished Goods		xxx	xxx
Work-in-progress		xxx	xxx
and Stock-in-Trade		xxx	xxx
Employee Benefits Expense		xxx	xxx
Finance Costs			
Depreciation and Amortisation 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 Expense:			
(1) Current Tax		xxx	xxx
(2) Deferred Tax		xxx	xxx
Xl. Profit (Loss) for the period from continuing operations (IX-X)		xxx	xxx
XII. Profit/(loss) from discontinuing operations		xxx	xxx
XIII. Tax expense of discontinuing operations		xxx	xxx
XIV. Profit/(Ioss) from discontinuing operations (after tax) (XII-XIII)		xxx	xxx

Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of the previous reporting period*
XV. Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI. Earnings per Equity Share:		xxx	xxx
(1) Basic		xxx	xxx
(2) Diluted		xxx	xxx

See accompanying notes to the financial statements.

NOTES

General Instructions for Preparation of Statement of Profit and Loss

1. The provisions of this part shall apply to the income and expenditure account referred to in sub-clause (ii) of clause (40) of section 2 in like manner as they apply to a statement of profit and loss.
2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—

   (a) Sale of products;

   (b) Sale of services;

   (c) Other operating revenues;

   Less:

   (d) Excise duty.

   (B) In respect of a finance company, revenue from operations shall include revenue from—

   (a) Interest; and

   (b) Other financial services.

   Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.
3. *Finance Costs*

   Finance costs shall be classified as:

   (a) Interest expense;

   (b) Other borrowing costs;

   (c) Applicable net gain/loss on foreign currency transactions and translation.
4. *Other Income*

   Other income shall be classified as:

   (a) Interest Income (in case of a company other than a finance company);

   (b) Dividend Income;

   (c) Net gain/loss on sale of investments;

(d) Other non-operating income (net of expenses directly attributable to such income).

5. *Additional Information*

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:—

(i) (a) Employee Benefits Expense: showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses,

(b) Depreciation and amortisation expense;

(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher,

(d) Interest income;

(e) Interest expense;

(f) Dividend income;

(g) Net gain/loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as (a) auditor; (b) for taxation matters; (c) for company law matters; (d) for management services; (e) for other services; and (f) for reimbursement of expenses;

(k) In case of companies covered under section 135, amount of expenditure incurred on corporate social responsibility activities;

(l) Details of items of exceptional and extraordinary nature;

(m)Prior period items;

(ii) (a) In the case of manufacturing companies,—

(1) Raw materials under broad heads.

(2) Goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of all concerns having works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:—

(a) Consumption of stores and spare parts;
(b) Power and fuel;
(c) Rent;
(d) Repairs to buildings;
(e) Repairs to machinery;
(f) Insurance;
(g) Rates and taxes, excluding taxes on income;
(h) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:—

(a) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of—
I. Raw materials;
II. Components and spare parts;
III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:—

I. Export of goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and dividend;

IV. Other income, indicating the nature thereof.

Note: Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

To prepare Financial Statements as per Schedule III, there are some special points which must be considered. These points are discussed in detail in Unit 7, Following which detailed illustrations will be given.

Illustration 3.1. From the following particulars furnished by Elegant Ltd., prepare the Balance Sheet as on 31st March 2014 as required by Part I, Schedule III of the Companies Act, 2013.

Particulars		*Debit* ₹	*Credit* ₹
Equity Share Capital (Face value of ₹100 each)			50,00,000
Call in Arrears		5,000	
Land & Building		27,50,000	
Plant & Machinery		26,25,000	
Furniture		2,50,000	
General Reserve			10,50,000
Loan from State Financial Corporation			7,50,000
Stock:			
Raw Materials	2,50,000		
Finished Goods	10,00,000	12,50,000	
Provision for Taxation			3,40,000
Sundry Debtors		10,00,000	
Advances		2,13,500	
Proposed Dividend			3,00,000
Profit & Loss Account			5,00,000
Cash in Hand		1,50,000	
Cash at Bank		12,35,000	
Preliminary expenses		66,500	
Unsecured Loan			6,05,000
Sundry Creditors (for Goods and Expenses)			10,00,000

The following additional information is also provided:

(i) Preliminary expenses included ₹ 25,000 Audit Fees and ₹ 3,500 for out of pocket expenses paid to the Auditors.

(ii) 10000 Equity shares were issued for consideration other than cash.

(iii) Debtors of ₹ 2,60,000 are due for more than 6 months.

(iv) The cost of the Assets were:

Building ₹ 30,00,000, Plant & Machinery ₹ 35,00,000 and Furniture ₹ 3,12,500

(v) The balance of ₹ 7,50,000 in the Loan Account with State Finance Corporation is inclusive of ₹ 37,500 for Interest Accrued but not Due. The loan is secured by hypothecation of Plant & Machinery.

(vi) Balance at Bank includes ₹ 10,000 with Global Bank Ltd., which is not a Scheduled Bank.

Solution:

Elegant Ltd.
Balance Sheet as on 31st March, 2014

	Particulars	*Notes*	₹
	Equity and Liabilities		
1.	Shareholders' Funds		
(a)	Share Capital	1	49,95,000
(b)	Reserves and Surplus	2	14,83,500
2.	Non-current Liabilities		
(a)	Long-term Borrowings	3	13,17,500
3.	Current Liabilities		
(a)	Trade Payables		10,00,000
(b)	Other Current Liabilities	4	37,500
(c)	Short-term Provisions	5	6,40,000
	Total		94,73,500
	Assets		
1.	Non-current Assets		
(a)	Fixed Assets		
	Tangible Assets	6	56,25,000
2.	Current Assets		
(a)	Inventories	7	12,50,000
(b)	Trade Receivables	8	10,00,000
(c)	Cash and Cash Equivalents	9	13,85,000
(d)	Short-term Loans and Advances		2,13,500
	Total		94,73,500

Notes to Accounts

	Particulars		₹
1.	Share Capital		
	Equity Share Capital		
	Issued & Subscribed & Called up		
	50,000 Equity Shares of ₹ 100 each (of the above 10,000 shares have been issued for consideration other than cash)	50,00,000	
	Less: Calls in Arrears	(5,000)	49,95,000
	Total		49,95,000

	Particulars		₹
2.	Reserves and Surplus		
	General Reserve		10,50,000
	Surplus (Profit & Loss A/c)	5,00,000	
	Less: Preliminary expenses	(66,500)	4,33,500
	Total		14,83,500
3.	Long-term Borrowings		
	Secured Term Loan		
	State Financial Corporation (Secured by hypothecation of Plant and Machinery)		
	(7,50,000- 37,500)		7,12,500
	Unsecured Loan		6,05,000
	Total		13,17,500
4.	Other Current Liabilities		
	Interest accrued but not due on loans from SFC		37,500
	Total		37,500
5.	Short-term Provisions		
	Provision for taxation		3,40,000
	Proposed Dividend		3,00,000
	Total		6,40,000
6.	Tangible assets		
	Land and Building	30,00,000	
	Less: Depreciation	(2,50,000)	27,50,000
	Plant & Machinery	35,00,000	
	Less: Depreciation	(8,75,000)	26,25,000
	Furniture & Fittings	3,12,500	
	Less: Depreciation	(62,500)	2,50,000
	Total		56,25,000
7.	Inventories		
	Raw Materials		2,50,000
	Finished goods		10,00,000
	Total		12,50,000
8.	Trade Receivables		
	Outstanding for a period exceeding six months		2,60,000
	Other Amounts		7,40,000
	Total		10,00,000
9.	Cash and Cash Equivalents		
	Cash at bank		
	with Scheduled Banks	12,25,000	
	with others (Global Bank Ltd.)	10,000	12,35,000
	Cash in hand		1,50,000
	Total		13,85,000

Note: According to AS 26, preliminary expenses are not to be shown in the balance sheet. They are to be written off. The amount of ₹ 25,000 as audit fee and out of pocket expenses paid to auditors amounting ₹ 3,500 have been included in the amount of ₹ 66,500. The consolidated figure of ₹ 66,500 has been deducted from Profit and Loss Account balance in the given solution.

Check Your Progress

1. Which section of the Companies Act 2013 mandates the preparation of financial statements?
2. Mention the entities on which the requirements of the Schedule III are not applicable.
3. Where is the debit balance of the Statement of Profit and Loss shown in the balance sheet?
4. What are the different classifications of finance cost?

3.3 MANAGERIAL REMUNERATION

A company is an artificial person owned and managed by its members. However, the number of members is so large that all of them cannot conveniently carry on the business of the company. They, therefore, have to elect certain persons among themselves to look after the affairs of the company. Such persons are called the directors of the company. However, the directors shall confine themselves to matters of general business policy and overall supervision of the management. They leave day-to-day working of the company to other persons appointed by them. Such persons(s) may be designed as Manager, Managing Director or Whole Time Director. The terms “Managerial Personnel” includes all the above categories of persons, i.e., a director, a manager, a managing director or a whole time director..

3.3.1 Remuneration Payable to Different Categories of Managerial Personnel and its calculation

The Companies Act, 2013 provides more flexibility to companies as compared the Companies Act, 1956 to draw a suitable remuneration packages as well as regulate the same with transparency and shareholders empowerment. The term managerial remuneration includes remuneration payable to the (a) managing director, (b) manager, and (c) the whole-time director and (d) other directors. It does not include remuneration paid to executives who are not members of the Board of Directors of the Company. Besides that, remuneration paid to a person of the category of “managerial personnel” stated above, for duties performed by him which cannot be termed as “managerial” shall not be called managerial remuneration, e.g., remuneration received by a director for working as secretary or technical adviser. But if a person is designated as secretary but performs the functions of a director or manager or managing director, then his remuneration will be included in the definition of managerial remuneration. Payment of Guarantee commission to a director of a company is included in managerial remuneration but interest received by a director for temporary loans given to the company will be excluded.

According to Section 197(1), the total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company, to its directors (including whole-time directors and managing directors) and manager in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year computed in the manner laid down in section 198. But directors' remuneration (excluding directors' fees) is not to be deducted from gross profits for computing the overall limit.

The percentage aforesaid shall be exclusive of any fees payable to directors for attending the board's meetings or a committee thereto [Sec. 197(2)].

Remuneration payable to different categories of Managerial Personnel

Within the overall rating of 11% a remuneration payable to different categories of managerial personnel will be as under:

(i) The remuneration payable to any one managing director; or whole-time director or manager shall not exceed five per cent of the net profits of the company and if there is more than one such director remuneration shall not exceed ten per cent of the net profits to all such directors and manager taken together;

(ii) The remuneration payable to directors who are neither managing directors nor whole-time ~ directors shall not exceed:-

   (A) One per cent of the net profits of the company, if there is a managing or whole-time director or manager;

   (B) Three percent of the net profits in any other case. [Sec. 197(1)]

   The percentages aforesaid shall be exclusive of any fees payable to directors. [Sec. 197(2)]

Modes of Paymentof Remuneration

All Directors and Managers may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by the other. [Sec. 197(6)]

Separate Provision for Independent Directors

The New Act has prescribed various provisions to maintain their independent identity. As regards the remuneration payable to Independent Directors, the New Act has tried to maintain a check from all sides, so that their independent identity does not get divulged. Some of the important provisions regarding remuneration to be paid to Independent Directors are as under:

(a) Different sitting fees are proposed to be prescribed for Independent Directors.

(b) Independent Directors are not allowed to receive stock options.

(c) Reimbursement of expenses for participation in the Board and other meetings are allowed.

(d) Profit-based commissions are allowed to Independent Directors subject to the condition that the same has to be approved by the shareholders at a general meeting. [Sec. 197(7)].

Waiver of Refundable Remuneration

The excess remuneration drawn by any Director is strictly refundable to the company. No waiver of remuneration is allowed except with the approval of Central Government. [Sec. 197(9)].

Payment of Remuneration at Exceeding Rate

(a) The New Act provides a way for payment of managerial remuneration at a rate exceeding 11% of net profit provided the same has to be approved by members at a general meeting coupled with the approval of the Central Government.

(b) Payment of remuneration to Managing Director and Whole-time Directors may be made at a rate exceeding 5% or 10% as the case may be, subject to the approval of members at a general meeting. [Sec. 197(1)]

In both the cases the Provision of Schedule V given below are to be observed.

Schedule V (Part II): Remuneration

Section I - Remuneration payable by companies having profits

As stated above: Increase in managerial remuneration has to be read according to Section 197 along with Schedule V. The Act, suggests that, for increase of managerial remuneration to Managing or Whole-time Director or even Non Whole-time Director within the limit of 5% and 10% or 1% and 3% as the case may be, Central Government's approval is not required. The company is free to draw a suitable package within the prescribed limit. For increase above the limit, approval of members would be required. One should keep in mind that only for raising the overall limit exceeding 11% Central Government approval will be required coupled with members approval.

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, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under (A) and (B) given below:-

NOTES

(A)

Sr. No.	*Where the effective capital is*	*Limit of yearly remuneration payable shall not exceed (₹)*
	(1)	(2)
1.	Negative or less than 5 crore	30 lakh
2.	5 crore and above but less than 100 crore	42 lakh
3.	100 crore and above but less than 250 crore	60 lakh
4.	250 crore and above	60 lakh plus 0.01% of the effective capital in excess of ₹ 250 crore.

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 prorated.

(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.

The following are the additional conditions applicable –

(i) The payment of remuneration is approved by a resolution passed by the Board and, in the case of a listed company also by the Nomination and Remuneration Committee.

(ii) The company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in the preceding financial year before the date of appointment of such managerial person.

(iii) A special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding three years.

(iv) A statement with prescribed particulars, along with a notice calling the general meeting is given to the shareholders.

Section III – Remuneration payable by companies having no profit for 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 company is a Foreign Company.

(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.

Policy to be followed while granting approval by company or Central Government for appointment and remuneration of managerial person

While fixing the remuneration under Sections 196 and 197 of the New Act the Central Government or the company shall have regard to the following:

(a) The financial position of the company;

(b) The remuneration or commission drawn by him from any other company;

(c) Professional qualifications and experience of the individual concerned;

(d) Such other matters as may be prescribed [Sec. 200].

This limit on the remuneration payable to different categories of managerial personnel as laid down by the Companies Act, have been shown in a simplified form in table below:

Category of Managerial Personnel	*Maximum Percentage of Annual Net Profit*	*Remarks*
(i) Overall limit for total remuneration to all managerial personnel	11%	Payment in excess of the limits besides, subject to the Provisions of Schedule V, requires:
(ii) Managing director (for one)	5%	(a) in case (i) approval of company in general
(iii) Managing directors (more than one—for all together)	10%	meeting and also that of Central Government
(iv) Whole-time director (for one)	5%	(b) in cases (ii) to (ix) approval

NOTES

Category of Managerial Personnel	*Maximum Percentage of Annual Net Profit*	*Remarks*
(v) Whole-time directors (more than one-for all together)	10%	of company in general meeting
(vi) Manager (there cannot be more than one manager)	5%	
(vii) Managing director or Managing directors or manager with one more whole-time director/ director (for all together)	10%	
(viii) Directors (for all) when there is no manager or managing director or whole-time director	3%	
(ix) Directors (for all) when there is a manager or managing director or a whole-time director	1%	

Perquisites excluded from Ceiling on Managerial Remuneration as per Schedule V (Part-IV)

1. A managerial person shall also be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified above.

   (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,

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

   (c) Encashment of leaves at the end of the tenure.

   In addition to the perquisites specified above, 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 the preceding pages:

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

   (b) Holiday passage for children studying outside India/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.

Computation of Net Profit for Managerial Remuneration [Sec. 198]

In computing the net profits of a company in any financial year for the purpose of managerial remuneration following adjustments are required—

1. Credit shall be given for the bounties and subsidies received from any Government, or any public authority constituted or authorized in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.
2. Credit shall not be given for the following sums, namely:
   (a) Profits, by way of premium on shares or debentures of the company, which are 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 undertakings of the company or of any part thereof;
   (d) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.
3. The following sums shall be deducted:
   (a) All the usual working charges;
   (b) Directors' remuneration;
   (c) Bonus or commission paid or payable to any member of the company's staff;
   (d) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits;
   (e) Any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf;
   (f) Interest on debentures issued by the company;
   (g) Interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets;
   (h) Interest on unsecured loans and advances;
   (i) Expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature;
   (j) Contributions to a bona fide and charitable trust;
   (k) Depreciation;

(l) Any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract;

(m) Any sum paid by way of insurance as is referred above;

(n) Debts considered bad and written off or adjusted during the year of account.

4. In making the computation aforesaid, the following sums shall not be deducted, namely:

   (a) Income-tax and super-tax payable by the company

   (b) Any compensation, damages or payments made voluntarily.

   (c) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

Note: In calculating net profit for overall maximum managerial remuneration limit and remuneration payable to directors (including managing and whole-time directors) directors' remuneration is not deducted from gross profits. However, fees payable to directors for attending Board's meeting are to be deducted. But for calculating remuneration payable to a manager, directors' remuneration shall also be deducted from gross profits as given in Section 198.

Illustration 3.2: A manager is entitled to a commission at a certain percentage of net profit (such commission to be charged in arriving at the net profit).

The commission is to be allowed on the following rates:

First ₹ 10,000	of the net profit		Nil
Next ₹ 20,000	" " " "	@	10%
Next ₹ 30,000	" " " "	@	15%
Next ₹ 60,000	" " " "	@	20%
Balance	" " " "	@	30%

The net profit before charging the manager's commission is ₹ 1,45,000. Compute the amount of manager's commission.

Solution:

Calculation of Commission Payable to Manager

Profit	*Commission* ₹	*Total Net Profit considered* ₹
First ₹ 10,000 net profit		10,000
Next ₹ 20,000 @ 10%	2,000	22,000
Next ₹ 30,000 @ 15%	4,500	34,500
Next ₹ 60,000 @ 20%	12,000	72,000
	18,500 (i)	1,38,500
Balance Net Profit:		
Total Profit		1,45,000
Less: Profit on which commission provided (as above)		1,38,500
		6,500
Commission = 6,500 × 30/130		1,500 (ii)
Total Commission payable (i) + (ii)		20,000

Illustration 3.3: The manager of M/s Slow and Steady Ltd. is entitled to get a salary of ₹ 2,500 per month plus 1 per cent 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 30 June, 2015.

Slow and Steady Limited

Statement of Profit and Loss for the year ended 30th June, 2015

Particulars		₹
1. Revenue from operations (Gross)		9,00,000
Less: Excise Duty		–
Revenue from Operations (Net)		9,00,000
2. Other Income		–
3. **Total Revenue (1) + (2)**		9,00,000
4. **Expenses**		
(a) Cost of Materials Consumed		–
(b) Purchases of Stock-in-trade		–
(c) Changes in Inventories of Finished Goods. Work-in-progress and Stock-in-trade		–
(d) Employee Benefits Expense:		
Salary, Wages and Bonus	1,92,500	
Manager's Salary	30,000	
Commission to Manager	6,000	2,28,500
(e) Finance Costs		
(f) Depreciation and Amortisation Expense		82,000
(g) Other Expenses		
General Expenses	4,000	
Expenditure on Scientific Research (cost of apparatus)	14,000	
Provision for bad and doubtful debts	17,500	
Subsidy from Government	(60,000)	45,500
Total Expenses		**3,56,000**
5. Profit/(Loss) before Exceptional and Extraordinary Items and Tax		5,44,000
6. Exceptional Items:		–
Profit on Sale of Fixed Assets (Cost price ₹2,50,000 less written down values ₹18,00,000)		1,00,000
7. Profit / (Loss) before Extraordinary Items and Tax (5) – (6)		6,44,000
8. Extraordinary Items		–
9. Profit / (Loss) before Tax (7) – (8)		6,44,000
10. **Tax Expense:**		
Current Tax		2,40,000
11. **Profit / (Loss) from Continuing Operations (9) – (10)**		4,04,000

Note: Proposed Dividend: ₹1,00,000.

Depreciation as per Schedule II amounts to ₹81,000. Calculate the remuneration payable to the Manager.

NOTES

Solution:

Calculation of Remuneration Payable to Manager

Particulars	₹	₹
Profit as per Profit & Loss A/c		3,04,000
Add: Inadmissible deductions:		
Depreciation	82,000	
Expenditure on Scientific Research (Capital expenditure)	14,000	
Salary & Commission paid to Manager	36,000	
Reserve for bad and doubtful debts	17,500	
Provision for Income-tax	2,40,000	
Proposed dividend	1,00,000	4,89,500
		7,93,500
Less: Depreciation as per Income-tax Rules	81,000	
Capital profit on sale of assets, (1,80,000 + 1,00,000 – 2,50,000)	30,000	1,11,000
Net Profit for calculation of managerial remuneration		6,82,500
Net profit as calculated above	6,82,500	
Less: Salary to Manager	30,000	
	6,52,500	

The amount of Commission would therefore be = 6,52,500 × 1/101 = ₹ 6,460.

However, the manager has already been paid commission to the extent of ₹ 6,000.

Balance to be payable therefore comes to: ₹ 460.

As per Section 197 of the Companies Act, 2013, the manager is entitled to a maximum remuneration of = 6,82,000 × 5/105 = ₹ 32,500.

Since maximum remuneration payable to the manager is ₹ 32,500 under Section 197, it has been assumed that the approval of the Company in General Meeting has been obtained for the excess payment.

Illustration 3.4: Following particulars are available from the books of Rajat Ltd.:

	₹
Net profit before provision for income-tax and managerial remuneration, but after depreciation and provision for repairs	98,04,100
Depreciation provided in the books	35,00,000
Provision for repairs of machinery during the year	2,50,000
Depreciation allowable under Schedule II of the Companies Act, 2013	28,00,000
Actual expenditure incurred on repairs during the year	1,50,000

You are required to calculate the managerial remuneration in the following cases:

(i) If there is one whole-time director; and

(ii) If there are two whole-time directors, a part-time director and a manager.

Solution:

Sections 197 of the Companies Act, 2013 prescribe the maximum percentage of profit that can be paid as managerial remuneration. For this purpose, profit is to be calculated in the manner as prescribed in Section 198 of the Companies Act.

NOTES

Calculation of Net Profit U/S 198 of The Companies Act, 2013

Particulars	₹	₹
Net profit before provision for income-tax and managerial remuneration, but after depreciation and provision for repairs		98,04,100
Add: Depreciation provided in the books	35,00,000	
Provision for repairs of machinery	2,50,000	37,50,000
		1,35,54,100
Less: Depreciation allowable under Schedule II	28,00,000	
Actual expenditure incurred on repairs	1,50,000	29,50,000
		1,06,04,100

Calculation of managerial remuneration:

(i) If there is only one whole-time director:
Managerial remuneration = 5% of net profit = 5% of ₹ 1,06,04,100
= ₹ 5,30,205

(ii) If there are two whole-time directors, a part time director and a manager:
Managerial remuneration = 11% of net profit = 11% of ₹ 1,06,04,100
= ₹ 11,66,451

Check Your Progress

5. Is the payment of guarantee commission to a director included under managerial remuneration?
6. What should be total managerial remuneration payable by a company to its director as per Section 197(1) of the Companies Act 2013?

3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 129 of the Companies Act 2013 mandates the preparation of the financial statements.
2. The requirements of the Schedule III, do not apply to 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 financial statement has been specified in or under any other Act governing such class of company.
3. Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'.
4. Finance costs shall be classified as: (a) interest expenses, (b) other borrowing costs and (c) applicable net gain/loss on foreign currency transactions and translation.
5. The payment of guarantee commission to a director is included under managerial remuneration.
6. According to Section 197(1) of the Companies Act 2013, the total managerial remuneration payable by a public company or private

NOTES

company which is a subsidiary of a public company, to its directors and manager in respect of any financial year shall not exceed 11 per cent of the net profits of that company for the financial year computed in the manner as mentioned under Section 198.

3.5 SUMMARY

- Financial statements include statements of balance sheet, profit and loss account, cash flow statement, and statement of changes in equity.
- Section 129 of the Companies Act 2013 mentions the provisions related to the financial statements.
- Auditor's report, Board of Director's report and Directors' Responsibility Statements are to be attached with the financial statements.
- Schedule III is applicable to all the financial statements to be prepared for the financial year commencing on or after 1 April 2014.
- While Part I of the Schedule III mentions the format of the Balance Sheet, Part II of the Schedule III mentions the format of the Profit and Loss Account.
- The terms managerial personnel include the following categories of persons including a director, manager, managing director or a whole time director.
- According to Section 197(1) discusses the total managerial remuneration payable.
- Section 198 provides the provisions related to the computation of the net profits of a company in any financial year for the purpose of managerial remuneration.

3.6 KEY WORDS

- **Balance sheet:** It represents all the assets owned by the business at a particular moment of time and the claims of the owners and outsiders against those assets at that time.
- **Profit and loss account:** Also known as Income Statement, it is a financial statement which matches revenues and costs incurred and shows the net profit earned or loss suffered during a particular period.
- **Managerial personnel:** It includes the director, manager, managing director or a whole-time director.

3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the different financial statements prepared as per the definition given in the Companies Act 2013?

NOTES

2. Write a short note on the general instructions as mentioned under Schedule III for the financial statements.
3. How are contingent liabilities and commitments classified in the Balance Sheet?
4. Who are managerial personnel in a company?
5. Briefly explain the remuneration payable to different categories of managerial personnel.
6. What are the provisions for the remuneration of independent directors?

Long Answer Questions

1. Discuss the general provisions in relation to the Financial Statements as given in the Companies Act 2013.
2. Examine the general instructions for the preparation of the Balance Sheet.
3. Describe the general instructions for the preparation of the statement of Profit and Loss.
4. Explain the calculation of net profits for managerial remuneration as mentioned under Section 198 of the Companies Act 2013.

Practical Problems

1. Calculate the managerial remuneration from the following particulars of Ankit & co. Ltd., due to the managing director of the company at the rate of 5% of the profits. Also determine the excess remuneration paid, if any.

	Particulars	₹
	Net Profit	2,00,000
	Net profit is calculated after considering the following:	
(i)	Depreciation	40,000
(ii)	Preliminary Expenses	10,000
(iii)	Tax Provision	3,10,000
(iv)	Directors' Fees	8,000
(v)	Bonus	15000
(vi)	Profit on Sale of Fixed Assets (Original cost: ₹ 20,000 WDV: ₹ 11,000)	15,500
(vii)	Provision for Doubtful Debts	9,000
(viii)	Scientific Research Expenditure (for setting up new machinery)	20,000
(ix)	Managing Director's Remuneration Paid	30,000
	Other Information:	
(i)	Depreciation Allowable under Income Tax Rules	35,000
(ii)	Bonus Liability as per Payment of Bonus Act, 1965	18,000

[**Ans.** Managerial remuneration due to the managing director-₹ 28,725;
Excess remuneration paid ₹ 1,275]

2. From the following particulars of a limited company, calculate the maximum remuneration payable to managing director and other part-time directors of a company.

Net profit before provision of income tax and managerial remuneration but after

	₹
Depreciation and provision for repairs	86,84,100
Depreciation provided in books	32,00,000
Repairs for machinery provided during the year	2,50,000
Actual Expenditure incurred on repairs during the year	1,50,000

[**Ans.** Net Profit for Managerial Remuneration ₹ 87,84,100,
Remuneration: MD ₹ 4,39,205,
Part-time Directors ₹ 87,841]

3. The balance in Profit & Loss Account as per Balance Sheet as at 31st March, 2015 is ₹ 16,300 whereas the balance on Balance Sheet as at 31st March, 2016 is ₹ 19,050.

   The following information is available:

   (i) ₹ 4,250 depreciation has been charged.
   (ii) Provision for dividend amounting to ₹ 7,500 has been made.
   (iii) ₹ 2,250 has been transferred to General Reserve.
   (iv) ₹ 500 dividend (gross) has been credited.
   (v) ₹ 1,150 loss on Sale of Fixed Assets has been debited.
   (vi) Indirect expenses debited, amount to ₹ 15,250.

   Find out Gross Profit, Trading Profit and Net Profit.

   [**Ans**. Gross Profit ₹ 32,650; Trading Profit ₹ 17,400; and Net Profit ₹ 12,500]

3.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

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Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

UNIT 4 VALUATION OF GOODWILL

NOTES

Structure

4.0 Introduction
4.1 Objectives
4.2 Valuation of Goodwill: Meaning and Need
4.3 Methods of Valuation of Goodwill:
Average Profit, Super Profit and Capitalization Methods
4.4 Answers to Check Your Progress Questions
4.5 Summary
4.6 Key Words
4.7 Self Assessment Questions and Exercises
4.8 Further Readings

4.0 INTRODUCTION

It is generally observed than an old and established firm is in a position to earn a higher amount of profit as compared to a new firm inspite of all other things (such as investment, location, quality of goods etc.) remaining the same. This is because, over a period of time a firm establishes its reputation on account of which not only do old customers continue to patronise the firm but they also bring in new customers. This enables the firm to earn excess profits as compared to a new firm. Goodwill has therefore been defined as "the present value of firm's anticipated excess earnings."

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept and need for valuation of goodwill
- Describe the factors which affect the valuation of goodwill
- Explain the methods of valuation of goodwill

4.2 VALUATION OF GOODWILL: MEANING AND NEED

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."*

*Guidance Note on Terms used in Financial Statements, ICAI, New Delhi.

From the above, it can be concluded that goodwill is the estimated value of the reputation of a business.

Need for Valuation of Goodwill

The need for valuation of goodwill in a joint stock company arises in the following circumstances:

(i) When the business of a company is taken over by another company, *e.g.*, in case of amalgamation or absorption.

(ii) When the company's shares are not quoted on the stock exchange and their value is to be determined for the purposes of estate duty and wealth tax, etc.

(iii) When a person wants to purchase a large block of the company's shares with a view to acquire control over the management of the company.

(iv) When the business of the company is being taken over by the government.

(v) When the management wants to write back goodwill which it wrote off earlier to reduce or eliminate the debit balance in the profit and loss account.

Factors Affecting Value of Goodwill

The following are the main factors which affect the value of the goodwill of a firm:

1. Profitability: The profitability of a firm is the main factor affecting the value of its goodwill. The term profitability here refers to the profit which the firm is expected to earn in future. The buyer of the business when paying for goodwill, looks to the future profit which he expects to earn and not the profit which the firm might have earned in the past. In case good profits in the past have been mainly due to the personality of the vendor, shortlived monopoly conditions or a temporary craze or fashion, etc., the buyer will not pay any amount for goodwill. However, if past good profitability was due to the nature of the business, favourable location, ownership of patents and trade marks, exceptionally favourable contracts or good management (which is likely to continue), the buyer will be prepared to pay a handsome amount for goodwill.

The following points should be kept in mind while estimating the future profits of the firm for valuation of goodwill:

(i) On the basis of the profits for the last 4 or 5 years, the average profits should be calculated. Such years should be normal years. The objective is to consider only the normal profits which the business is expected to earn in the normal circumstances. Hence, any abnormal gain or loss has to be excluded.

(ii) In case the profits of the last few years used for calculating average profit, show a marked rising trend, it will be appropriate to give more weightage to the profits of the later years as compared to the former years. For example, if the profits for the last 5 years are ₹ 70,000, ₹ 90,000, ₹ 80,000, ₹ 1,20,000 and ₹ 1,40,000, it will be appropriate to calculate the average profits by giving suitable weights as follows:

Year	Profits	Weights	Products
1	70,000	1	70,000
2	90,000	2	1,80,000
3	80,000	3	2,40,000
4	1,20,000	4	4,80,000
5	1,40,000	5	7,00,000
	5,00,000	15	16,70,000

Weighted Average Profit = ₹ 16,70,000 □15 = ₹ 1,11,333

In the above example, the profits are showing a constantly rising trend. However, if the profits are showing a constantly falling trend, it will be appropriate to estimate the future profits on the basis of the trend, *i.e.*, they will be less than the profits for the latest year.

(iii) On the basis of average profits, maintainable profit should be calculated after making provision, if necessary, for any additional working expenses including interest on debentures and depreciation on assets. In case the fixed assets are revalued, depreciation should be provided on the new values. Moreover, in case of a sole proprietary and partnership firm, provision should be made for reasonable salary to the partners or the sole proprietor, as the case may be.

(iv) It is equity shareholders who generally stand to gain on account of the company having a goodwill in the market. It is, therefore, advisable to take into consideration for valuation of goodwill only the profits expected to be available for the equity shareholders. This means provision for taxation, preference dividends etc; are to be deducted from the net profit of the company. However transfers to general reserve, dividend equivalisation fund, sinking funds for redemption of debentures, etc., should not be deducted since they in no way affect the availability of profits for the equity shareholders.

(v) Non-trading income (*i.e.* incomes earned on account of non-trading assets) should generally be excluded from the net profits. The objective is to consider only the "operating profits" from the business.*

* Some accountants are of the opinion that market is entitled to consider the total profits and not merely the operating profits. In case this view is adopted, non-operating incomes and expenses should not be excluded.

Illustration 4.1: From the following data, calculate the average maintainable profits of a company:

Years	*Profit (₹)*
2014	2,20,500
2015	3,22,500
2016	2,40,000

The following is the additional information supplied to you:

(i) The profits are after charging debenture interest and tax but before providing preference dividend.

(ii) A claim of ₹ 8,250 was omitted to be provided in the year 2016.

(iii) Non-recurring profits are to be eliminated. 10% of the profits for 2015 referred to above are of a non-recurring nature.

(iv) A provision of ₹ 15,750 on sundry debtors made in 2016, is no longer required.

(v) The company has 6% preference share capital of ₹ 1,50,000.

(vi) The taxation rate may be presumed as 50%.

(vii) Debentures of ₹ 3,00,000 carrying 5% interest will be redeemed before sale of business.

(viii) The above profits included Interest on Investments amounting to ₹ 18,000 per annum.

Solution:

Statement Showing Average Future Maintainable Profits

Year				*(₹) Profits*
2014				2,20,500
2015			3,22,500	
	Less: 10% non-recurring Profit		32,500	2,90,000
2016				2,40,000
	Add: Provision on Sundry Debtors not required	15,750		
	Less: Omission of claim	8,250		
		7,500		
	Less: Tax effect (@50%)	3,750	3,750	2,43,750
				7,54,500
	Average Profits (₹ 7,54,500 ¸ 3)			2,51,500
	Less: After Tax Income on investments			9,000
				2,42,500
	Add: Interest on debentures (after adjusting for tax) since they will be redeemed			7,500
	Future maintainable Profit			2,50,000
	Less: Preference Dividend			9,000
	Profit available for equity shareholders			2,41,000

2. Normal rate of return: The term normal rate of return means the rate of return that will satisfy an ordinary investor (neither very eager nor very reluctant to invest) in the industry concerned. Such a return differs from industry to industry. It comprises of three components:

(i) **Return at zero risk level.** This refers to the expected rate of return when a project involves no risk–whether business or financial.

(ii) **Premium for business risk.** The term business risk refers to the variability in operating profits due to change in sales. In case the nature of the business of a firm is such that it has more than the normal or average risk, the investor will expect a higher rate of return.

(iii) **Premium for financial risk.** The term financial risk refers to the risk on account of pattern of capital structure (or debt equity mix). In general, it may be said that a firm having a higher debt content in its capital structure is more risky as compared to a firm which has comparatively a low debt content.

The normal rate of return is determined keeping in view the above factors. Stock exchange quotations usually give a very fair idea about the return expected by investors from a particular company. For example, if the share of a company having a paid-up value of ₹ 20 is quoted on the stock exchange at ₹ 40 on the basis of 30% dividend, the return expected by the investor from the company is 15% (*i.e.* 6/40 × 100).

While calculating the normal yield expected in case of a given company, the yield calculated as above may have to be suitably adjusted keeping in view the circumstances of the company concerned. For example, if in the above case, the company whose normal yield is to be calculated, is better than the company whose shares have been quoted as above, the investor may be willing to expect a lower rate of return than 15%. In a reverse case, the investor will expect a higher rate of return than 15%.

Illustration 4.2: *A* Ltd. has equity shares of ₹ 10 each. In a similar company, the market value of equity shares of the same denomination is ₹ 25 per share on the basis of average dividend declared of 20% without any major fluctuations from year to year. In the case of *A* Ltd. the dividend rate has been fluctuating from year to year. The current ratio of *A* Ltd. is better than that of the company referred to above. You are required to calculate the normal rate of return expected from *A* Ltd.

Solution:

A shareholder holding one share of ₹ 10 gets a dividend of ₹ 2 per share. Since the market price of the share is ₹ 25, the normal rate of return expected from the company referred to in the question comes to 8% (2/25 × 100). However, the following adjustments will have to be made to determine the normal rate of return for *A* Ltd.

	Normal rate of return		8%
Add:	For instability in dividend rates in case of *A* Ltd.	(say)	2%
Less:	For better current ratio in *A* Ltd.	(say)	1%
	Normal rate of return expected in case of *A* Ltd.		9%

NOTES

3. **Capital employed:** The value of goodwill depends not only on the amount of "average maintainable profits" but also on the capital employed in the business to earn such profit. The term, capital employed for valuation of goodwill should generally be calculated from the point of view of the equity shareholders. In other words, it represents the equity shareholders' funds in the company. While calculating equity shareholders' funds, any profit or loss on revaluation of assets should also be taken into account. Non-trading assets,* fictitious assets and goodwill if any appearing in the balance-sheet, should be excluded.

Illustration 4.3: The following is the balance sheet of *A* Ltd. as on 31 December 2015:

Liabilities	₹	*Assets*	₹
Share Capital:		Fixed Assets:	
12% Preference Shares of ₹ 10	1,50,000	Goodwill	1,50,000
Equity Shares of ₹ 10 each	4,50,000	Freehold Property	3,75,000
Reserves & Surplus		Plant and Machinery	1,50,000
Profit and Loss Account	7,50,000	Current Assets:	
Secured Loans		Investments in Govt. Securities	3,00,000
10% Debentures	3,00,000	Stock	2,50,000
Current Liabilities		Debtors	3,00,000
Sundry Creditors	1,85,000	Bank Balance	3,00,000
		Miscellaneous Expenses & Losses:	
		Preliminary Expenses	10,000
	18,35,000		18,35,000

The following is the additional information supplied to you:

(i) Debentures are to be redeemed in full before business is taken over by the new company.

(ii) The investments in government securities have a market value of ₹ 2,50,000. The securities will be sold and the proceeds so realised will be used in partly redeeming debentures.

(iii) The value of freehold property is to be ascertained on the basis of 8% return. The current rental value is ₹ 50,400.

Calculate the amount of capital employed in the business for valuation of goodwill.

* In case non-trading income have not been excluded while calculating "average maintainable profits" non-trading assets should not be excluded.

Solution:

Statement Showing Capital Employed in the Business

		₹
Free hold Property (₹ 50,400 × 100 ¸ 8)		6,30,000
Plant and Machinery		1,50,000
Stock		2,50,000
Debtors		3,00,000
Bank Balance (₹ 3,00,000 + ₹ 2,50,000 – ₹ 3,00,000)		2,50,000
		15,80,000
Less: Preference Share Capital	1,50,000 ₹	
Sundry Creditors	1,85,000	3,35,000
Capital employed for Equity Shareholders		12,45,000

Alternatively, the capital employed for the equity Shareholders can be ascertained as follows:

Equity Share Capital		₹ 4,50,000
Profit and Loss Account		7,50,000
Profit on revaluation of building		2,55,000
		14,55,000
Less: Preliminary expenses		₹ 10,000
Loss on sale of investments		50,000
Goodwill	1,50,000	2,10,000
Capital employed for equity Shareholders:		12,45,000

It is considered desirable to use “Average Capital Employed” in place of “Terminal Capital Employed” for valuation of goodwill. This is because of the fact that profits are earned throughout the year and therefore, average capital employed will be a better basis for calculating Return on Investment as compared to terminal capital employed. Average capital employed is the average of the capital employed in the beginning and that employed at the end of the year. For example, if in the above illustration, the capital employed as on 31 December, 2014 is ₹ 11,55,000, the average capital employed will be ₹ 12,00,000 (*i.e.* ½ of ₹11,55,000 + ₹ 12,45,000).

4.3 METHODS OF VALUATION OF GOODWILL: AVERAGE PROFIT, SUPER PROFIT AND CAPITALIZATION METHODS

The following are three basic methods for valuation of goodwill:

Simple profit or average profit methods: In this method goodwill is valued on the basis of a certain number of years’ purchase of the average profits of the past few years. For example, if the average annual profits of a business for the past 5 years are ₹ 10,000 and goodwill is to be valued on the basis of 2 years’ purchase of such average annual profits, the value of goodwill will be ₹ 20,000.

NOTES

Capitalisation of profit method: In this method, the total value of the business is found out by capitalising the expected average profits on the basis of normal rate of return. The value of goodwill is the difference between the value of the business so found out and the actual capital employed in the business. For example, if the average annual expected profit in a business is ₹ 10,000, normal rate of return 10% and the actual capital employed in the business ₹ 80,000, the value of goodwill will be ₹ 20,000 (i.e. capitalised value of the business ₹ 1,00,000—Actual capital employed ₹ 80,000).

Super profit method: In case of this method, goodwill is based on the average annual super profit earned by the business. The term super profit means the profit over and above the normal profit.

This method is most popular for valuation of goodwill in case of joint stock companies. However, in case of this method, goodwill can also be valued by any of the following methods:

(i) **Purchase of super profit method.** According to this method, the value of goodwill is ascertained as follows:

Average Annual Super Profit × Number of years

For example, if the amount of average annual super profit is ₹ 3,000, and it is expected that the purchaser of the business will be in a position to maintain this profit for three years (only on account of old reputation of the business), the value of the goodwill will be ₹ 9,000.

(ii) **Sliding scale valuation of super profit.** This method of valuation of goodwill is a slight variation of the purchase of super profit method. It has been advocated by A.E. Cutforth. The method is based on the theory that the greater the amount of the super profit, the more difficult, it would be to maintain it. The super profit, in this case is divided into two or three divisions. Each of these divisions is multiplied by a different number of years' purchase in descending order from first division. For example, if the amount of super profit is estimated at ₹ 6,000, the value of the goodwill will be calculated as under:

First	₹ 2,000 at (say) 3 years' purchase	6,000
Second	₹ 2,000 at (say) 2 years' purchase	4,000
Third	₹ 2,000 at (say) 1 year's purchase	2,000
	Total value of goodwill	₹ 12,000

(iii) **Annuity method of super profit.** 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 of 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

Example:	Average annual super profit	₹ 5,000
	Rate of interest	10%

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 Re 1 for three years. The value of goodwill will, therefore, be ascertained as follows:

₹ 5,000 × 2.48685 = ₹ 12,434 or (say) ₹ 12,500.

(iv) **Capitalisation of super profit method.** In this method the amount of super profit is capitalised at the normal rate of return. In other words, the method tries to find out the amount of capital needed for earning the super profit. According to this method, the value of goodwill is ascertained as follows:

Average Annual Super Profit × 100/Normal rate of return.

For example, if the annual average super profit is ₹ 5,000 and the normal rate of return 10%, the value of goodwill will be ₹ 50,000.

The super profit method of calculating goodwill is considered better than simple profit method since it gives due consideration to capital employed in the business which is absolutely ignored in case of simple profit method.

Illustration 4.4: The average net profit of a business as adjusted for valuation of good will amounted to ₹ 2,35,000. The net tangible assets employed were of the value of ₹ 14,50,000. But upon valuation, they amounted to ₹ 15,00,000. Assuming that 10% represented a fair commercial return, calculate the amount of goodwill by capitalising super profits.

[CS Executive June, 2014]

Solution:

(a) Normal Profit = Average Capital Employed × Normal Rate of Return
= ₹ 15,00,000 × 10%
= ₹ 1,50,000

(b) Super Profit = Average Profit – Normal Profit
= ₹ 2,35,000 – 1,50,000
= ₹ 85,000

(c) Goodwill = Super Profit/Normal rate of Return
= ₹ 85,000/10%
= ₹ 8,50,000

NOTES

Illustration 4.5: The following is the Balance-Sheet of Quality Traders Ltd., as at 30 April, 2016:

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 30 April, 2013	₹ 64,000
Year ended 30 April, 2014	72,000
Year ended 30 April, 2015	86,000
Year ended 30 April, 2016	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 30 April, 2013	60,000	1	60,000
Year ended 30 April, 2014	68,000	1.5	1,02,000
Year ended 30 April, 2015	82,000	2	1,64,000
Year ended 30 April, 2016	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 4.6: The Balance Sheet of Toy Gun Manufacturing Co. Ltd. discloses the following financial position as at 31 March, 2017.

Liabilities	₹	*Assets*		₹
:Paid-up Capital		Goodwill at Cost		30,000
Shares of ₹ 10 30,000 each fully paid	3,00,000	Land and Buildings at Cost (*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

		₹
Super Profit Method .1		
: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

Capitalisation of Profits .2 Method		
Total Value of Business	12 ÷ 100 × 55,000	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.

Illustration 4.7: The Balance Sheet of Domestic Ltd. as on 31st March, 2017 is as under:

(*All figures are in lakhs*)

Liabilities	₹	*Assets*	₹
Equity Shares ₹ 10 each	3,000	Goodwill	744
Reserves (including provision		Premises and Land at Cost	400
for taxation of ₹ 300 lakhs)	1,000	Plant and Machinery	3,000
5% Debentures	2,000	Motor Vehicles	
Secured Loans	200	(purchased on 1.10.16)	40
Sundry Creditors	300	Raw materials at Cost	920
Profit & Loss A/c		Work-in-progress at Cost	130
Balance from previous B/S ₹ 32		Finished Goods at Cost	180
Profit for the year (After		Book Debts	400
taxation) ₹ 1,100	1,132	Investment (meant for replacement	
		of Plant and Machinery)	1,600
		Cash-at-Bank and Cash-in-hand	192
		Discount on Debentures	10
		Underwriting Commission	16
	7,632		7,632

The resale value of Premises and Land is ₹ 1,200 lakhs and that of Plant and Machinery is ₹ 2,400 lakh. Depreciation @ 20% is applicable to Motor vehicles. Applicable depreciation on Premises and Land is 2%, and that on Plant and Machinery is 10%. Market value of the investments is ₹ 1,500 lakh. 10% of book debts is bad. In a similar company the market value of equity shares of the same denomination is ₹ 25 per share and in such company dividend is consistently paid during last 5 years @ 20%. Contrary to this, Domestic Ltd. is having a marked upward or downward trend in the case of dividend payment.

Past 5 years' profits of the company were as under:

2011–12		₹ 67 lakh
2012–13	(–)	₹ 1,305 lakh (loss)
2013–14		₹ 469 lakh
2014–15		₹ 546 lakh
2015–16		₹ 405 lakh

The unusual negative profitability of the company during 2012–13 was due to the lock out in the major manufacturing unit of the company which happened in the beginning of the second quarter of the year 2011–12 and continued till the last quarter of 2012–13.

Value the goodwill of the company on the basis of 4 years' purchase of the super profit. (Necessary assumption for adjustment of the company's inconsistency in regard to the dividend payment, may be made by the examinee.) (*CA Final Nov. 2007, May 2013, adapted)*

Solution:

1. Computation of Capital Employed:

Present Value of assets:	₹ (in lakhs)
Premises and land	1,200
Plant and Machinery	2,400
Motor Vehicles (book value less depreciation for ½ year)	36
Raw Materials	920
Work-in-progress	130
Finished Goods	180
Book Debts (400 × 90%)	360
Investments	1,500
Cash-at-bank and-in-hand	192
	6,918
Less: Liabilities:	
Provision for Taxation	300
5% Debentures	2,000
Secured Loans	200
Sundry Creditors	3002,800
Total capital employed on 31.3.17	4,118

2. Profit available for Shareholders for the year 2016–17:

Profit for the year as per Balance Sheet	1,100	
Less: Depreciation to be considered		
Premises and Land	24*	
Plant & Machinery	240*	
Motor Vehicles	4	268
	832	
Less: Bad Debts		40
Profit for the year 2016–17		792

3. Computation of average Capital Employed:

Total capital employed	4,118
Less: ½ of profit for the current year (Refer point 2)	396
Average capital employed	3,722

4. Computation of Future Maintainable Profits:

Profit for the year 2016–17	792
Profit for the year 2015–16	405
Profit for the year 2014–15	546
Profit for the year 2013–14	469
	2,212/4
	553

5. Computation of General Expectation:

Domestic Ltd. pays ₹ 2 as dividend (20%) for each share of ₹ 10

Market value of equity shares of the same denomination is ₹ 25 which fetches dividend of 20%. Therefore, share of ₹ 10 (Face value of shares of Domestic Ltd.) is expected to fetch (20/25) × 10 = 8% return.

Since Domestic Ltd. is not having a stable record in payment of dividend, in its case the expectation may be assumed to be slightly higher, say 10%.

6. Computation of Super Profit:

Future maintainable profit (See point 4)	553
Normal profit (10% of average capital employed as computed in point 3)	372.2
Super Profit	180.8

7. Valuation of Goodwill:

Goodwill at 4 years' purchases of Supper Profit	723.20

Note:

(1) It is apparent from the Balance Sheet that depreciation was not charged to Profit & Loss Account.

(2) It has been assumed that provision for taxation already made is sufficient.

(3) While considering past profits for determining average profit, the years 2011–12 and 2012–13 have been left out, as during these years normal business was hampered.

Check Your Progress

1. How is non-trading income treated under valuation of goodwill?
2. What is business risk?
3. How does the annuity method of super profit work?

4.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Non-trading income should generally be excluded form the net profits during valuation of goodwill because the objective is to consider only the 'operating profits' from the business.
2. Business risk refers to the variability in operating profits due to change in sales.
3. In annuity method, goodwill is the discounted value of the total amount calculated as per purchase of super profit method.

4.5 SUMMARY

- 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 valuation of goodwill is needed in case when business is taken over by another company, when company's shares are not quoted on the stock exchange, when a person wants to purchase a large block of shares, when business is being taken over by the government and when management wants to write back goodwill which it wrote off earlier.
- The following are the main factors which affect the value of goodwill of a firm: profitability, normal rate of return and capital employed.

- The following are the three basic methods for valuation of goodwill: simple profits methods, capitalisation of profit method and super profits method.
- The following are the methods of super profits method: purchase of super profit method, sliding scale valuation of super profit, annuity method of super profit, capitalisation of super profits method.

4.6 KEY WORDS

- **Goodwill:** It is the estimated value of the reputation of a business.
- **Profitability:** In case of valuation of goodwill, it refers to the profit which the firm is expected to earn in future.
- **Average capital employed:** It is the average of the capital employed in the beginning and that employed at the end of the year.
- **Super profit:** It refers to the profit over ad above the normal profit.

4.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. List the circumstances in which the need for valuation of goodwill arises.
2. How is normal rate of profit treated under valuation of goodwill?
3. Why is the use of average capital employed preferred over terminal capital employed for valuation of goodwill?
4. Write a short note on average profits and capitalisation of profits methods of valuation of goodwill.

Long Answer Questions

1. Discuss the points which should be kept in mind while estimating the future profits of a firm for its valuation of goodwill.
2. Explain the different methods available under the super profits method of valuation of goodwill.

4.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

NOTES

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *An Introduction to Accountancy, 12/e.* New Delhi: Vikas Publishing House.

Goyal, V. K. and R Goyal. 2012. *Corporate Accounting.* India: PHI Learning.

Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

BLOCK - II
LIQUIDATION OF COMPANIES AND AMALGAMATION

NOTES

UNIT 5 VALUATION OF SHARES

Structure

5.0 Introduction
5.1 Objectives
5.2 Valuation of Shares: Meaning and Need
5.3 Methods of Valuation of Shares
5.4 Answers to Check Your Progress Questions
5.5 Summary
5.6 Key Words
5.7 Self Assessment Questions and Exercises
5.8 Further Readings

5.0 INTRODUCTION

Valuation of shares is one of the most perplexing problems that confront students of accountancy. The basic principles are by no means difficult but their applications calls for a considerable degree of knowledge of the various technicalities involved.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the need for valuation of shares
- Explain the methods of valuation of shares

5.2 VALUATION OF SHARES: MEANING AND NEED

The need for valuation of shares arises in one or more of the following circumstances:

(i) Assessments under estate duty, wealth tax, gift tax, etc.

(ii) Purchase of a block of shares generally involving acquisition of controlling interest in the company.

(iii) Formulations of schemes of amalgamation, absorption, etc.

(iv) Acquisition of interest of dissenting shareholders under reconstruction scheme.

(v) Conversion of preference shares into equity shares.

(vi) Advancing loans on the security of shares.

(vii) Compensating shareholders on the acquisition of their shares, by the government under a scheme of nationalisation.

Valuation and Stock Exchange Prices

In case of shares quoted on a recognised stock exchange, stock exchange prices are generally taken as the basis for the valuation of those shares. However, the stock exchange quotations are not generally acceptable when a large block of company's shares is involved. This is because stock exchange price is basically determined on the interactions of demand and supply and business cycles. They cannot form a fair and equitable or rational basis for compensation.

The Council of the London Stock Exchange has also expressed the same opinion in the following words:

"The stock exchange may be likened to a scientific recording instrument which registers, not its own actions and opinions but the actions and opinions of private institutional investors all over the country and indeed the world. These actions and opinions are the result of fear, guess work, intelligent or otherwise, good or bad investment policy and many other considerations. The quotations that result definitely do not represent valuation of a company by reference to its assets and its earning potential."

On account of the above reasons, accountants are frequently required to place a proper value on the shares in a company. The methods adopted by them are being explained in the following pages.

5.3 METHODS OF VALUATION OF SHARES

The methods of valuation of share may be broadly classified as follows:

1. Net Assets Backing Method;
2. Yield Method.

Both the above methods are generally used for valuation of equity shares. However, they can also be used to some extent in case of preference shares, as explained later.

1. Net Assets Backing Method

This is also termed as balance sheet method or asset backing method or intrinsic or break-up value method. In case of this method, the net assets of the company (including goodwill and non-trading assets) are divided by the number of issued shares to arrive at the asset backing for each share. For instance, if the assets total ₹ 50,000, liabilities ₹ 10,000 and the number of shares 20,000, the value of each share according to the method would be ₹

2 (i.e., ₹ 40,000/20,000). The following points should be kept in mind while valuing shares according to this method:

(i) A proper value should be placed on the goodwill of the business

(ii) Fictitious assets, such as preliminary expenses, debit balance in the profit and loss account etc. should be excluded.

(iii) All other assets, (including non-trading assets, such as investments) should be taken at their market values. In the absence of information in the question about the market values of the different assets, book values may rightly be taken as the market values of the different assets. Liabilities payable to third parties and preference share capital should be deducted from the total assets. It should be noted that items constituting part of the equity shareholders' funds (*e.g.* general reserve, profit and loss account credit balance, debentures redemption fund, dividends equivalisation reserve, contingency reserve etc.) should not be deducted.

(iv) The net assets so arrived at should be divided by the number of equity shares to arrive at value of the share. However, this has to be done only when all shares are equally paid-up. In case the company's equity shares are of different paid-up values, the total net assets should allocated to the different paid-up value groups. Each such allocation should then be divided by the number of shares in each of such groups.

Thus, the value of an equity share, according to this method, can be found out as shown in the following statement:

Goodwill as valued			......
Investments at market value			......
Other assets at market value			......
			......
Less:	Debentures	...	
	Accounts Payable	...	
	Other Liabilities	...	
	Preference Capital	...	......
Net Assets available for equity shareholders (i)			......
Number of Equity Shares (ii)			......
Value of an Equity Share (i)/(ii)			......

This method of valuation is generally not recommended for going concerns since in their case yield is the predominant factor. However, in case of companies like, investment companies, such a basis of valuation may be acceptable since yield, in their case primarily depends upon the assets position. Similarly in case of companies having highly uneven past results, this method of valuation may be the only choice since no reliable information is available about the expected earnings of the company. The method is also suitable for a company which has been showing consistent losses with no apparent prospect of recovery.

Illustration 5.1: The following particulars relate to a company:

	₹
Total Assets	18,50,000
External Liabilities	2,50,000
Share Capital:	
14% Preference Shares of ₹ 10 each, fully paid	5,00,000
40,000 Equity Shares of ₹ 10 each, fully paid	4,00,000
60,000 Equity Shares of ₹ 10 each, ₹ 7.50 paid	4,50,000

Calculate the value of each category of equity shares of the company based on a deemed liquidation.

Solution:

Asset-basis Value of an Equity Share

	₹
Total Assets	18,50,000
Less: Liabilities	2,50,000
Net worth	16,00,000
Less: Preference Shares	5,00,000
Net worth applicable to Equity	11,00,000
Add: National call on 60000 Equity Shares @ ₹ 2.5 per Share	1,50,000
Adjusted Net Worth	12,50,000
No. of Equity Shares	1,00,000
Value per Share (fully paid)	₹ 12.50
Value of Equity Share on which ₹ 7.50 paid	₹ 12.50– ₹ 2.50 = ₹ 10

Illustration 5.2: The following is the Balance Sheet (as on 31st December, 2016) of Sun Ltd.:

Liabilities	₹	*Assets*	₹
Share Capital:		Fixed Assets:	
80,000 Equity Shares of ₹ 10 each fully paid up	8,00,000	Goodwill	1,00,000
50,000 Equity Shares of ₹ 10 each ₹ 8 paid up	4,00,000	Plant and Machinery	8,00,000
36,000 Equity Shares of ₹ 5 each fully paid up	1,80,000	Land and Building	1,00,000
30,000 Equity Shares of ₹ 5 each ₹ 4 paid up	1,20,000	Furniture and Fixtures	1,00,000
3,000 10% Preference Shares of	3,00,000	Vehicles	2,00,000
₹ 100 each fully paid up		Investments	3,00,000
Reserve and Surplus:		Current Assets:	
General reserve	1,40,000	Stock	2,10,000
Profit and Loss Account	2,10,000	Debtors	1,95,000
Secured Loan: 12% Debenture	2,00,000	Prepaid Expenses	40,000
Unsecured Loan: 15% Term loan	1,50,000	Advances	45,000
Deposits	1,00,000	Cash and Bank Balance	2,00,000
Current Liabilities:		Preliminary Expenses	10,000
Bank Loan	50,000		

Liabilities	₹	*Assets*	₹
Creditors	1,50,000		
Outstanding Expenses	20,000		
Provision for Tax	2,00,000		
Proposed Dividend:			
Equity	1,50,000		
Preference	30,000		
	32,00,000		23,00,000

Additional Information:

(1) In 2014 a new machinery costing ₹ 50,000 was purchased, but wrongly charged to revenue (no rectification has yet been made for the same).

(2) Stock is overvalued by ₹ 10,000 in 2015. Debtors are to be reduced by ₹ 5,000 in 2016, some old furniture (Book value ₹ 10,000) was disposed of for ₹ 6,000.

(3) Fixed assets are worth 5 per cent more than their actual book value. Depreciation on appreciated value of Fixed assets except machinery is not to be considered for valuation of goodwill.

(4) Of the investment 20 per cent is trading and the balance is non-trading. All trade investments are to be valued at 20 per cent below cost. Trade investment were purchased on 1st January, 2016. 50 per cent of the non-trade investments were acquired on 1st January, 2015 and the rest on 1st January, 2014. A uniform rate of dividend of 10 per cent is earned on all investments.

(5) Expected increase in expenditure without commensurate increase in selling price is ₹ 20,000.

(6) Research and Development expenses anticipated in future ₹ 30,000 per annum.

(7) In a similar business a normal return on capital employed is 10%.

(8) Profit (after tax) are as follows:
In 2014— ₹ 2,10,000, in 2015— ₹ 1,90,000 and in 2016— ₹ 2,00,000.

(9) Current income tax rate is 50%, expected income tax rate will be 40%.

From the above, ascertain the ex-dividend and cum-dividend intrinsic value for different categories of equity shares. For this purpose goodwill may be taken as 3 years purchase of super profits. Depreciation is charged on machinery @ 10% on reducing system. (*CA Final, May 2007, adapted*)

Solution:

Computation of Intrinsic Value of Shares:

(1) Computation of Net Assets for Equity Shares:

	₹
Value of Net Assets (as computed for Goodwill)	21,02,073
Value of Goodwill [WN 3]	11,406

Non-trade investments		2,40,000
		23,53,479
Less: Preference Share Capital	3,00,000	
Proposed Dividend of Preference Shares	30,000	
Proposed Dividend of Equity Shares	1,50,000	4,80,000
Net Assets available for Equity Shareholders		18,73,479

(2) Computation of Number of Equivalent Equity Shares:

		No. of Equivalent shares
80,000 shares + 50,000 shares =		
1,30,000 shares of ₹ 10 each	$1{,}30{,}000 \times \frac{10}{10}$	1,30,000
36,000 shares + 30,000 shares =		
66,000 shares of ₹ 5 each	$66{,}000 \times \frac{5}{10}$	33,000
Total Equivalent Equity Shares of ₹ 10 each		1,63,000

(3) Net Assets Available to Deemed Fully Paid-up Equity Shareholders:

= Net Assets as computed above + Notional Cash from partly paid-up shares

= ₹ 18,73,479 + (50,000 × 2 + 30,000 × 1)

= ₹ 18,73,479 + 1,00,000 + 30,000 = ₹ 20,03,479

(4) Computation of Ex-Dividend Value per Equity Share:

(i) Value of ₹ 10 fully paid Equity Share = $\frac{20,03,479}{1,63,000}$ = ₹ 12.29 per share (approx.)

(ii) Value of ₹ 8 paid-up Equity Share = 12.29 – 2 = ₹ 10.29 per share (approx.)

(iii) Value of ₹ 5 fully paid-up Equity Share = 12.29 × $\frac{5}{10}$ = ₹ 6.15 per share (approx.)

(iv) Value of ₹ 4 paid-up Equity Share = 6.15 – 1= ₹ 5.15 per share (approx.)

(5) Value of Net Assets:

Value of Net Assets (including proposed dividend on equity shares) = ₹ 18,73,479 + 1,50,000

= ₹ 20,23,479

Net assets (including dividend) available to deemed fully paid-up Equity Shareholders

= Net Assets as computed above + Notional cash from partly paid-up shares

= ₹ 20,23,479 + (50,000 × 2 + 30,000 × 1)

= ₹ 20,23,479 + 1,00,000 + 30,000 = ₹ 21,53,479.

(6) Computation of Cum-Dividend Value per Share:

(i) Value of ₹ 10 fully paid Equity Share = $\frac{21,53,479}{1,63,000}$ = ₹ 13.21 per share (approx.)

(ii) Value of ₹ 8 paid-up Equity Share = 13.21 – 2 = ₹ 11.21 per share (approx.)

(iii) Value of ₹ 5 fully paid-up Equity Share = $13.21 \times \frac{5}{10} =$ ₹ 6.605 per share (approx.)

(iv) Value of ₹ 4 paid-up Equity Share = 6.605 – 1 = ₹ 5.605 per share (approx.)

Working Notes:

1. **Computation of Average Capital Employed:**

		₹
Fixed Assets:		
Plant and Machinery (including ₹ 36,450 for a Machine charged in 2014)		8,36,450
Land and Building		10,00,000
Furniture & Fixtures (1,00,000 – 4,000)		96,000
Vehicles		2,00,000
		21,32,450
Add: Appreciation @ 5%		1,06,623
		22,39,073
Trade Investment $\left(3,00,000 \times \frac{20}{100} \times \frac{80}{100}\right)$		48,000
Current Assets:		
Stock		2,10,000
Debtors (1,95,000 – 5,000)		1,90,000
Prepaid Expenses		40,000
Advances		45,000
Cash and Bank Balance		2,00,000
		29,72,073
Less: Outside Liabilities:		
12% Debentures	2,00,000	
15% Term Loan	1,50,000	
Deposits 1,00,000		
Bank Loan	50,000	
Creditors	1,50,000	
Outstanding Expenses	20,000	
Provision for Tax	2,00,000	8,70,000
Capital employed at the end of the year, i.e., Net Assets		21,02,073

Less: ½ of the current year's Accounting Profit after Tax:		
Profit before Tax	3,80,950	
Less: Tax 40%* of ₹ 3,80,950	1,52,380	
	2,28,570	
50% of ₹ 2,28,570		1,14,285
Average capital employed		19,87,788

2. *Future Maintainable Profits*

Statement of Average Profit ₹

Particulars	*2014*	*2015*	*2016*
Profit after Tax	2,10,000	1,90,000	2,00,000
Profit before Tax $\left(\text{PAT} \times \frac{1}{0.50}\right)$	4,20,000	3,80,000	4,00,000
Add: Capital expenditure charged to revenue	50,000	—	—
Less: Depreciation of the Machinery	(5,000)	(4,500)	(4,050)
Dividend on Non-Trade Investments	(12,000)	(24,000)	(24,000)
Over-valuation of closing stock	—	(10,000)	—
Add: Overvaluation of opening stock	—	—	10,000
Add: Loss on sale of furniture	—	—	—
(presumed to be extraordinary items)	—	—	4,000
Less: Provision for Debtors	—	—	(5,000)
	4,53,000	3,41,500	3,80,950
Total Profit for the three years			11,75,450
Average Profit = $\frac{₹11,75,450}{3}$			3,91,817
Less: Depreciation @ 10% on increase in the value of machinery			
$8,36,450 \times \frac{5}{100} \times \frac{10}{100} = ₹\ 41,823 \times \frac{10}{100}$, *i.e.*,		4,182	
Expected increase in expenditure		20,000	
Annual R & D Expenses anticipated in future		30,000	54,182
Future Maintainable Profit before Tax			3,37,635
Less: Tax@40% of ₹ 3,37,635			1,35,054
Future Maintainable Profit after Tax			2,02,281

3. *Computation of Goodwill*

	₹
Future Maintainable Profit After Tax	2,02,581
Less: Normal Profit (10% of ₹ 19,87,788)	1,98,779
Super Profit	3,802
Value of Goodwill = Super Profit × No. of years' purchase	
= ₹ 3,802 × 3	11,406

*Future tax rate has been considered.

2. Yield Method : Dividend Yield and Earning Yield

The yield basis of valuation may take any of the following two forms:

(i) Valuation based on rate of return.

(ii) Valuation based on productivity factor.

This will be discussed in the succeeding sections.

(i) Valuation based on rate of return. The term "rate of return" refers to the return which a shareholder earns on his investment. It may further be classified as (a) rate of dividend and (b) rate of earning.

(a) *Valuation based on rate of dividend.* This method of valuation is particularly suitable for valuing small block of shares. The value of a share according to this method can be found out by applying the following formula:

Paid-up value of share × Possible rate of dividend ÷ Normal rate of dividend.

For example, if the paid-up value of a share is ₹ 80, the normal rate of return 10 per cent and the past results show that the company will pay a dividend of 12 per cent in future, the value of a share, according to this method will be arrived at as follows:

$$80 \times 12 \div 10 = ₹\ 96$$

(b) *Valuation based on rate of earning.* This method of valuation is particularly suitable for valuing a large block of the company's shares. A big investor is more interested in what the company earns and not simply in what the company distributes. This is because the rate of earning of the company explains the effective utilisation of the company's assets. In case the company does not distribute 100 per cent of its earning among its shareholders, it, as a matter of fact, strengthens the financial position of the company.

The value of a share according to this method can be calculated by the following formula:

Paid-up value × Possible earning rate ÷ Normal earning rate.

For example, if the paid-up value of a share is ₹ 80, normal earning rate 16 per cent and the company's past performance shows that it is expected to earn at 20 per cent in future, the value of a share, according to this method, will be calculated as follows:

$$80 \times 20 \div 16 = ₹\ 100$$

The valuation of shares on yield basis requires determination of normal rate of return (dividend or earnings as the case may be). Such normal rate is determined in the same way as in case of goodwill. However, following additional factors must also be kept in mind.

- *Restrictions on transfer of shares.* If the restrictions are more it will increase the normal rate while less restrictions will decrease the normal rate.

- *Disabilities attached to shares.* For example, shares may be partly paid-up or they may be subject to a right of lien by the company etc. More disabilities will increase the normal rate.
- *Dividend performance.* Stability in dividend will decrease the normal rate.
- *Net asset backing.* The poor net asset backing will increase the normal rate since the investors will consider themselves more unsafe.
- *Financial prudence.* Financial prudence on the part of the company's management also affects the normal rate of return. In case of companies whose management follow sound financial policies, an investor is prepared to accept a lower rate of return. Contrary is the case, in case of companies which do not follow such policies.

Valuation based on productivity factor: Productivity factor represents the earning power of the company in relation to the value of the assets employed for such earning. The factor is applied to the net worth of the company on the valuation date to arrive at the projected earnings of the company. The projected earnings after necessary adjustments (as discussed later) are multiplied by the appropriate capitalisation factor to arrive at the value of the company's business. The total value is divided by the number of equity shares to ascertain the value of each share.

The productivity factor based valuation is merely a method for ascertaining a reliable figure of future profits. The steps involved in such a method of valuation are as follows:

(a) Average net worth of the business is ascertained by taking those number of years whose results are relevant to the future. It will be appropriate to determine the average net worth of each year on the basis of net worth of the business at the commencement and at close of each of the accounting years under consideration. The average net worth of the business for the period under study would be calculated on the basis of the average net worth calculated as above for each of the accounting years.

(b) Net worth of the business on the valuation date is ascertained.

(c) Average profit earned for the period under consideration is ascertained on the basis of the profit earned by the business during the period by simple or weighted average method as may be considered appropriate.

(d) The productivity factor is found out as: $\dfrac{\text{Average profit}}{\text{Average net worth}} \times 100$

(e) The productivity factor calculated as above is applied to the net worth of the business on the valuation date to ascertain the projected income of the business in future.

(f) The projected income so calculated is adjusted further by making appropriations for replacement, tax, rehabilitation of plant and equipments, under-utilisation of productive capacity, effects of restrictions on monopoly and dividend on preference shares. Thus, the profits available for the equity shareholders are ascertained.

(g) The normal rate of return for the company is ascertained keeping in view nature and size of the undertaking.

(h) Appropriate capitalisation factor or multiplier based on normal rate of return is ascertained, as explained earlier.

(i) The capitalisation factor obtained as above is applied to adjusted projected profits available for the equity shareholders to ascertain the capitalised value of the undertaking.

(j) The capitalised value of the undertaking as ascertained above is divided by the number of equity shares to arrive at the value per share.

NOTES

Illustration 5.3: From the following information, calculate the value of shares of ₹ 10 —

(a) On dividend basis; and

(b) On return on capital employed basis.

Year	*Capital employed (₹)*	*(₹) Profit*	*Dividend*	*Weight*
2011	10,00,000	80,000	12%	1
2012	16,00,000	1,60,000	14%	2
2013	20,00,000	2,20,000	16%	3
2014	25,00,000	3,75,000	18%	4

The market expectation being 10%. Use weighted average for calculation.

(*CS Executive, June 2016*)

Solution:

(i) Calculation of Value of Shares

(a) On dividend basis:

Year	*Dividend Rate*	*Weight*	*Product*
2011	12	1	12
2012	14	2	28
2013	16	3	48
2014	18	4	72
Total	10		160

160/10 = 16

Value of shares = (16/10) ×10 = 16

(b) Return on capital employed basis:

Year	*(%) ROCE*	*Weight*	*Product*
2011	8	1	8
2012	10	2	20
2013	11	3	33
2014	15	4	60
Total		10	121

121/10 = 12.10

Value of shares = (12.1/10) × 10 = 12.10

Illustration 5.4: On 31st March, 2016, the balance sheet of Raghuvans Ltd. disclosed the following position:

Liabilities:	₹
Subscribed Share Capital in Shares of ₹ 10 each, fully paid	4,00,000
General reserve	1,90,000
Profit and Loss Account	1,20,000
14% Debentures	1,00,000
Current Liabilities	1,30,000
	9,40,000
Assets:	
Goodwill	40,000
Fixed Assets (tangible)	5,00,000
Current Assets	4,00,000
	9,40,000

On the above-mentioned date, the tangible fixed assets were independently valued at ₹ 3,50,000 and goodwill at ₹ 50,000. The net profits for the three years were — 2013-2014: ₹ 1,03,200; 2014-15: ₹ 1,04,000; and 2015-16: ₹ 1,03,300 of which 20% was placed to general reserve, this proportion being considered reasonable in the industry in which the company is engaged and where a fair return on investment may be taken at 18%.

Compute the value of the company's share by — (i) the net assets method; and (ii) the yield method. Ignore taxation. (*CS Inter, June 2003, adapted*)

Solution:

Computation of Value of an Equity Share

(i) *Net Assets Method:*	₹	
Goodwill as revalued		50,000
Tangible Fixed Assets (revalued)		3,50,000
Current Assets (as per balance sheet)		4,00,000
	8,00,000	
Less: 14% Debentures	1,00,000	
Current liabilities	1,30,000	2,30,000
Net Assets		5,70,000

Value per share = Net assets/No. of shares

= ₹ 5,70,000/40,000

= ₹ 14.25

(ii) Yield Method:

Average Profits for last 3 years		1,03,500
Less: Transfer to General Reserve @ 20%		20,700
	82,800	

$$\text{Expected return on equity} = \frac{\text{₹ } 82,000}{\text{₹ } 4,00,000} \times 100 = 20.7\%$$

Value per share = $\frac{20.7}{18} \times 10 = ₹ 11.50$

Illustration 4.5: Yogesh Ltd. showed the following performance over 5 years ended 31st March, 2017:

Ended 31st March	*Net Profit before Tax* (in ₹)*		*Prior period Adjustment (in ₹)*	*Remarks*
2013	4,00,000	(–)	1,00,000	Relating to 2011–12
2014	3,50,000	(–)	2,50,000	Relating equally to 2011–12 and 2012–13
2015	6,50,000	(+)	1,50,000	Relating to 2013–14
2016	5,50,000	(–)	1,75,000	Relating to 2013–14
2017	6,00,000	(–)	1,00,000	Relating to 2013–14
		(+)	25,000	Relating to 2015–16

*Net profit before tax is after debiting or crediting the figures of loss (–) or gains (+) mentioned under the columns for prior period adjustments.

The net worth of the business as per the balance sheet of 31st March, 2012 is ₹ 6,00,000 backed by 10,000 fully paid equity shares of ₹ 10 each. Reserve and surplus constitute the balance net worth. Yogesh Ltd. has not declared any dividend till date. You are asked to value equity shares on:

(a) Yield basis as on 31.3.2017, assuming:

(i) 40% rate of tax (ii) anticipated after tax yield of 20% (iii) differential weightage of 1 to 5 being given for the six years starting on 1.4.2012 for the actual profits of the respective years.

(b) Net asset basis as per corrected balance sheets for each of the six years ended 31.3.2017. Looking at the performance of the company over the 5-year period, would you invest in the company?

Solution:

(a) **Valuation of Shares on Yield Basis**

as on 31 March, 2017

Ended 31st March	*Profits as given*	*Adjustments*		*Revised profits*	*Tax provisions*	*After Tax Profit*	*Weights*	*Weighted Profit*
		Increase	*Decrease*					
2013	4,00,000	1,00,0000	1,25,000	3,75,000	1,50,000	2,25,000	1	2,25,000
2014	3,50,000	2,50,000 1,50,000	1,00,000 1,75,000	4,75,000	1,90,000	2,85,000	2	5,70,000
2015	6,50,000	Nil	1,50,000	5,00,000	2,00,000	3,00,000	3	9,00,000
2016	5,50,000	1,75,000 25,000	Nil	7,50,000	3,00,000	4,50,000	4	18,00,000
2017	6,00,000	1,00,000	25,000	6,75,000	2,70,000	4,05,000	5	20,25,000
							15	55,20,000

Weighted average profit (after tax) = $\frac{₹\ 55,20,000}{15} = ₹\ 3,68,000$

Value of business = $\frac{3,68,000}{20\%} = ₹\ 18,40,000$

$$\text{Value of an equity share} = \frac{\text{Value of business}}{\text{No. of equity shares}} = \frac{18{,}40{,}000}{10{,}000} = ₹\ 184$$

(b) Valuation of Shares on Net Asset Basis

(i) Revised net worth as on 31st March, 2012	₹	₹
Net worth as given		6,00,000
Less: Adjustments since made during		
2012–13	1,00,000	
2013–14	1,25,000	
	2,25,000	
Less: Relief from Tax @ 40%	90,000	1,35,000
		4,65,000
(ii) Net Asset value		
As on	(No. of Shares = 10,000)	
31st March	₹	₹
2012: Revised net worth (See (i) above)	4,65,000	
Value per share (4,65,000 ÷ 10,000)		46.50
2013: Revised net worth as on 31.3.2012	4,65,000	
Add: after tax revised profits of 2012–2013	2,25,000	
Net worth as on 31.3.2013	6,90,000	
Value per share (6,90,000 ÷ 10,000)		69.00
2014: Revised net worth as on 31.3.2013	6,90,000	
Add: After tax revised profits of 2013–14	2,85,000	
Net worth as on 31.3.2014	9,75,000	
Value per share (9,75,000 ÷ 10,000)		97.50
2015: Revised net worth as on 31.3.2014	9,75,000	
Add: after tax revised profits of 2014–15	3,00,000	
Net worth as on 31.3.2015	12,75,000	
Value per share (12,75,000 ÷ 10,000)		127.50
2016: Revised net worth as on 31.3.2015	12,75,000	
Add: after tax revised profit of 2015–16	4,50,000	
Net worth as on 31.3.1996	17,25,000	
Value per share (17,25,000 ÷ 10,000)		172.50
2017: Revised net worth as on 31.3.2016	17,25,000	
Add: after tax revised profits of 2016–17	4,05,000	
Net worth as on 31.3.2017	21,30,000	
Value per share (21,30,000 ÷ 10,000)		213.00

Statement of Performance Appraisal as on 31 of March, 2012

Revised net worth as on 31st March	₹	*Profit after Tax during the year ended 31st March*	₹	*Return on Net Worth %*
2012	4,65,000	2013	2,25,000	48.39
2013	6,90,000	2014	2,85,000	41.30
2014	9,75,000	2015	3,00,000	30.77
2015	12,75,000	2016	4,50,000	35.29
2016	17,25,000	2017	4,05,000	23.48

The company's return has come down from 48.39% as on 31st March 2012 to 23.48% as on 31st March, 2016. This may perhaps be due to the fact that the company has been ploughing back its profits without having adequate reinvestment opportunities. Hence, in the absence of profitable investment opportunities, it may not be advisable to invest in the company.

Note: Return on Net worth may also be calculated on the basis of average net worth during the relevant accounting year.

Illustration 5.6: *PIR* Ltd. and its subsidiary *MAS* Ltd. get their supply of some essential raw material from *DSS* Ltd. To coordinate their production on a more profitable basis *PIR* Ltd. and *MAS* Ltd.' agree between themselves each to acquire a quarter of shares in others Authorised Capital by means of exchange of shares. The terms are as follows:

(i) *PIR* Ltd. shares are quoted in the stock exchange at ₹ 10. The value to be taken for this purpose was either the quoted price or on the basis of balance sheet valuation, whichever is higher.

(ii) *DSS* Ltd. shares which are not quoted in stock exchange are to be considered on the yield basis or Balance Sheet basis, whichever is higher.

(iii) The future profits are estimated @ ₹ 2,10,000 subject to one third to be retained for the development purposes. The shares of the similar company yield 8%.

(iv) Freehold properties of *DSS* Ltd. are to be valued @ ₹ 8,60,000.

(v) No cash is to pass and the balance due on settlement is to be treated as loan between the two companies.

The summarised Balance Sheets of the companies at the relevant date stood as follows:

Particulars	*PIR Ltd.*	*MAS Ltd.*	*DSS Ltd.*
EQUITY & LIABILITIES			
Share Capital			
Authorised Equity Share Capital	24,00,000	10,00,000	20,00,000
Issued & Paid up Equity Share Capital @ 10 each	16,00,000	10,00,000	15,00,000
Reserves & Surplus			
Security Premium	1,60,000		
Profit & Loss	4,40,000	4,20,000	4,00,000
Non-current Liabilities			
7% Debentures	6,00,000		
Current Liabilities			
Current Liabilities	5,60,000	3,60,000	4,20,000
Proposed Dividend	2,00,000	1,00,000	
	35,60,000	18,80,000	23,20,000
ASSETS			
Non-current Assets			
Freehold properties	13,20,000	5,80,000	6,60,000
Plant & Machinery	9,00,000	8,20,000	8,80,000
Investments	9,20,000		

Particulars	*PIR Ltd.*	*MAS Ltd.*	*DSS Ltd.*
80,000 shares in MAS Ltd.			
Current Assets			
Current Assets	4,20,000	4,80,000	7,80,000
	35,60,000	18,80,000	23,20,000

You are required to compute the value of the shares according to the terms of the agreement and to present the final settlement showing all the necessary workings.

(*CA Final, November 2016*)

Solution:

Statement showing value of a share on Balance Sheet basis

	Particulars	*PIR Ltd.* ₹	*MAS Ltd.* ₹	*DSS Ltd.* ₹
A.	Total Assets, i.e., at Current Values:			
	Freehold properties	13,20,000	5,80,000	8,60,000
	Plant & Machinery	9,00,000	8,20,000	8,80,000
	Investment in MAS Ltd. (4/5 of its Net Assets, i.e., ` 14,20,000)	11,36,000	–	–
	Current Assets	4,20,000	4,80,000	7,80,000
		37,76,000	18,80,000	25,20,000
B.	Outside Liabilities:			
	7% Debentures	6,00,000		
	Current Liabilities	5,60,000	3,60,000	4,20,000
	Proposed Dividend	2,00,000	1,00,000	–
		13,60,000	4,60,000	4,20,000
C.	Net Assets [A - B]	24,16,000	14,20,000	21,00,000
D.	No. of Shares	1,60,000	1,00,000	1,50,000
E.	Balance sheet Value per Share	15.10	14.20	14.00

Valuation of DSS Ltd.'s shares on yield basis

(.Estimated annual future Profits (Assumed to be of *DSS* Ltd	2,10,000
Less: 1/3 retained for development purposes	(70,000)
Distributable Profits	1,40,000
[Earning Rate [(₹ 1,40,000 / ₹ 15,00,000) × 100	9,33%
Normal Rate of Yield	8%

Value per share on yield basis = $\left[\frac{\text{Earning Rate}}{\text{Normal Rate}} \times \text{Paid up Value}\right] = \frac{9.33\%}{8\%} \times 10$ = ₹11.67

Value taken as per agreement for exchange of shares between *PIR* Ltd. and *DSS* Ltd.:

PIR Ltd.: ₹ 15.10 per share, being the amount of Balance Sheet value, higher than the quoted value of ₹ 10.00 per share.

DSS Ltd.: ₹ 14.00 per share being the amount of Balance Sheet value, higher than the yield value of ₹ 11.67 per share.

Statement of Settlement

	₹
Shares issued by *PIR* Ltd. to *DSS* Ltd. - 60,000 shares @ ₹ 15.10 per share	9,06,000
Shares issued by *DSS* Ltd. to *PIR* Ltd. - 50,000 shares @ ₹ 14.00 per share	7,00,000
.Loan by *PIR* Ltd. to *DSS* Ltd	2,06,000

Note: In the absence of information, shares of *MAS* Ltd. have been valued on net asset basis for the purpose of valuation of investment of *PIR* Ltd. Alternatively, the investment of *PIR* Ltd. in the shares of MAS Ltd. may be valued on cost basis, *i.e.*, at ₹ 9,20,000. In such a situation, the Balance Sheet value of *PIR* Ltd. will be ₹ 13.75 per share. The exchange of shares for settlement and amount of loan will now be as follows:

Statement of Settlement

	₹
Shares issued by *PIR* Ltd. to *DSS* Ltd. - 60,000 shares @ ₹ 13.75 per share	8,25,000
Shares issued by *DSS* Ltd. to *PIR* Ltd. - 50,000 shares @ ₹ 14.00 per share	7,00,000
.Loan by *PIR* Ltd. to *DSS* Ltd	1,25,000

Check Your Progress

1. Mention some of the different terms used for the net assets backing method.
2. Why is the net assets backing method generally not recommended for going concerns?
3. How can the valuation based on rate of return be further classified?

5.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The Net Assets Backing method is also termed as Balance Sheet method or Asset backing method or intrinsic or break-up value method.
2. The net assets backing method is generally not recommended for going concerns since in their case yield is the predominant factor.
3. Valuation based on rate of return may be classified as (a) rate of dividend and (b) rate of earning.

5.5 SUMMARY

- The need for valuation of shares arises when considering assessments under estate duty, gift tax etc; when purchasing of a block of shares; formulation of schemes of amalgamation, absorption, etc; acquisition of interest of dissenting shareholders; conversion of preference shares; advancing loans on security of shares and compensating shareholders on acquisition of shares by the government.

- In case of shares quoted on a recognised stock exchange, stock exchange prices are generally taken as the basis for the valuation of those shares.
- But stock exchange price is basically determined on the interactions of demand and supply and business cycles. This is why they cannot form a fair and equitable or rational basis for compensation.
- The methods of valuation of shares may be broadly classified as follows: net assets backing method and yield method.
- The yield basis of valuation may take the forms of valuation based on rate of return and valuation based on productivity factor.

5.6 KEY WORDS

- **Net assets:** It refers to the value of a company's total assets including goodwill and non-trading assets) minus the liabilities.
- **Yield:** It is defined as the rate of return expressed as the percentage of initial investment.
- **Rate of return:** It refers to the rate at which a shareholder earns on his investment.

5.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the circumstances in which the need for valuation of shares arises?
2. How are shares quoted on the recognised stock exchange valued?
3. List the types of companies in which the net asset backing method can be used for valuation of shares.

Long Answer Questions

1. Describe the net assets backing method of valuation of shares.
2. Explain the forms of yield basis of valuation.

5.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Corporate Accounting, 6th ed.* New Delhi: Vikas Publishing House.

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Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

UNIT 6 LIQUIDATION OF COMPANIES

NOTES

Structure

6.0 Introduction
6.1 Objectives
6.2 Liquidation: Meaning
6.2.1 Modes and Consequences of Winding Up
6.3 Statement of Affairs and Defciency and Surplus Account
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

6.0 INTRODUCTION

A company is an artificial person. It is created by law, and, therefore, the law alone can dissolve it. On dissolution, the company's name shall be struck off by the Registrar from the register of companies and he shall also get the fact published in the official gazette. Thus, liquidation or winding up ultimately leads to dissolution of a company. In between winding up and dissolution, the legal entity of the company remains, and it can be sued in a court of law. In this unit, you will be introduced to the basics of the liquidation process.

6.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the meaning of liquidation
- Discuss the modes and consequences of winding up
- Describe the preparation of Statement of Affairs and Deficiency and Surplus Account

6.2 LIQUIDATION: MEANING

Liquidation or winding up of a company is a process by which dissolution of a company is brought about and its property administered for the benefit of its creditors and members. An administrator called liquidator is appointed and he takes over the control of the company, collects its assets, pays its debts and finally distributes the surplus among its members in accordance with their rights.

6.2.1 Modes and Consequences of Winding Up

Earlier, the Companies Act 2013 allowed two modes of winding up: voluntary and by the National Company Tribunal. There were in fact provisions from Section 304 to 323 which dealt with provisions of voluntary liquidation. But after the passing of the Insolvency and Bankruptcy Code, 2016, these provisions have now been omitted. So now, only liquidation by NCLT is allowed.

According to section 271 of the Companies Act 2013, a company may, on a petition filed by any of the parties referred below, may be wound up by the National Company Law Tribunal (popularly known as 'Tribunal' only) in each of the following cases

(a) If the company has, by special resolution, resolved that the company be wound up by the Tribunal;

(b) If the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;

(c) If on an application made by the Registrar or any other person authorized by the Central Government by notification under this Act, the Tribunal is of the opinion that

   (i) the affairs of the company have been conducted in a fraudulent manner or;

   (ii) the company was formed for fraudulent and unlawful purpose or

   (iii) the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up;

(d) If the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or

(e) If the Tribunal is of the opinion that it is just and equitable that the company should be wound up.

Petitioners

According to section 272 of the Companies Act 2013, a petition to the Tribunal for the winding up of the company can be presented by any of the following persons

(a) The company;

(b) Any contributory or contributories;

(c) All or any of the persons specified in clauses (a) and (b);

(d) The Registrar; except on grounds specified in clause (a) or (e) under Section 271 referred above and also with the previous sanction of the Central Government

(e) Any person authorized by the Central Government in that behalf; or

(f) In a case falling under clause (b) of section 271, referred above by the Central Government or State Government.

A petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a Statement of Affairs in such form and in such manner as may be prescribed. A copy of the petition made under this section shall also be field with the Registrar and the Registrar shall, without prejudice to any other provisions, submit his views to the Tribunal within sixty days of receipt of such petition.

Commencement of Winding up

The winding up of a company by the Tribunal under the companies Act, 2013 shall be deemed to commence at the time of presentation of petition for the winding up [Sec. 357]

Consequences of Winding up

The following are the consequences which generally follow a company's winding up decision:

(1) For the purposes of winding up of a company by the Tribunal, the Tribunal at the time of the passing of the order of winding up, shall appoint a Provisional Liquidator or Company Liquidator from the panel maintained for this purpose.

    The provisional liquidator or the Company Liquidator, as the case may be, shall be appointed by the Tribunal from amongst the insolvency professionals registered under the Insolvency and Bankruptcy Code, 2016 [Sec. 275]. The intimation of such appointment shall be sent by the Tribunal to the Registrar within a period of seven days [Sec. 277(1)].

(2) The winding up order shall be deemed to be a notice of discharge to all the officers, employees and workmen of the Company except when the business of the company is to be continued [Sec. 277 (3)]

(3) The order for the winding up of a company shall operate in favour of all the creditors and all contributories of the company as if it had been made out on the joint petition of creditors and contributories. [Section 278]

(4) When a winding up order has been passed or a provisional liquidator has been appointed, no suit or other legal proceeding shall be commenced, or if pending at the date of the winding up order, shall be proceeded with, by or against the company, except with the leave of the Tribunal and subject to such terms as the Tribunal may impose. [Section 279]

(5) The Company Liquidator shall be make an application to the Tribunal within three weeks of the winding up order for the contribution of a winding up committee to assist and monitor the progress of liquidation proceeding [Sec. 277 (4)].

(6) The power of the Board of Directors will terminate and will now vest with the liquidator.

(7) The winding up order shall operate as a notice of discharge to all members of the company. The members of the company will be termed as contributories on the commencement of company's winding up. The liquidator shall prepare a list of all such contributories who may be made liable to contribute towards the company on account of deficiency in the assets of the company. In case there is a surplus in the assets, the liquidator shall prepare a list of those members, who are entitled to share this surplus. The term contributory includes members of both the above categories.

(8) The liquidator will realize the assets of the company and distribute the proceeds among various claimants in the following order:

(a) Legal charges, (b) Liquidator's remuneration, (c) Cost of expenses of winding up, (d) Workmen's dues and claims of the secured creditors as mentioned in Section 326, (e) Preferential creditors, (f) Creditors secured by floating charge and (g) Unsecured creditors.

In case, some surplus is still left, it will be distributed among the contrarieties as follows:

(a) Preferential shareholders: These shareholders are entitled to the return of their capital in priority to any return of capital to the equity shareholders. In the absence of any provisions in the company's articles, any arrears of preference dividend will be paid only after returning their capital to the equity shareholders. It may also be noted that right to claim arrears is available only to the holders of cumulative preference shares. Preference shares are always taken as cumulative unless otherwise stated. In any case, any dividend declared but unpaid has to be paid in priority to even return of capital to the preference shareholders.

(b) Equity shareholders: Any amount left after paying to preference shareholders will be used for returning their capital to the equity shareholders. In case any surplus is still left, such surplus will also go to the equity shareholders. However, if the preference shares are participating, they will be entitled to share such surplus with the equity shareholders in the ratio as given in the company's articles.

(9) The company Liquidator shall prepare the draft final report for consideration and approval of the winding up committee. [Sec. 277 (7)]

(10) The final report to approved by the winding up committee shall be submitted by the Company Liquidator before the Tribunal for passing of a dissolution order in respect of the company.

NOTES

Check Your Progress

1. When does the winding of a company begin as per the Companies Act 2013?
2. To whom do the powers of the Board of Directors go to in case of winding up of a company?
3. State the order in which proceeds of realised assets distributed by the liquidator.

6.3 STATEMENT OF AFFAIRS AND DEFCIENCY AND SURPLUS ACCOUNT

A Statement of Affairs has to be filed by the following persons filing a petition for the company's winding up:

1. *By the Company on its own winding up petition:* A petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a Statement of Affairs in such form and in such manner as may be prescribed. [Sec. 272(4)]

   A company, which fails to file the Statement of Affairs as referred above, shall forfeit the right to oppose the petition. Such director(s) and officer(s) of the company, as found responsible for such non-compliance, shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both. [Sec. 274(2 & 3)]

2. *By the Company on others' winding up petition:* Where a petition for winding up is filed before the Tribunal by any person other than the company, the Tribunal shall, if satisfied that a *prima facie case* for winding up of the company is made out, by an order direct the company to file its objections along with its Statement of Affairs within thirty days of the order in such form and in such form and in such manner as may be prescribed:

   Provided that the Tribunal may allow a further period of thirty days in a situation of contingency or special circumstances:

Provided further that the Tribunal may direct the petitioner to deposit such security for costs as it may consider reasonable as a precondition to issue directions to the company.

The Statement should be submitted to the Tribunal and should contain the following particulars:

(i) The assets of the company, stating separately the cash balance in hand, at the bank and negotiable instruments, if any, held by the company;

(ii) Company's debts and liabilities;

(iii) The names, residences and occupations of its creditors, stating separately the amount of secured and unsecured debts, and in case of secured debts, particulars of securities given, whether by the company or an officer thereof, their value and the dates on which they were given;

(iv) The debts to the company and the names, residences, and occupations of persons from whom they are due and the amount likely to be realised on account thereof;

(v) Such further or other information as may be prescribed or as the official liquidator may require.

The statement is required to be made in the prescribed form and duly verified by an affidavit and signed by a Director and the Manager, Secretary, or other chief officer of the company, as given below:

Statement of Affairs

Statement of affairs of the above-named company as on the...day of ......20....., the date of the winding up order (or the order appointing Provisional Liquidator or the date directed by the Company Liquidator).

I/We .... of .... do solemnly affirm and say that the statement made overleaf and the several lists hereunto annexed marked '*A*' to '*I*' are to the best of my/our knowledge and belief, a full, true and complete statement as to the affairs of the above named company, on the ....day of ....20....., the date of the winding up order (or the order appointing Provisional Liquidator or the date directed by the Company Liquidator), and that the said company carries/carried on the following business:

(*Here set out nature of company's business*)

Signature(s)

Solemnly affirmed..........this......day of ....20....., before me.

Commissioner for Oaths

The Commissioner is particularly requested, before swearing the affidavit, to ascertain that the full name, address and description of the dependents are stated, and to initial any crossing-out or other alterations in the printed form. A deficiency in the affidavit in any of the above respects will entail its refusal by the Tribunal, and will necessitate its being re-sworn

Note: The several lists annexed are not exhibits to the affidavit.

Statement of Affairs and Lists to be Annexed

Statement as to the affairs of..........Ltd., on the ......day of ....20..... being date of the winding up order (or order appointing Provisional Liquidator or the date directed by the Company 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 realisable (₹) value*
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, Utensils, etc				...
Investments other than marketable securities				
Livestock	...	...	...	...
.Other Property, etc		...	...	...
....	...	...	...	...
....	...	...	...	...

Assets* specifically pledged (as per (‘list ‘*B*	(*a*) Estimated realisable values ₹	(*b*) Due to secured creditors ₹	(*c*) Deficiency ranking as **unsecured ₹	(*d*) Surplus carried to last column ₹	
:Freehold Property					
....					
....					
	...	...	...	...	
Estimated surplus from assets specifically pledged					...
,Estimated total assets available for preferential creditors					...
debentureholders secured by a floating charge, and unsecured					...
creditors** (carried for(ward					
Summary of Gross Assets ((*d*					
Gross realisable value of assets					
specifically pledged	...	...	...	..........₹	
Other Assets	...	...	...	..........₹	
Gross Assets				..........₹	
Estimated total assets available for preferential creditors debentureholders secured by a (floating charge,and unsecured creditors (brought forward					...

NOTES

(e) *Gross* *liabilities*	*Liabilities* *(to be deducted from surplus or added to deficiency as the 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) on 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 regards debentureholders		...
	Unsecured creditors (as per list 'E'):		...
	Estimated unsecured balance of claims of creditors partly secured on specific assets, brought from preceding pages (c)		
	Trade Account	...	
	Bills payable	...	
	Outstanding expenses	...	
	....	...	
	Contingent liabilities (state nature)	...	...
	....		...
...	Estimated surplus/deficiency as regards creditors [being difference between gross assets brought from preceding page (d) and Gross liabilities as per column (e)]		...
	Issued and called-up capital:		
	........Preference share of.........each		
	₹ ....called-up (as per list 'F')	.....	
	........Equity shares of ....each		
	₹ ....called-up (as per list 'G')	.....	...
	Estimated surplus/deficiency as regards Members (as per list 'H')***		...

***The figures must be read subject to the following notes:

(1) (f) There is no unpaid capital liable to be called up, or

(g) the nominal amount of unpaid capital liable to be called up is ₹ ....estimated to produce ₹......which is/is not charged in favour of Debentureholders (Strike out (*f*)/(*g*)].

(2) The estimates are subject to cost 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. This consists of all "free" assets, i.e., assets not specifically pledged in favour of any creditor. Assets against which there is a floating charge will also be included in this list. Calls in arrears will also come in this category to the extent they are realisable. However, uncalled capital should not be included in this list.

NOTES

List B. This consists of assets pledged specifically in favour of certain creditors. Any excess of the realisable value of the assets over the amount due should be shown separately as given in the prescribed form of the statement of affairs. In case of deficiency, the amount of such deficiency has to be included in list E, i.e., unsecured creditors. For example, building worth ` 20,000 has been mortgaged in favour of bank for a loan of ` 30,000, the bank is unsecured to the extent of ` 10,000 and, therefore, this amount will be included in list E of unsecured creditors.

List C. This consists of preferential creditors, i.e., creditors, who are unsecured but are entitled to priority in payment over creditors having a floating charge and other unsecured creditors.

List D. This consists of those creditors who have floating charge over the assets of the company. Usually in this list, debentureholders are included since they are generally presumed to have a floating charge over the assets of the company in the absence of any specific instruction in the question.

List E. This consists of unsecured creditors, i.e., creditors who do not have any sort of charge whatsoever against the assets of the company. Trade creditors, bills payable, liability for bills discounted (to the extent of possible loss on account of dishonour of the bills), creditors on open account etc., come in this category.

List F. This consists of holders of the preference share capital of the company. They are to be taken at a value which is left after unrealisable calls in arrears.

List G. This consists of holders of the equity share capital of the company. The amount due to them is to be arrived after deducting from the called up share capital, any unrealisable amount of calls in arrears.

List H. This explain the reasons for the surplus or the deficiency as shown by the statement of affairs. Earlier this list used to be in the form of ledger account. Of course, it is still termed as a 'Deficiency or Surplus Account' but it is shown in the form of a statement. The period covered by this account must commence on a date not less than three years before the date of winding up order (or the order appointing Provisional Liquidator, or the date directed by the company 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.

The Deficiency or Surplus Account prescribed form is given below:

List *H*—Deficiency or Surplus Account

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 (given particulars or annex schedule).	...
5. Estimated losses now written off for which provision has been made for the purposes of preparing the statement (given particulars or annex 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 profit (after charging items shown in note below) for the period from the.........20.....to the date of statement.	...
9. Profits and income other than trading profits during the same period (give particulars or annex schedule).	...
10. Other items reducing deficiency or contributing to surplus:	
deficiency/surplus (as shown by the statement of affairs)	...

*Only one item will appear.

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 profit or loss.

Net trading profit or loss as shown in Deficiency or Surplus A/c above........ .

Signature: Dated...............20...

The following points should be kept in mind while preparing a statement of affairs and a deficiency or surplus account.

(i) Any likely expenditure on liquidation should be ignored. A note may simply be given stating that "Deficiency or Surplus as shown by this statement of affairs is subject to the cost of liquidation."

(ii) Personal guarantee given by any party including the guarantees given by the directors for loans raised by the company, should be ignored while preparing the statement of affairs.

(iii) Any unrecorded asset or liability should be shown both in the statement of affairs and the deficiency or surplus account to give dual effect. For example, if out of bills discounted for ₹ 20,000, bills of ₹ 6,000 are likely to be dishonoured, this amount of ₹ 6,000 should be included in the statement of affairs in the list of unsecured creditors and in the deficiency or surplus account as an item increasing deficiency or reducing surplus.

(iv) If at any stage, in the statement of affairs, the deduction to be made is more than the amount available, deficiency will appear, otherwise there will be a surplus. In case of deficiency at any stage, items after this stage will be added to find out the total deficiency.

(v) In case the company in liquidation has stopped maintaining proper books of account after a certain date (as given in the question) a trial balance should be prepared with the available information. The items should be taken at their book values. Any difference in the trial balance is the profit or loss made by the company during the period the company did not maintain proper books of account.

Illustration 6.1: A winding up order has been issued against *M* Ltd.

The following information is obtained with regard to the assets and liabilities as on 30 June, 2016:

		₹
Freehold Premises (book value ₹ 4,50,000) valued at ...		3,75,000
First Mortgage of Freehold Premises ...		3,00,000
Second Mortgage of Freehold Premises ...		1,12,500
8% debentures carrying a floating charge on the undertaking, interest due 1st September, and 1st April, and paid on due dates ...		1,50,000
Managing Director's salary unpaid (6 months) ...		22,500
Staff Salary Unpaid (one month) ...		16,050
Trade debtors-Good ...		31,500
Doubtful (estimated to realise 50 per cent) ...		12,900
Bad ...		72,750
Plant and Machinery (book value ₹ 2,47,500) estimated to realise ...		1,74,000
Bank overdraft-unsecured ...		58,125
Cash in Hand ...		825
Stock (at cost ₹ 50,850) estimated to realise ...		33,900
Issued Capital:		
Equity shares of ₹ 10 each fully called-up ...		1,50,000
Calls in arrears, ₹ 3,000 estimated to realise ...		1,500
Unsecured creditors ...	2,96,250	
Contingent liability in respect of a claim for damages ₹ 37,500—estimated to be settled for ...		18,000
Income-tax liability		
For 30 June, 2014 ...		5,250
For 30 June, 2015 ...		1,275
For 30 June, 2016 ...		2,700

The Reserves of the company on 1 Sept., 2015 amounted to ₹ 7,500.

You are required to prepare:

(i) Statement of Affairs, and (ii) Deficiency Account.

Solution:

***M* Ltd.**

(i) **Statement of Affairs**

(in ₹)

Particulars					*Estimated Realisable Values*
Assets not specifically pledged, as per List :*A*					
Cash in Hand					825
Trade Debtors					37,950
Unpaid Calls					1,500
Stock					33,900
Plant and Machinery					1,74,000
Assets specifically pledged as :per List *B*					
	Estimated realisable value	*Due to secured creditors*	*Deficiency ranking as unsecured*	*Surplus*	
Freehold Premises	3,75,000	3,00,000	–	–	
Second Mortgage on above		1,12,500	37,500		
Estimated total assets available for Preferential creditors, Debentureholders (secured by a floating charge and other creditors (carried forward					2,48,175
Summary of Gross Assets		₹			
Assets Specifically Pledged		3,75,000			
Other Assets		2,48,175			
		6,23,175			
Estimated total assets available for preferential creditors, debentureholders secured by a floating charge and unsecured creditors brought forward					2,48,175

Gross Liabilities ₹	*Liabilities to be deducted from surplus or added to deficiency as the) (case may be*		
3,75,000	Secured creditors as per List *B* to the extent claims are covered by assets specifically pledged		....
35,025	Preferential creditors as per list *C*		35,025
	Estimated balance of assets available for debentureholders having a floating charge and unsecured *creditors		2,13,150
1,53,000	Debentureholders secured by floating charge as per list *D*		1,53,000
	Estimated surplus as regards debentureholders		60,150
	:Unsecured creditors as per List *E*		
37,500	Estimated unsecured balance of claims of partly secured creditors	37,500	

Gross Liabilities ₹	*Liabilities to be deducted from surplus or added to deficiency as the) (case may be*		
2,96,250	Trade Creditors	2,96,250	
12,750	Outstanding Expenses and Taxes (5,250 + (7,500	12,750	
58,125	Bank Overdraft	58,125	
18,000	Contingent liability for claim for damages	18,000	4,22,625
9,85,650			
	Estimated deficiency as regards creditors, being the excess of gross liabilities over gross assets		3,62,475
	:Issued and called-up capital		
	:Preference share capital as per List *F*		
	equity shares of ₹ 10 each fully 15,000 called-up less calls in arrear, ₹ 1,500 as per List *G*		1,48,500
	*Estimated deficiency as regards contributories as per list *H*		5,10,975

*The figures must be read subject to the following.

1. There is no unpaid capital liable to be called-up.
2. The estimates are subject to cost of the winding up and to any surplus or deficiency on trading, pending realisation of assets.

(ii) **List *H*—Deficiency Account**

A.	Items Contributing to Deficiency		₹
.1	Excess of capital and liabilities over assets on 1 September, 2015		–
.2	Dividends and bonuses declared		–
.3	Net trading losses after charging depreciation taxation, interest on .debentures etc		2,55,825
.4	Losses other than trading losses		
.5	Estimated losses now written off		
	Freehold Premises	75,000	
	Trade Debtors	79,200	
	Plant and Machinery	73,500	
	Stock	16,950	
	Claim for Damages	18,000	2,62,650
.6	Any other item		–
			5,18,475
B.	Items Reducing Deficiency		
.7	Excess of assets over capital and liabilities as on 1 September, 2015		7,500
.8	Net Trading Profit	–	
.9	Profit and incomes other than trading profit		–
.10	Other Items		–
	Deficiency as explained in the Statement of Affairs		5,10,975

Working Notes:

(i) Balance Sheet

as at 30 June, 2016

Liabilities	₹	*Assets*	₹
(Capital (net	1,47,000	Freehold Premises	4,50,000
Reserve	7,500	Plant and Machinery	2,47,500
1st Mortgage	3,00,000	Sundry Debtors	1,17,150
2nd Mortgage	1,12,500	Stock	50,850
per cent Debentures 8	1,50,000	Cash	825
Interest for 3 months	3,000	Profit and Loss A/c (Balancing (figure	2,55,825
Sundry Creditors (including managerial remuneration (and salaries	3,34,800		
Bank Overdraft	58,125		
Provision for Taxation	9,225		
	11,22,150		11,22,150

(ii) Preferential Creditors:

		₹
Income Tax:	2014–2015	1,275
	2015–2016	2,700
Staff Salary		16,050
Managing Director's Salary for 4 months		15,000
		35,025

(iii) Managing Directors emolument's have been categorised as preferential creditors since he is also an employee and not the owner of the company as was held in the case of ESILV Apex Engineering Ltd (1997) LLR 1097.

Illustration 6.2: From the following particulars, prepare a Statement of Affairs and the Deficiency Account for submission to Company Liquidator of Sun City Development Ltd., which went into liquidation on 31st March 2016:

Liabilities	₹	₹
Equity shares of ₹ 10 each, ₹ 8 paid-up 6,00,000		48,00,000
Preference shares of ₹ 10 each 2,00,000 6%	20,00,000	
Less: Calls in arrear	1,00,000	19,00,000
Debentures having a floating charge on the assets 5% ((interest paid up to 30th September, 2015		20,00,000
Mortgage on Land & Building		16,00,000
Trade Payable		53,10,000
Wage Payable		4,00,000
.Secretary's Salary Payable @ ₹ 10,000 p.m		60,000
.Managing Director's Salary Payable @ ₹ 30,000 p.m		1,20,000

Assets	*Estimated to produce (₹)*	*Book value (₹)*
Land & Building	26,00,000	24,00,000
Plant & Machinery	26,00,000	40,00,000
Tools & Equipments	80,000	4,00,000
Patents & Copyrights	6,00,000	10,00,000
Inventory	14,80,000	17,40,000
Investments in the hand of a Bank for an Overdraft of 38,00,000 ₹	34,00,000	36,00,000
Trade Receivables	12,00,000	18,00,000

On 31st March, 2011 the Balance Sheet of the Company showed a General Reserve of ₹ 8,00,000 accompanied by a debit balance of ₹ 5,00,000 in the Profit & Loss Account.

In 2012, the Company made a profit of ₹ 8,00,000 and declared a dividend of 10% on Equity Shares.

The Company suffered a total loss of ₹ 21,80,000 besides loss of stock due to fire to the tune of ₹ 8,00,000 during financial years ending March 2013, 2014 and 2015. For the financial year ended 31st March, 2016, accounts were not made.

The cost of winding-up is expected to be ₹ 3,00,000.

(*IPC Intermediate, May 2016*)

Solution:

Sun City Development Ltd. (in winding up)
Statement of Affairs on 31st March, 2016, the date of winding up

Assets					₹
Assets not specifically pledged (as per list A)					
Trade receivables					12,00,000
Inventory					14,80,000
Plant and Machinery					26,00,000
Tools and Equipment					80,000
Patents and copyrights					6,00,000
Unpaid calls					1,00,000
					60,60,000
Assets specifically pledged (as per list B)					
	Estimated Realisable Value	*Due to Secured Creditors*	*Deficiency Ranking as Unsecured*	*Surplus carried to the last column*	
	₹	₹	₹	₹	₹
Investments	34,00,000	38,00,000	4,00,000		
Land & Building	26,00,000	16,00,000		10,00,000	
	60,00,000	54,00,000			
	Estimated surplus from assets specifically pledged				10,00,000
	Estimated total assets available for preferential creditors, debenture-holders and unsecured creditors				70,60,000
	Summary of Gross Assets:				
	Gross realisable value of - assets specifically charged		60,00,000		

others assets		60,60,000	
		1,20,60,000	
Estimated total assets available for preferential creditors, debenture-holders, bank overdraft and unsecured creditors brought forward			70,60,000

Gross Liabilities ₹	*Liabilities*	₹	₹
50,00,000 (34,00,000 +16,00,000)	Secured creditors (as per List B) to the extent to which claims are estimated to be covered by assets specifically pledged		
4,20,000*	Preferential creditors as per list C		4,20,000*
	Estimated balance of assets available for Debenture-holders, Bank & unsecured creditors		66,40,000
20,50,000 (20,00,000 + 50,000)	Debentureholders secured by a floating charge as per list D		(20,50,000)
	Surplus as regards debentureholders		45,90,000
	Unsecured creditors as per list E		
	Estimated unsecured balance of claim of creditors partly secured on		
	Specific assets	4,00,000	
	Trade payable	53,10,000	
58,70,000	Outstanding expenses (40,000 + 1,20,000)	1,60,000	58,70,000
	Estimated deficiency as regards creditors being the difference between gross liabilities and gross assets		12,80,000
1,33,40,000			
	Issued & Called up Capital:		
	6,00,000 Equity shares or ₹ 10 each, ₹ 8 paid	48,00,000	
	6% 2,00,000 Preference shares of ₹ 10 each fully called	20,00,000	68,00,000
	Estimated Deficiency as regards members as per list H		80,80,000

***Note**

(i) The Secretary of a Company, being an officer, is to be included within the definition of 'employee' for the purpose of computing preferential creditors. The preferential creditor for secretary's salary has been restricted to 4 months salary but maximum pay shall not exceed ₹ 20,000 per claimant as per the requirement of the law.

(ii) The above is subject to cost of winding up estimated as ₹ 3,00,000 and to any surplus / deficiency on realisation of assets.

(iii) There are 6,00,000 shares unpaid @ ₹ 2 per share liable to be called up.

Deficiency Account (List H)

A. Item contributing to Deficiency	₹
1. Excess of capital and liabilities over assets on 1-4-2011	NIL
2. Net dividend and bonuses during the period (4,80,000 + 1,14,000)	5,94,000
3. Net trading losses after charging depreciation, taxation, interest on debentures, etc. during the same period (₹ 21,80,000 + ₹ 26,26,000)	48,06,000
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (stock loss).	8,00,000

NOTES

5. Estimated losses now written off or for which provision has been made for the purpose of preparing the statement:

		₹
Plant and Machinery		14,00,000
Tools and Equipments		3,20,000
Patents and Copyrights		4,00,000
Inventories		2,60,000
Investments		2,00,000
Debtors	6,00,000	31,80,000
6. Other items contributing to deficiency		NIL
		93,80,000

B. Items reducing Deficiency

7. Excess of assets over capital and liabilities on 1st April, 2011 (8,00,000 – 5,00,000)	3,00,000
8. Net trading profit during the period	8,00,000
9. Profit & Incomes other than trading profit during the same period	–
10. Other items - Profit expected on Land & Building (26,00,000 – 24,00,000)	2,00,000
	13,00,000
Deficiency as shown by the Statement of Affairs (A) – (B)	80,80,000

Working Notes:

(1) Trial Balance
for the year ended 31st March, 2016

	.Dr ₹	.Cr ₹
Land and Building	24,00,000	
Plant and Machinery	40,00,000	
Tools and Equipments	4,00,000	
Patents and Copyrights	10,00,000	
Inventories	17,40,000	
Investment	36,00,000	
Trade Receivables	18,00,000	
Equity Capital		48,00,000
Preference share capital 6%		19,00,000
Debentures 5%		20,00,000
Interest Outstanding		50,000
Mortgage on Land & Building		16,00,000
Trade Creditors		53,10,000
Owing for Wages		4,00,000
Secretary's Salary		60,000
Managing Director's Salary		1,20,000
Bank Overdraft		38,00,000
Profit & Loss Account on 1.4.2015	24,74,000	
	1,74,14,000	2,00,40,000
(Loss for the year (balancing figure	26,26,000	-
	2,00,40,000	2,00,40,000

(2) **Reserve & Surplus Account**

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.4.2011	To Profit & Loss A/c (Transfer)	5,00,000	1.4.2011	By Balance b/d	8,00,000
31.3.2012	:To Dividend Equity Preference	4,80,000 1,14,000	31.3.2012	By Profit for year	8,00,000
1.04.2012 to	To Profit & Loss A/c (Loss)	21,80,000	31.3.2015	By Balance c/d	24,74,000
31.03.2015	To Loss of Stock	8,00,000			
		40,74,000			40,74,000

Check Your Progress

4. What does List B in the Statement of Affairs comprise of?
5. How is personal guarantee given by any party treated while preparing the Statement of Affairs?

6.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The winding of a company as per the Companies Act 2013 shall be deemed to commence at the time of presentation of petition for the winding up (Sec. 357).
2. The power of the Board of Directors will terminate and will now vest with the liquidator in case of winding up of a company.
3. The liquidator will realize the assets of the company and distribute the proceeds among various claimants in the following order: legal charges, liquidator's remuneration, cost of expenses of winding up, workmen's dues and claims of the secured creditors as mentioned in Section 326, preferential creditors, creditors secured by floating charge and unsecured creditors.
4. List B consists of assets pledged specifically in favour of certain creditors. Any excess of the realisable value of the assets over the amount should be shown separately. In case of deficiency, it is to be included in List E.
5. Personal guarantee given by any party including the guarantees given by the directors for loans raised by the company, should be ignored while preparing the statement of affairs.

6.5 SUMMARY

NOTES

- Liquidation or winding up of a company is a process by which dissolution of a company is brought about and its property administered for the benefit of its creditors and members.
- An administrator called liquidator is appointed and he takes over the control of the company, collects its assets, pays its debts and finally distributes the surplus among its members in accordance with their rights.
- A company may be wound up on a petition submitted owing to cases like special resolution, company's acts against interest of the nation, on application bye Registrar or any other person authorised by Central Government as per the Act; if the company has made a default, if the Tribunal thinks that it is just and equitable to wound up the company.
- Section 272 of the Companies Act provides the list of persons who can raise a petition for winding up of a company.
- The consequences of winding up include: appointment of a company liquidator, notice of discharge to all officers, employees and workmen of the company; termination of power of Board of Directors, stopping of all other legal proceedings, the realization of assets and distribution of proceeds among the various claimants, preparation of the draft final report for consideration of winding up committee and the approval and submission of the final auditor's report to the Tribunal for dissolution order.
- A Statement of Affairs has to be filed by specified persons containing certain specific particulars.
- List H of the Statement of Affairs explains the reasons for the surplus or the deficiency as shown by the statement. Earlier, this list used to be in the form of a ledger account. But it is still termed as Deficiency or Surplus Account, and shown in the form of a statement.

6.6 KEY WORDS

- **Liquidation:** It refers to the process by which dissolution of a company is brought about and its property administered for the benefit of its creditors and members.
- **Statement of affairs:** It is a legal document prepared by companies while winding up listing the assets and liabilities.
- **Deficiency or Surplus Account:** It is a statement mentioned under List H which shows the reasons for surplus or deficiency as shown by the Statement of Affairs.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What are the modes or cases in which on petition filed can a company be wound up by the National Company Law Tribunal?
2. Who are the persons who can file petition for winding up of the company?
3. What is the condition under which the petition presented by a company for winding up admitted?
4. Write a short note on Deficiency or Surplus Account.
5. List the points to be kept in mind while preparing the Statement of Affairs and Deficiency or Surplus Account.

Long Answer Questions

1. Discuss the consequences which generally follow a company's winding up decision.
2. Explain the persons who are required to file a Statement of Affairs and the particulars to be included therein.

6.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e*. New Delhi: Vikas Publishing House.

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *An Introduction to Accountancy, 12/e*. New Delhi: Vikas Publishing House.

Goyal, V. K. and R Goyal. 2012. *Corporate Accounting*. India: PHI Learning.

Radhika, P and Anita Raman. 2018. *Corporate Accounting*. New Delhi: McGraw-Hill Education.

UNIT 7 COMPANY FINAL ACCOUNTS

NOTES

Structure

7.0 Introduction
7.1 Objectives
7.2 Schedule VI: Part I and Part II
  7.2.1 Managerial Remuneration
7.3 Acquisition of Business: Preparation of Profit and Loss Account and Balance Sheet
  7.3.1 Profits Prior To Incorporation
7.4 Answers to Check Your Progress Questions
7.5 Summary
7.6 Key Words
7.7 Self Assessment Questions and Exercises
7.8 Further Readings

7.0 INTRODUCTION

Every company is required to prepare its financial statements at the end of the accounting year. Financial Statements are also termed as Final Accounts. Financial statements for businesses usually include income statements, balance sheets, statements of retained earnings and cash flows. It is standard practice for businesses to present financial statements that adhere to generally accepted accounting principles (GAAP) to maintain continuity of information and presentation across international borders. Financial statements are often audited by government agencies, accountants, firms, etc. to ensure accuracy and for tax, financing or investing purposes. You have already learnt about the preparation of final accounts as per the Companies Act 2013 in Unit 3. You should note that with the introduction of the Companies Act 2013, the Schedule VI of the Companies Act 1956 has now been replaced by Schedule III of the Companies Act 2013. In this unit, you will learn about some of the differences that have been brought due to the 2013 Act in the schedules along with treatment of special items. Further in the unit, you will learn about the preparation of final accounts in case of acquisition of business and lastly you will learn about the adjustments related to the profits prior to incorporation.

7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the aspects of Schedule VI of the Companies Act 1956 which have been changed with the new Schedule III under Companies Act 2013

- Describe the concept of acquisition of business and preparation of financial statements
- Explain the concepts of calculating profits prior to incorporation

7.2 SCHEDULE VI: PART I AND PART II

As mentioned earlier in Unit 3, Revised Schedule VI has been replaced by Schedule III to the Companies Act 2013 w.e.f. financial year commencing on or after April 1, 2014. Some of the special points to be kept in mind while preparing Financial Statements as per Schedule III are as under:

1. Nomenclature of Parts I and II Changed

The nomenclature of the Parts I and II of Revised Schedule VI was "Form of Balance Sheet" and "Format of Statement of Profit and Loss", where as it is "Balance sheet" and "Statement of Profit and Loss" under Part I and II of Schedule III. This change is made in order to state that Schedule III is not limited to only Form of Financial Statements.

2. Separate disclosure in notes regarding amount of expenditure incurred on Corporate Social Responsibility

Section 135 of the Companies Act, 2013 mandates certain companies to incur expenditure on Corporate Social Responsibility, which was not required under the Companies Act, 1956. Consequently in case of such companies the amount of expenditure incurred on corporate social responsibility activities need to be separately disclosed by way of notes.

3. Horizontal format of Balance Sheet deleted

Horizontal format of Balance Sheet known as conventional or customary form (T-shaped) of Balance Sheet was deleted in Revised Schedule VI which is now Schedule III.

Part III of Old Schedule VI, on Interpretation which contained definition of terms like Provision, Reserve etc. has been omitted since these terms are already defined in the Accounting Standards.

4. Proposed Dividend

Appropriation amount towards the proposed dividend along with tax on same would be shown as appropriation under sub-head "Surplus" under head "Reserves and Surplus" in the notes to accounts. Provisions towards these items would be shown under head 'Short Term Provisions' under Current Liabilities.

5. Miscellaneous Expenditure

Preliminary Expenses, Incorporation Expenses are not to be carried forward but should be written off against profits under the sub-head Surplus under head Reserves & Surplus. Debit balance of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus' after adjusting negative balance of surplus, if any shall be shown under the head 'Reserves and Surplus' even if the figure is in the negative.

6. Balance Sheet Abstract and Company's General Business Profile no longer required to be given

Balance Sheet Abstract and Company's General Business Profile as provided in Part-IV of Old Schedule VI was removed in Revised Schedule VI and same also does not form part of Schedule III as well.

7. Ancillary Finance Cost

These costs are other than normal interest costs. They include costs such as discount on issue of debentures, premium payable on redemption debentures underwriting costs etc. These costs being fictitious assets should be written off out of profit at the earliest. Alternatively, a company may decide to amortize these costs over the period over which the benefit of the borrowing would be available. Keeping this in view the unamortized portion of such expenses, can be disclosed as "Unamortized Expenses" under the head other current /non-current assets depending on whether the amount will be amortized in the next 12 months or thereafter.

8. Cash & Cash Equivalents

The term has replaced the old term "Cash and Bank Balances". It may be noted here that Bank deposits with more than 12 months maturity cannot be shown as Cash and Cash Equivalents. Any deposit maturing after 12 months would be regarded as a non-current asset.

9. Profit (Loss) Balance from Last Year

This is to be shown in the notes to accounts under the Sub-head Surplus under the heading Reserves & Surplus in Notes to Accounts.

10. Disclosure of Revenue other-than a Finance Company

In respect of a company other than a finance company revenue from operations shall be disclosed separately in notes revenue from (a) Sale of Products (b) Sale of Services (c) Other Operating Revenues (d) *Less* Excise Duty.

11. Disclosure of Revenue-Finance Company

In case of finance company, revenue from operations shall include revenue from (a) Interest and (b) Other financial services. It has further been stated both in the Revised Schedule VI as well as Schedule III that revenue from each of the above heads shall be disclosed separately by way of Notes to Accounts, to the extent applicable.

12. Limit for non-inclusion in Miscellaneous Expenditure

Additional information regarding aggregate income or expenditure exceeding 1% of the revenue from operations or ₹ 1,00,000/-, whichever is higher, needs to be disclosed by way of notes under Revised Schedule VI which is now Schedule III.

13. Separate Disclosures

Schedule III requires separate disclosures regarding each of the following in the Statement of Profit & Loss

(i) Gain/Loss on foreign currency transactions and translations to be separated into finance costs (to the extent of adjustment to interest cost) and other expenses.

(ii) Profit before tax, tax expense and profit after tax from discontinuing operations.

(iii) Exceptional and Extraordinary items have not been defined in Schedule III. However, a reference to such items has been made in AS: 5. According to AS 5: Net Profit or Loss for the period, Prior Period Items & Changes in Accounting Policies, exceptional items are "items of income and expense within Profit & Loss from ordinary activities of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise." These include for example, the following:

(a) The write-down of inventories to net realizable value as well as reversal of such write-downs.

(b) Restructuring of the activities of an enterprise.

(c) Reversal of any provisions for the cost of restructuring.

(d) Disposal of items of fixed assets.

(e) Disposal of long-term investments.

(f) Legislative changes having retrospective application.

(g) Other reversal of provisions.

According to AS: 5 extraordinary items are, "incomes or expenses" that arise from events of transactions that are clearly distinct from the ordinary activities of enterprise and, therefore are not expected to recur frequently or regularly. It may be noted that an event or item may be extraordinary for one enterprise but not so far another enterprise. For example, losses sustained as a result of an earthquake/fire/flood may be qualify as an extraordinary item for many enterprises. However, claims from policy-holders arising from an earthquake/fire/flood etc. do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

14. Tax Adjustments

In case companies, tax adjustments may relate to the following items:

(i) **Tax deducted at source:** A company is required to deduct tax from any amount paid by it by way of interest, salaries to employees, etc.

The rates of deduction of tax at source are fixed by the Finance Act passed by the Parliament in March every year. The Act comes into effect from 1st April next. The following journal entry is passed by the company in respect of any of the payments.

Interest on debentures/Salaries A/c	*Dr.*
To Bank A/c	
To Tax Deducted at Source A/c	

The profit and loss account is debited with the gross amount of salaries or interest. The tax deducted at source is shown in the balance sheet on the liabilities side till it is finally paid by the company to the Government.

Tax is also deducted at source in respect of dividends or interest which the company gets on its investments. The following journal entry should be passed in respect of such income received.

Bank A/c	*Dr.*
Tax Deducted at Source A/c	*Dr.*
To Interest/Dividends A/c	

The Profit and Loss Account is credited with the gross amount of interest/dividends while tax deducted at source is shown as an asset in the company's balance sheet.

As per the existing provisions the companies declaring dividends have to pay Dividend Distribution Tax as per the rate determined by The Finance Act. The rate of tax may change each year as per the relevant provisions of Finance Act. The effective rate of taxation at present comes to around 20%.

The following entry will be passed for such tax payable by the company:

Profit and Loss Account	*Dr.*
To Provision for Taxation Account	

No tax was to be deducted at source in respect of dividend paid by the company to its shareholders *w.e.f.* April 1, 2003. Hence the need for grossing of the dividend received by a company did not arise for the dividend received for financial year 2003-2004 and onwards. However, in the Budget for financial year 2016-17, the Government provided that income by way of dividend in excess of ₹ 10 lakh would be chargeable at the rate of 10% for individuals, Hindu Undivided Family or Partnership Firms. In the 2017-18 Budget, the Government extended the rule also to include private trusts.

(ii) **Advance payment of tax**: According to Section 266 of the Income Tax Act, 1961, every person is required to pay advance tax when his income tax liability is expected to be ₹ 10,000 more in the relevant previous year. The following entry is passed when tax is paid in advance.

Tax paid in Advance A/c *Dr.*
To Bank A/c

Tax paid in advance account appears as an asset in the company's balance sheet. The amount so paid is adjusted against the income tax payable by the company whenever the company's assessment for that year is finished.

(iii) **Provision for taxation:** A company makes provision for taxation in respect of profit made during a particular accounting year. The net profit is arrived at after deducting provision for taxation. The following entry is made for such provision:

Profit and Loss A/c *Dr.*
To Provision for Taxation A/c

Provision for taxation appears as a liability till assessment in respect of that year is finalised.

Illustration 7.1: The following are the extracts from the trial balance of a company on 31 December, 2016:

Particulars	₹	₹
Provision for Taxation (2015)		10,000
Advance Tax paid for 2015	8,000	
Advance Tax paid for 2016	10,000	
Tax Deducted at Source (2016)	1,000	2,000
Profits and Loss Account balance (2015)		20,000

Assessment for the year 2015 was finalised during the year 2016. The final total tax liability for that year was fixed at ₹12,000. The net profit earned by the company during 2016 before tax amounts to ₹30,000. The company is in the 50% tax bracket.

You are required to pass the necessary journal entries and show how the various items will appear in the company's final accounts.

Solution:

Journal Entries

	Particulars	₹	₹
	Profit and Loss (Surplus) A/c *Dr.* To Provision for Taxation (2015) A/c (Extra provision of ₹ 2,000 made for 2015)	2,000	 2,000
	Provision for Taxation (2015) A/c *Dr.* To Advance Tax (2015) A/c To Tax Payable (2015) A/c (Advance tax paid in respect of 2015 provision for Tax for 2015)	12,000	 8,000 4,000

	Profits and Loss (Surplus) A/c	*Dr.*	15,000	
	To Provision for Taxation (2016) A/c			15,000
	(Provision for tax made for 2016)			

_X_ Ltd.
Statement of Profit and Loss for the year ended 31st December, 2016

Particulars	₹
Revenue from Operations	
(i) Profit / (Loss) before Exceptional and Extraordinary Items and Tax	30,000
(ii) Tax Expense:	
(a) Current Tax Expense	15,000
(b) Current Tax Expense Relating to Previous Year	2,000
	17,000
(iii) **Profit / (Loss) from Continuing Operations (i) – (ii)**	13,000

_X_ Ltd.
Extracts from Balance Sheet as at 31 December, 2016

	Particulars		₹
A	**Equity and Liabilities**		
1.	Shareholders' Funds		
	(a) Share Capital		–
	(b) Reserves and Surplus		
	Profit and Loss Account (₹20,000 for year 2015 and ₹13,000 for year 2016)		33,000
			33,000
2.	Current Liabilities		
	(i) Other Current Liabilities:		
	Tax Deducted at Source	2,000	
	Tax Payable (2015)	4,000	
	(ii) Short-term Provision:		
	Provision for Taxation (2016)	15,000	21,000
B	**Assets**		
1.	Non-current Assets		
2.	Current Assets		
	(a) Other Current Assets:		
	Advance Tax Paid (2016)		10,000
	Tax Deducted at Source (2016)		1,000
			–
			–

Note: The above illustration has been worked out on the presumption that the company has not disputed the tax assessment finalised by the tax authorities. However, if the company files an appeal challenging the assessment made for the year 2015, the need for making extra provision for tax for 2015 will not at all arise. In such a case, the illustration will be worked out on the basis as if no assessment has been done in respect of the income of 2015. However, a note will be given in the balance sheet stating the facts regarding assessment made by taxation authorities and filing of an appeal by the company against such assessment.

Illustration 7.2: Trial Balance of Soma Ltd. as on 31st March, 2016 [Extracts]

Name of Account	*Dr. (₹)*	*Cr. (₹)*
Advance Income Tax for 2014-15	2,20,000	
Advance Income Tax for 2015-16	2,30,000	
Provision for Income Tax 2014-15		2,00,000

Adjustments:

(i) The income tax assessment for 2014-2015 completed during the year showed gross tax demand of ₹2,40,000 but no effect has been given for this in the account.

(ii) Provision for income tax is to be made for ₹ 2,10,000 for 2015-2016. show journal entries and relevant extracts in the Final Account.

Solution:

Soma Limited

Journal

	Particulars	Dr. (₹)	Cr. (₹)
	Profit and Loss (Surplus) A/c *Dr.*	2,10,000	
	To Provision for Income Tax A/c		2,10,000
	(Being the amount of provision for income tax for the year 2015-2016 charged to P/L A/c)		
	Profit and Loss (Surplus) A/c *Dr.*	40,000	
	To Provision for Income Tax A/c		40,000
	(Being the amount of less provision for income tax for 2014-15 charged to P/L A/c of this year 2015-16)		
	Provision for Income Tax A/c *Dr.*	2,40,000	
	To Advance Income Tax A/c		2,20,000
	To Tax Payable A/c		20,000
	(Being the amount of advance income-tax for earlier year 2014-15 adjusted with provision for tax)		

Soma Limited

Statement of Profit and Loss for the year ended 31st March 2016

Particular	₹
Profit/(Loss) before Exceptional and Extraordinary Items and Tax	–
Tax Expense:	
(a) Current Tax Expense for Current Year	2,10,000
(b) Current Tax Expense Relating to Prior Years	40,000
	2,50,000
Profit / (Loss) from Continuing Operations	(2,50,000)

Soma Limited

Extracts from Balance Sheet as at 31st March 2016

	Particulars	₹
A	**Equity and Liabilities**	
1.	Shareholders' Funds	
	Share Capital	–
	Reserves & Surplus	
	P & L Account	(2,50,000)
	(Tax Expense)	(2,50,000)

	Particulars	₹
2.	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	
	(a) Other Current Liabilities	
	Tax Payable (2014-2015)	20,000
	(b) Short-term Provisions:	
	Provision for Taxation (2015-2016)	2,10,000
		2,30,000
B	**Assets**	
1.	Non-current Assets	
2.	Current Assets	
	(a) Other Current Assets:	
	Advance Tax Paid	2,30,000
		–

15. Dividends

The term dividend refers to that part of the profit of a company which is distributed among its shareholders. The decision regarding declaration of dividends is taken by the shareholders in the annual general meeting. Of course, the recommendation regarding dividends has to come from the directors of the company. The shareholders by themselves cannot declare dividends. The Board of Directors has the power to declare interim dividend (i.e., the dividend declared between two annual general meetings of a company). The final dividend declared at the annual general meeting does not include the interim dividend already declared by the directors unless otherwise provided. For example, if the directors have declared an interim dividend of 5% and the company at the annual general meeting has declared a final dividend of 10%, this means the shareholders will get in all 15% as dividend.

Divisible Profits

Dividends can be declared only out of divisible profit. In computation of such profits, the following rules based on statutory provisions as well as legal decisions, will be a good guide:

1. Dividend can only be paid out of (a) the current profits of the company, or (b) the past accumulated profit, or (c) money provided by the Central or State Governments for the payment of dividends in pursuance of the guarantee given by the Government (Sec. 123). Payment of dividend out of capital is illegal. Directors, who pay dividends out of capital, shall be personally liable to make good such amounts to the company.
2. No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year or years are set off against profit of the company for the current year.

3. A company may before the declaration of dividend in any financial year transfer such percentage of its profits for that financial year as if many consider appropriate to the reserves of the company. Thus transfer of any specific amount to reserves is now not mandatory [Sec. 123(1)].
4. Capital profits may also be utilised for the purposes of declaration of dividend provided (a) they have been realised in cash, (b) they remain as profits after revaluation of all the assets and liabilities', and (c) there is nothing in the Articles of Association of the company prohibiting their distribution amongst the shareholders in the shape of cash dividends.
5. No dividend shall be declared or paid by a company from its reserves other than free reserves.
6. In case of inadequacy or absence of profits the in any financial year the company may use accumulated profits or free reserves to pay dividends. However, to prevent companies from using freely accumulated reserves to declare dividends the Central government has framed the "Companies (Declaration of Dividend out of Reserves) Rules, 2014". According to these rules accumulated profit can be used for declaration of dividends for a financial year if the following conditions are satisfied:
   (i) The rate of dividend declared shall not exceed the average of the rates at which the dividend was declared by the company in the three years immediately preceding that year or 10% of its paid-up capital, whichever is less.

   (ii) The total amount to be drawn from the accumulated profits earned in the previous years and transferred to the reserves (including transfers from Development Rebate Reserves excluding all items of Capital Reserves or reserves created by revaluation of assets) shall not exceed an amount equal to 10% of the sum of its paid-up capital and free reserves as appearing in the latest audited financial statement.

   The amount so drawn shall be first utilised to set off the losses incurred in the financial year before declaration of any dividend in respect of preference or equity shares.

   (iii) The balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital as appearing in the latest audited financial statement.

Rules Regarding the Payment of Dividends

The following are the rules regarding declaration and payment of dividends:

1. Board of directors determines and recommends to the shareholders the portion of net profits to be utilised for the purposes of distribution and also the rate of dividend to be declared. Dividend is always declared on account of one financial year of the working of the company.

NOTES

2. Regulation 80 of Table *F* provides: “The company in general meeting may declare dividends but no dividend shall exceed, the amount recommended by the board.”

   The rate of dividend recommended by the board of directors is required to be approved by the members of the company in general meeting before it can be declared and distributed amongst the shareholders of the company. Members, however, can neither increase the rate or the amount of dividend recommended by the Board of directors nor insist upon the payment of dividend if the directors decide otherwise. How much of profit is to be distributed as dividend is a matter of internal management and the court will not interfere with the discretion of the directors or shareholders.

3. Interim, dividends can be declared by the directors on their own responsibility with the authority of the Articles of Association any time between two annual general meetings of the company.

4. Dividends are to be paid only in cash. Payment of dividends in the shape of scrips is not allowed. However, a company, if so authorised by the Articles of Association, may decide to pay dividends in the shape of bonus shares or paying up any unpaid amount on the shares already issued. In such a case, company shall have to satisfy all the legal conditions required for increasing of the capital by issuing more shares.

   Any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of dividend.

5. Dividend shall be paid only to those persons whose names appear in the Register of Members on the date when dividend is declared or to the holders of share warrants, if issued by the company. A company should not pay dividends declared after the death of a shareholder to his legal representatives even though they may have obtained authorisations to the estate of the deceased shareholder, unless they have been brought on the Register as shareholders.

6. Every company shall pay dividend on the nominal amount of the shares. Paid-up value of the share shall not be taken into account. But Articles of Association may provide for the payment of dividends in proportion to the amounts paid upon each share. Table *F* also makes such provision. Calls paid in advance shall not rank for dividend (Sec. 51).

   At the *SEBI’s* meeting on 3rd February 2009, it has been decided to amend the listing agreement to provide that listed entities shall declare dividend on per share basis only. At present there is no uniformity in declaring dividend. Some companies declare dividend on per share basis and some as percentage of face value, creating confusion.

7. All dividends must be paid (or dividend warrants must be posted) within 30 days of their declaration (Sec. 127). If dividends are not so paid, every director of the company, who is knowingly a party to the default, shall be liable to imprisonment which may extend to two years besides a fine which shall not be less than ₹ 1,000 for every day the default continues. The company shall also be liable to pay simple interest at 18% per annum during the period such default continues.

   However, no offence shall be deemed to have been committed in respect of above, in each of the following cases:

   (a) When dividend could not be paid due to the operation of any law.

   (b) When dividend could not be paid in order to comply with the directions of the shareholders;

   (c) When any dispute regarding the right to receive dividend is pending;

   (d) When non-payment of dividend is not due to the default of the company; and

   (e) When the company has lawfully adjusted the amount of dividend against any sum due by the company from the shareholder.

   It is to be noted that, if a dividend warrant issued to but not received by the shareholder is cashed by an unauthorised person, the company shall be liable to the true owner, however *bona fide* the payment might have been made.

8. After a dividend has been declared, it becomes a debt due on the company and the shareholder who is entitled to it, can enforce its payments through court within three years of its declaration.

   Company may, however, deduct from the amount of dividend any calls due or any other amount of money payable in relation to the shares of the company. (Regulation 84 of Table *F*).

   But when a company goes into liquidation, a declared dividend though remaining due as an arrear of debt, will not rank with other debts due to creditors. It will only be taken into account while adjusting the rights of shareholders as contributories.

9. Dividend is usually declared at the annual general meeting (except the interim dividend). But a company may declare dividend at the general meeting other than the annual general meeting unless articles otherwise provide. Table *F* permits such declaration. Thus, a company which could not declare dividend at an annual general meeting, may do so at a subsequent meeting.

However, the above power should be exercised by the companies reasonably. Companies cannot be permitted to declare dividends for past years in respect of which accounts have already been closed at previous annual general meetings.

10. No dividend shall bear interest against the company (Regulation 88 of Table *F*).
11. The company cannot declare a further dividend after declaration of dividend at the annual general meeting. Dividend once declared cannot also be revoked except with the consent of shareholders. But Board of directors is justified in revoking dividend in those cases where the dividend has been illegally declared or on account of unforeseen compelling circumstances, e.g., new killing tax burden, destruction of company's property, etc., it will be advisable to conserve the remaining assets.

Companies (Declaration and Payment of Dividend) Rules, 2014

Declaration of dividend out of reserves

According to the above rules In the event of inadequacy or absence of profits in any year, a company may declare dividend out of surplus subject to the fulfillment of the following conditions, namely:–

(1) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year:

Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(4) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(5) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

16. Interim Dividends

Subject to the authority of the Articles of Association, directors of a company can pay interim dividends. Regulation 81 of Table *F* provided that the board may from time to time pay to the members such interim dividends as appear to it to be justified by the profits of the company.

An interim dividend is only a payment on account of the whole dividend for the year. If the working of the whole year results in loss, payment of interim dividend will amount to the payment of dividend out of capital and the directors will be personally liable to make good to the company the amount of interim dividend improperly disbursed.

It is essential for a company to provide depreciation for the whole of the year and not proportionately for any fraction of the year before declaring interim dividend. This is because provision for depreciation is a condition precedent for declaration or payment of any dividend.

It is considered prudent to prepare interim accounts to ascertain the amount of profits earned and to see whether the profits for the accounting period up-to-date sufficiently justify the payment of an interim dividend. The directors should not rely on a receipt and payment account for the purpose of determining whether or not an interim dividend should be paid as the excess of receipts over payments does not reflect the profit and loss of the company. Of the profits computed from the interim accounts a sufficient margin should be allowed before arriving at the amount that may be declared as interim dividend.

Apart from preparing interim profit and loss account, a cash budget should also be prepared before declaring interim dividend. Under no circumstances should such a distribution be made unless the working capital of the company after payment of such a dividend is amply sufficient to provide all the company's known and prospective needs. It is unwise to establish the precedents unless there are good reasons for believing that it can be followed in the future years. A great deal of caution should be exercised before declaring interim dividend if there are no reserves or undistributed profits to fall back upon.

Legal Provisions: The Companies Amendment Act 2013, has in the definition of dividend included interim dividend by amending Section 2(35). Thus:

1. Interim dividend is a part of dividend and hence all provisions of the Companies Act have also become applicable to interim dividend.
2. The Board of Directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited

in a separate account with a scheduled bank within five days from the date of declaration of such dividend. [Sec. 123(4)]

3. The amount of dividend including interim dividend so deposited above shall be used for payment of interim dividend.

Revocation of Interim Dividend

There is a controversy regarding revocation of interim dividend by the Directors. Some people have the opinion that interim dividend can be revoked by the Directors. However, the general view is that interim dividend can be revoked only before the amount of such dividend is transferred to a separate bank account as mentioned above. This is further confirmed by Secretarial Standard 3 of the ICSI that interim dividend once declared cannot be revoked. Thus, the interim dividend, like final dividend, should be considered as a debt due and thus cannot be revoked.

17. Unpaid Dividend to be Transferred to a Special Dividend Account [Sec. 124]

The Companies Act, 2013 makes it obligatory for the companies to transfer within seven days after expiry of thirty days from the date of declaration of dividend, any unpaid dividend or dividends in respect of which dividend (irrespective of the fact whether dividend warrants have been posted or not) to a special dividend account. The account has to be opened in a scheduled bank and to be called "Unpaid Dividend Account of ... Company Limited/ Company (Private) Limited." In case any amount transferred to such account alongwith accrued interest remains unpaid or unclaimed for a period of seven years from the date of such transfer, it shall be transferred by the company to the Investor Education and Protection Fund established under Section 125 of the Act. All shares in respect of which dividend has not been paid or claimed for seven consecutive years or more shall also be transferred to the above Fund alongwith a statement containing prescribed details. Any claimant in respect the shares as transferred can claim the transfer of shares from such Fund in the manner prescribed.

In case a company fails to deposit the unpaid or unclaimed dividend in a scheduled bank, as stated above, the company shall be liable to pay interest at the rate of 12% per annum from the date of default on the relevant amount. Such interest will be shared by the persons entitled to claim dividend in proportion to the amount remaining unpaid to them.

If company fails to comply with any of the above requirements the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty five lakh rupees. Moreover, every officer of the company who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Illustration 7.3: Rajianand Carpets Limited started its business in 2002 and closed its accounts on 31st December. The position in different years is given below:

Year	*Depreciation charge* ₹	*Net profit or net loss* ₹	*Dividend declared* ₹
2012	15,000	10,000 (Loss)	–
2013	18,000	26,000	10,000
2014	20,000	30,000 (Loss)	–
2015	30,000	35,000	10,000
2016	28,000	10,000 (Loss)	–
2017	32,000	18,000	–

The company wants to know the amount of divisible profit in its hand as at 31st December, 2017 in order to determine the rate of dividend that can be declared.

Solution:

Statement of Divisible Profit
as on 31 December, 2017

Year	*Particulars*		*Profit/ Loss*	*Remarks*
2012	Loss ₹ 10,000 has been arrived at after charging ₹ 15,000 depreciation and hence ₹ 5,000 was trading profit. Thus loss of ₹ 10,000 represents arrears of depreciation for the year.		10,000	Arrears of depreciation for the year
2013	Profits	26,000		Balance of Divisible profit of the year
	Less: Dividend	10,000	16,000	
2014	Depreciation or loss whichever is less is to be provided. In this case, depreciation ₹ 20,000 being less, is to be provided. Actually trading loss was ₹ 10,000 and net loss amounted to ₹ 30,000 after depreciation. That means entire depreciation remains unabsorbed. There is no legal compulsion for making good past trading losses.		20,000	Arrears of depreciation of the year
2015	Profit	35,000		Balance of divisible profit of the year
	Less: Dividend	10,000	25,000	
2016	There was a trading profit of ₹ 18,000. After providing for ₹ 28,000 depreciation, loss amounts to ₹ 10,000. Thus, depreciation of ₹ 10,000 remains unabsorbed.		10,000	Arrears of depreciation of the year
2017	Profit available for the year		18,000	
	Divisible Profit as on 31st December 2017		19,000	

Illustration 7.4: Due to inadequacy of profit during the year the company proposes to declare dividend out of general reserves. From the following particulars you are to ascertain the amount that can be drawn applying the Companies (Declaration of Dividend out of Reserve) Rules, 2014:

	₹
5,000, 8% Preference Shares of ₹ 100 each fully paid	5,00,000
2,00,000 Equity Shares of ₹ 10 each fully paid	20,00,000
General Reserve	6,00,000
Capital Reserve on revaluation of assets	1,00,000
Share Premium	1,00,000
Profit and Loss A/c—credit balance	18,000
Net Profit for the year	1,02,000

Average rate of dividend during the last five years: 15%

Solution:

Amount available for dividend:	₹
Profit and Loss A/c—credit balance	18,000
Profit for the year	1,02,000
	1,20,000
Less: Dividend on Preference Shares	40,000
Profit available for Equity Shareholders	80,000
In this instance, profits being low, maximum of 10% dividend can be declared on Equity Share Capital and hence the amount needed comes to	2,00,000

Shortfall which is to be drawn from General Reserve is subject to the following provisions:

(i) Maximum amount that can be drawn should not exceed 10% of paid-up capital and free reserves, *i.e.,* 1/10 of 31,00,000 = ₹ 3,10,000

(ii) After drawing the balance the reserve should not fall below 15% of paid up capital, *i.e.*, ₹ 25,00,000 × 15/100 = ₹ 3,75,000

(Capital Reserve and Share Premium have to be ignored for this purpose).

In case ₹ 1,20,000 is drawn, the balance of reserves comes to ₹ 4,80,000, which is more than the minimum required.

Hence, ₹ 1,20,000 can be safely drawn from reserves, besides ₹ 80,000 is already available from current profits as shown above. The rate of dividend shall be 10%.

Illustration 7.5: The accounting year of *PQR* Ltd. ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.2011. For the years 31.3.2012 and 31.3.2013 it made profits of ₹ 1,00,000 and ₹ 1,20,000 respectively. If is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2011, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2012 and 2013 for tax purposes. Prepare a Statement of Profit and Loss for the years ending 2011, 2012 and 2013

Solution:

***PQR* Ltd**
Statement of Profit & Loss

Particulars	31.3.2011 ₹	31.3.2012 ₹	31.3.2013 ₹
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current Tax			(8,000)
Deferred Tax:			
Tax effect of timing differences originating during the year	80,000		
Tax effect of timing differences reversed/adjusted during the year		(40,000)	(40,000)
Profit (or Loss) after Tax effect	(1,20,000)	60,000	72,000

Accounting entries

The following accounting entries are to be passed in respect of dividends:

Final dividends:

(i) On recommending dividend to shareholders:

Profit and Loss appropriation A/c *Dr.*
To Proposed dividends A/c

In case the balance in profit and loss appropriation account is not sufficient to pay dividend to the shareholders, the balance lying in the "General Reserve" or "Dividend Equalisation Reserve" can be used for dividend.

(ii) On declaration of dividend:

Proposed dividend A/c (with gross amount) *Dr.*
To Dividend payable A/c
(with the net amount payable)
To Income tax A/c
(Tax deducted at source*)

(iii) On opening a separate bank account:

Company Dividend bank A/c *Dr.*
To Bank A/c

(with the net amount payable as dividend)

(iv) On payment of dividend:

Dividend payable A/c *Dr.*
To Company Dividend bank A/c

(v) On payment of tax:

Income tax/Tax deducted at source A/c *Dr.*
To Bank A/c

(vi) On transfer of unpaid dividend to Company's unpaid Dividend Account

Dividend payable A/c *Dr.*
To Company Dividend bank A/c

(vii)Company on transfer of unpaid Dividend to Investor Education and Protection Fund Account

Investor Education and Protection Fund *Dr.*
To Company Dividend bank A/c

Interim dividends:

On declaration of interim dividend by the Directors:

Interim dividend A/c (with gross amount) *Dr.*
To Interim dividend payable A/c
(with net amount payable)
To Income-tax A/c (with tax deducted at source)*

(Interim dividend is generally paid only for 6 months. In case the rate of dividend is per annum, *e.g.*, 12% per annum, dividend should be calculated at 6% only. However, if the dividend rate is simply 12%, dividend should be calculated at 12% on the paid-up value of the shares.)

Other entries regarding opening of a separate "interim dividend bank account" and payment of dividend will be the same as in case of final dividend as explained in the preceding pages. At the end of the accounting year, the amount of interim dividend will be transferred to the profit and loss appropriation account by means of the following journal entry:

Profit and Loss appropriation A/c *Dr.*
To Interim dividend A/c

It should be noted that dividend to the preference shareholders is a priority and is paid before payment to equity shareholders. No dividend is to be paid on calls in advance because, generally if dividend is paid as a certain percentage (and not a fixed amount per share) the dividend is paid only on the actual amount paid by the shareholder. Of course, the company may provide in its articles that no dividend will be paid on shares having calls in arrears.

18. Creation of Reserves

It is not obligatory for a company to distribute whole of its profits by way of dividends among its shareholders. The company may form a reserve fund out of profit unless the memorandum or articles otherwise provide. Article 82 of Table *F* provides as follows in this connection:

"The Board may before recommending any dividend, set aside out of the profits of the company such sums as it thinks proper as a reserve or reserves which shall, at the discretion of the board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalising dividends; and pending such application, may, at their own discretion either be employed in the business of the company or be invested in such investment (other than shares of the company) as the board may, from time to time, think deemed fit."

19. Establishment of Investor Education and Protection Fund (Sec. 125)

The Companies Act, 2013, provides for establishment by the Central Government a fund to be called the Investor Education and Protection Fund.

The Fund is to be credited by the following amounts:

(a) Amounts in the unpaid dividend account of companies;

(b) The application moneys received by companies for allotment of any securities and due for refund;

(c) Matured deposits with companies other than banking companies;

(d) Matured debentures with companies;

(e) The interest accrued on the amounts referred to in clauses (a) to (d);

(f) Grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purposes of the Fund;

(g) The interest or other income received out of the investment made from the Fund;

(h) The amount lying in the Investor Education & Protection Fund established as per Sec. 125C of the Companies Act, 2013; and

(i) Such other amount as may be prescribed.

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

Any person claiming to be entitled to any amount credited to the fund may apply to the authority constituted by the Central Government in the prescribed manner.

The fund shall be utilised for promotion of investors' awareness and protection of the interests of investors in accordance with the prescribed rules.

20. Dividend Received

A company may also receive dividend on account of investment made by it in shares of other companies. Since such dividend received must be after deduction of tax, it will be appropriate to gross up the amount of dividend. The following entry should, therefore, be passed for dividend received:

Bank A/c	*Dr.*
Tax deducted at source A/c	*Dr.*
To Dividends A/c	

For example if the rate of deducting tax from dividends is 10%, the amount of dividend received by a domestic company is to be grossed up as follows:

Amount of dividend received × 100/90.

The profit and loss account will be credited with the amount of gross dividend while the tax deducted at source account will appear as an asset in the company's balance sheet.

It may be noted as per the existing provisions no tax at source is to be deducted in case of inter corporate dividends.

21. Dividend Distribution Tax (DDT)

In India, a company which has declared, distributed or paid any amount as dividend is required to pay a dividend distribution tax at 15%. The provisions of DDT were introduced by the Finance Act 1997. Only a domestic company is liable for the tax. Domestic companies have to pay the tax even if the company is not liable to pay any tax on its income.

At present the effective tax rate for dividend distribution after surcharge and education cess are added comes to 20.36 or say 20%

A company has to pay tax on the distributed profits to the government within 14 days of declaration, distribution or payment of any dividend, whichever is earliest. If a company has not paid it within that time frame, an interest will be accumulated at 1% per month or part thereof till it is paid

The journal entries will be as under:

P & L Account	*Dr.*
To Dividend Distribution Tax A/c	
(For making appropriation)	
Dividend Distribution Tax A/c	*Dr.*
To Bank Account	
(On making payment)	

22. Interest Received

A company may also receive interest on debentures, bonds or government securities. Since amount of interest received by a domestic company must be after deducting tax at the prescribed rate (say 20%) the amount of interest received will have to be grossed up. The grossing up can be done as follows:

Gross interest = Interest received × 100/80

The accounting entry for interest received will be as follows:

Bank A/c	*Dr.*
Tax Deducted at source A/c	*Dr.*
To Interest received A/c	

The amount of gross interest will be shown as income in the profit and loss account, while tax deducted at source will appear as an asset in company's balance sheet.

It may be noted that if the company has passed entry with only the amount of net dividend or interest received, at the end of the accounting year, the following accounting entry has to be passed for tax deducted at source:

Tax deducted at source A/c	*Dr.*
To Dividend/Interest A/c	

23. Auditor's Remuneration

The remuneration payable to the auditor has to be shown as follows as per the requirements of the Institute of Chartered Accountants of India:

(i) Remuneration as auditor.

(ii) Remuneration for other services:

(a) for tax representation

(b) for company law matters

(c) for management services

(d) for internal auditing

(e) for other services.

24. Bonus

The term bonus means, "An extra dividend to the equity shareholders in a joint stock company from surplus profits." This extra dividend may be paid in the form of cash or shares. In the latter case, such shares are issued to the equity shareholders in proportion to their holdings of the equity share capital of the company. Thus, a shareholder continues to retain his proportionate ownership of the company.

Issue of bonus shares is beneficial both for the company as well as for the shareholders. Company stands to gain since issue of bonus shares makes it possible for the company to pay extra dividend to the shareholders, without using the cash resources which may be needed for operation or expansion. The shareholders stand to gain since receipt of stock dividend as compared to cash dividend results in tax advantage to them. Moreover, they get extra dividend in future even if the existing cash dividend per share is continued.

Profit available for the bonus issue

Issue of bonus shares can be made out of the accumulated profits lying in one or more of the following accounts:

(i) Profit and Loss Account, (ii) General Reserve or other Reserves created out of accumulated profits, (iii) Debentures Sinking Fund (after redemption of debentures), (iv) Realised Capital Profits, (v) Capital Redemption Reserve Account, and (vi) Premium Received on Issue of Shares.

It may be noted that only fully paid bonus shares can be issued out of capital redemption reserve account and share premium account referred above.

Requirements of Bonus Issue

The requirements applicable for bonus issue can be classified into two categories (i) Statutory Restrictions (ii) Compliance of *SEBI* Guidelines, Statutory restrictions are applicable to all companies. However listed companies will also have to follow *SEBI* Guidelines.

1. Statutory Restrictions [Sec. 63]

(1) A Company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of –

(i) Its free reserves;

(ii) The securities premium account; or

(iii) The capital redemption reserve account

Provided that no issue of bonus shares shall be made by capitalizing reserves created by the revaluation of assets.

(2) No company shall capitalize its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless –

(a) It is authorized by its articles;

(b) It has, on the recommendation of the Board, been authorized in the general meeting of the company;

(c) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(d) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(e) The partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(f) It complies with such conditions as may be prescribed.

The company shall file, within 30 days of the allotment of the bonus shares, a return stating the number and nominal amount of bonus shares issued together with the names and addresses of the allottees and a copy of the resolution authorising issue of such shares (Sec. 39).

2. *SEBI* Guidelines for Bonus Issues

The Securities and Exchange Board of India (*SEBI*) issued on June 11, 1992 guidelines regarding issue of bonus shares. In keeping with current phase of liberalisation and reforms, the *SEBI* later decided to modify the existing guidelines for issue of bonus shares. Consequently, new bonus guidelines were issued by *SEBI* on 13.4.1994. These guidelines have been further revised *w.e.f.* February 3, 2009.

SEBI believes that the Board of Directors of the companies wishing to make bonus issues will take into due consideration the relevant financial factors while deciding on bonus issues and observe the following guidelines:

(i) These guidelines are applicable to existing listed companies who shall forward a certificate duly signed by the issuer and duly countersigned by its statutory auditor or by a company secretary in practice to the effect that the terms and conditions for issue of bonus shares as laid down in these guidelines have been complied with.

(ii) Issue of bonus shares after any public/rights issue is subject to the condition that no bonus issue shall be made which will dilute the value or rights of the holders of debentures, convertible fully or partly.

In other words, no company shall, pending conversion of *FCDs/PCDs*, issue any shares by way of bonus unless similar benefit is extended to the holders of such *FCDs/PCDsm* through reservation of shares in proportion to such convertible part of *FCDs* or *PCDs.* The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.

(iii) The bonus issue is made out of free reserves build out of the genuine profits or share premium collected in cash only.

(iv) Reserves created by revaluation of fixed assets are not capitalised.

(v) The declaration of bonus issue, in lieu of dividend, is not made.

(vi) The bonus issue is not made unless the partly-paid shares, if any existing, are made fully paid-up,

(vii) The company:

(a) has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof, and

(b) has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.

(viii) A company which announces its bonus issue after the approval of the Board of Directors must implement the proposals within a period of 15 days, if the shareholders approval is not required. However, in case such approval is required, as per the Company's Articles, the bonus issue must be completed within 60 days.

(ix) There should be a provision in the Articles of Association of the company for capitalisation of reserves, etc. and if not, the company shall pass a resolution at its General Body Meeting making provisions in the Articles of Association for capitalisation.

(x) Consequent to the issue of bonus shares, if the subscribed and paid-up capital exceed the authorised share capital, a resolution shall be passed by the company at its General Body Meeting for increasing the authorised capital.

There are no SEBI Bonus Issue Guidelines for private or unlisted companies.

Accounting Entries

(i) For making appropriation for bonus:

P & L A/c / General reserve or Securities A/c	*Dr.*
To Bonus payable A/c	

(ii) When bonus is paid by issue of new shares:

Bonus payable A/c	*Dr.*
To Share capital A/c	

(iii) When bonus is paid in cash:

Bonus payable A/c	*Dr.*
To Bank A/c	

In case bonus is paid by converting partly paid shares into fully paid-up shares, the following journal entries will be passed:

(i) For making appropriation for bonus:

P & L A/c /General reserve/Securities premium A/c	*Dr.*
To Bonus payable A/c	

(ii) For making call:

Share final call A/c	*Dr.*
To Share capital A/c	

(iii) For setting off call against bonus payable:

Bonus payable A/c	*Dr.*
To Share final call A/c	

Illustration 7.6: The Balance Sheet of *A* Ltd. as at 31.3.2015 is as follows:

***A* Ltd**
Extracts from Balance Sheet as at 31 March, 2015

	Particulars		₹
A	**Equity and Liabilities**		
1.	Shareholders' Funds		
	(a) Share Capital		
	Authorised Share Capital: 1,50,000 Equity Shares of ₹10 each		15,00,000
	Issued, Subscribed & Paid up: 80,000 Equity Shares of ₹7.5 each		6,00,000
	(b) Reserves and Surplus		
	Capital Redemption Reserve	1,50,000	
	Plant Revaluation Reserve	20,000	
	Securities Premium Reserve Account	1,50,000	
	Development Rebate Reserve	2,30,000	
	Investment Allowance Reserve	2,50,000	
	General Reserve	3,00,000	11,00,000
			17,00,000

	Particulars	₹
2.	Share Application Money Pending Allotment	–
3.	Non-current Liabilities	–
4.	Current Liabilities	
	TOTAL (1) + (2) + (3) + (4)	17,00,000
B	**Assets**	
1.	Non-current Assets	–
2.	Current Assets	
	(a) Current Investments	–
	(b) Inventories	–
	(c) Trade Receivables	–
	(d) Cash and Cash Equivalents	–
	(e) Short-term Loans and Advances	–
	(f) Other Current Assets:	17,00,000
		17,00,000
	TOTAL (1) +(2)	17,00,000

The company wanted to issue bonus shares to its shareholders at the rate of one share for every two shares held. Necessary resolutions were passed; requisite legal requirements were complied with:

(a) You are required to give effect to the proposal by passing journal entries in the books of *A* Ltd.

(b) Show the amended Balance Sheet.

Solution:

Books of *A* Ltd.

(a) **Journal Entries**

Sr. No.	*Particulars*		*Dr.* ₹	*Cr.* ₹
(i)	Share Final Call A/c	*Dr.*	2,00,000	
	To Share Capital A/c			2,00,000
	(Being the final call made @ ₹2.50 each on 80,000 equity shares to make them fully paid up)			
(ii)	General Reserve A/c	*Dr.*	2,00,000	
	To Bonus to Shareholders A/c			2,00,000
	(Being transfer of ₹2,00,000 from General Reserve to make the partly paid-up shares fully paid-up)			
(iii)	Bonus to Shareholders A/c	*Dr.*	2,00,000	
	To Share Final Call A/c			2,00,000
	(Being the amount due on final call adjusted against Bonus to shareholders A/c)			
(iv)	General Reserve	*Dr.*	1,00,000	
	Securities Premium A/c	*Dr.*	1,50,000	
	Capital Redemption Reserve A/c	*Dr.*	1,50,000	
	To Bonus to Shareholders A/c			4,00,000
	(Being appropriations made to facilitate issue of fully paid-up bonus shares at the rate of one share for every two shares held)			

(v)	Bonus to Shareholders A/c *Dr.* To Equity Share Capital A/c (Being the issue of 40,000 fully paid-up shares of ₹10 each by way of bonus)	4,00,000	4,00,000

Tutorial Notes:

(i) It is permissible to utilise Reserves other than Capital Redemption Reserve, Plant Revaluation Reserve and Securities Premium for making the partly paid up shares fully paid up.

(ii) Except Plant Revaluation Reserve, all other Reserves and Securities Premium account can be utilised to make the issue of bonus shares.

***A* Ltd.**

(b) **Extracts from Balance Sheet as at 31 March, 2015 (after issue of bonus shares)**

	Particulars		₹
A	**Equity and Liabilities**		
1.	Shareholders' Funds		
	(a) Share Capital		
	Authorised Share Capital: 1,50,000 Equity Shares of ₹10 each		15,00,000
	Issued, Subscribed & Paid up: 1,20,000 Equity Shares of ₹10 each (Of the above call on 80,000 shares @ 2.5 each has been adjusted taking transfer from General reserve without payments being received in cash. Of the above shares 40,000 equity shares are allotted as fully paid by way of bonus shares)		12,00,000
	(b) Reserves and Surplus		
	Plant Revaluation Reserve	20,000	
	Development Rebate Reserve	2,30,000	
	Investment Allowance Reserve	2,50,000	5,00,000
			17,00,000
2.	Share Application Money Pending Allotment		–
3.	Non-current Liabilities		–
4.	Current Liabilities		–
	TOTAL (1) + (2) + (3) + (4)		17,00,000
B	Assets		
1.	Non-current Assets		–
2.	Current Assets		
	(a) Current Investments	–	
	(b) Inventories	–	
	(c) Trade Receivables	–	
	(d) Cash and Cash Equivalents	–	
	(e) Short-term Loans and Advances	–	
	(f) Other Current Assets:	17,00,000	17,00,000
	TOTAL (1) +(2)		17,00,000

25. Political Contributions

According to Section 182 as amended on the Finance Act, 2017 Government companies and companies which have been in existence for less than three financial years are prohibited from making any political contribution.

However any other company may contribute any amount directly or indirectly to any political party if a resolution authorizing such contribution is passed at a meeting of the Board of Directors.

Every company shall disclose in its profit and loss account the total amount contributed by it under this section.

The contribution under this section has to be made by an account payee cheque drawn on a bank or an account payee bank draft or use of electronic clearing system through a bank account.

26. Depreciation

According to Section 123(2) of the Companies Act 2013, depreciation has to be provided in accordance with the provisions of Schedule II to the Act. These provisions are being summarized below:

(i) **Meaning**: Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity. Depreciation here includes amortization.

(ii) **Useful life of asset:** Useful life (in years) of various types of assets has been indicated in Part C Schedule II to the 2013 Act. For example it is 30 years for factory buildings, 15 years for general plant and machinery, 10 years for motor vehicles, scooters and other mopeds. Schedule II showing useful a life of different assets is being given in a separate appendix given at the end of the book.

Depreciation should be provided on the 'depreciable amount' of asset over the useful life of an asset.

Useful life of an asset shall not be longer that useful life specified in part C of Schedule II and residential value of an asset shall not be more than 5% of original cost of the asset.

(iii) **Different useful life and residual value if Regulatory Authority so provides:** The Regulatory Authority constituted under an Act of Parliament or by the Central Government may specify useful life or residual value of any specified asset. If such residual value has been prescribed, that shall be applied in calculating the depreciation to be provided for such asset, irrespective of the requirements of this Schedule.

This can happen in respect of regulatory authority for Telecom, Electricity, Banking companies etc.

(iv) **Different useful life and residual value if company is following accounting standards:** Companies required to prepare financial statements as per Accounting Standards, can use different useful life or different residual value, but if they do so, its justification should be disclosed.

Thus, these companies should normally have the same useful life and residual value for each of their assets, as given in Schedule II.

(v) **Other companies to follow depreciation as per Schedule II:** Companies not required and not following Accounting Standards, the useful life of an asset shall not be longer than the useful life and the residual value shall not be higher than that prescribed in Part C of Schedule II in the Companies Act, 2013.

Thus, the useful life and residual value can be lower than prescribed in Schedule II in case of these companies but not more.

(vi) **Depreciation in case of addition or reduction of assets to be on *pro rata* basis:** Where, during any financial year, any addition has been made to any asset, or where any asset has been sold, discarded, demolished or destroyed, the depreciation on such assets shall be calculated, on a *pro rata* basis from the date of such addition or, as the case may be, up to the date on which such asset has been sold, discarded, demolished or destroyed.

(vii) **Depreciation if major part of asset is replaced:** Useful life specified in Part C of Schedule II of the Companies Act, 2013 is for whole of the asset. In case cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the asset, useful life of that significant part shall be determined separately.

(viii) **Extra Shift Depreciation:** In case of plant and machinery, extra shift depreciation shall be increased by 50% for that period if used in double shift and by 100% if used in triple shift for that period. Thus, the extra depreciation is to be provided only for the period during which the plant and machinery is used in two or three shifts.

For assets in respect of which no extra shift depreciation is permitted (as specified by *NESD* in Part C of Schedule II), extra depreciation cannot be provided.

(ix) **Depreciation in case of intangible assets:** Depreciation on intangible assets shall be provided as per Accounting Standards. According to AS 26: Intangible Assets, the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Generally the presumption is that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. As a matter of fact due to rapid technological changes, it may be less than 10 years. Amortization should commence when the asset is available for use.

(x) **Depreciation method:** Depreciation can be provided on Written Down Value (WDV) or Straight Line Method (SLM). The method used shall be disclosed in the accounts. It may be noted that under the Income Tax Act, depreciation is charged according to WDV Method. However, there depreciation has to be calculated on block of assets. This concept is not at all there under Companies Act. Under Income Tax Act, if an asset is added during the year, full depreciation can be claimed if asset is used for 180 or more days in a year, while 50% depreciation can be claimed if asset is used for less than 180 days. While under Companies Act, depreciation should be calculated on *pro rata* basis.

(xi) **Sale or scrapping of old asset:** If a depreciable asset is sold, discarded, demolished or destroyed before an asset is fully depreciated, the excess of *WDV* over its sales proceeds is 'loss on sale of asset'. This should be fully written off in the financial year in which the asset is sold, discarded, demolished or destroyed. If there is surplus, it will be reflected as profit on sale of asset in the accounts and credited to *P&L* Account.

27. Corporate Social Responsibility

With a view to have greater responsibility towards society by the corporates, section 135 of the Companies 2013 Act, provides for *CSR* as under:

(i) Provisions applicable to every company having:

(a) net worth of ₹ 500 crore or more; or

(b) turnover of ₹ 1,000 crore or more; or

(c) net profit of ₹ 5 crore or more during any financial year

(ii) Board of Directors of such companies are required to spend, in every financial year, minimum 2% of the average net profits of the company made during the 3 immediately preceding financial years, in pursuance of the *CSR* Policy.

(iii) Such companies are required to constitute *CSR* committee of its Board of Directors which is responsible for formulating and recommending to the BOD the CSR Policy of the company. The activities covered by CSR have been given in Schedule VII to the Act as under:

(a) Eradicating hunger, poverty and malnutrition, promoting preventive health care and sanitation including contribution to Swatch Bharat Kosh set up by the Central Government for promotion and sanitation and making available safe drinking water;

(b) Promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly, and the differently abled and livelihood enhancement projects;

(c) Promoting gender quality, empowering women, setting up homes and hostels for women and orphans, setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups;

(d) Ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water including contribution to clean Ganga Fund set up by the Central Government for rejuvenation of river Ganga;

(e) Protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts;

(f) Measures for the benefit of armed forces veterans, war widows and their dependents;

(g) Training to promote rural sports, nationally recognised sports, paralympic sports and Olympic sports;

(h) Contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women;

(i) Contributions or funds provided to technology incubators located within academic institutions which are approved by the Central Government;

(j) Rural development projects;

(k) Slum area development.

(iv) Board of Directors is required to approve the *CSR* policy and disclose its content in the Directors's Report and also place the same on the company's website.

(v) The company is required to give preference to local area and areas where it operates for spending the amount earmarked to *CSR*.

(vi) If the company fails to spend such amount, Board of Directors is required to specify the reasons for not spending the amount in the Directors' report.

NOTES

28. Preliminary Expenses

These are expenses incurred by the promoters of the company before its incorporation. The examples of these expenses are as under:

(i) Fee paid to a Chartered Accountant or an Advocate for incorporation of the company.

(ii) Expenses incurred for the approval of the name of company.

(iii) Expenses for printing of statutory documents like Memorandum of Association/Articles of Association etc.

(iv) Stamp duties paid.

(v) Expenses incurred for raising initial share capital.

However, the following expenses should not be included in preliminary expenses:

(i) Cost of preparation of the feasibility report.

(ii) Cost of preparation of the project report.

(iii) Cost of conducting market survey or any other survey necessary for the business of the company.

(iv) Consultancy fees payable for engineering services in connection with the business.

Preliminary expenses are of capital nature since they represent a fictitious asset. However, according to AS: 26 preliminary expenses are not to be carried forward but to be written off against profits-whether Capital or Revenue.

The accounting entries for writing off these expenses will be as under:

(i) When expenses are incurred
 Preliminary Expenses A/c *Dr.*
  To Bank Account

(ii) When they are written off
 P&L Account/Capital Reserve Account *Dr.*
  To Preliminary Expenses Account

Illustration 7.7: The following are the balances of Johri Albhushan Bhandari Co. Ltd. as on 31st March, 2017:

Debit	₹	*Credit*	₹
Premises	30,72,000	Share Capital	40,00,000
Plant	33,00,000	12% Debentures	30,00,000
Stock	7,50,000	*P&L* A/c	2,62,500
Debtors	8,70,000	Bills Payable	3,70,000
Goodwill	2,50,000	Creditors	4,00,000
Cash and Bank	4,06,500	Sales	41,50,000
Calls in Arrear	75,000	General Reserve	2,50,000

Interim Dividend Paid	3,92,500	Bad Debt. Provision on 1.4.2016	35,000
Purchases	18,50,000		
Preliminary Expenses	50,000		
Wages	9,79,800		
General Expenses	68,350		
Salaries	2,02,250		
Bad debts	21,100		
Debentures Interest Paid	1,80,000		
	1,24,67,500		1,24,67,500

Additional Information:

(a) Depreciate Plant by 15%.

(b) Write off ₹5,000 from Preliminary Expenses.

(c) Half-year's Debenture Interest due.

(d) Credit 5% Provision on Debtors for Doubtful Debts.

(e) Provide for Income Tax @ 50%.

(f) Stock on 31st March, 2017 was ₹9,50,000.

(g) A claim of ₹25,000 for workmen's compensation is being disputed by the company. Prepare Final Accounts of the company.

Solution:

Johri Albhushan Bhandari Co Ltd.
Statement of Profit and Loss for the year ended 31 March, 2017

Particulars		₹
1. Revenue from Operations (Gross)		41,50,000
Less: Excise Duty		–
Revenue from Operations (Net)		41,50,000
2. Other Income	–	.....
3. Total Revenue (1) + (2)		41,50,000
4. Expenses		
(a) Cost of Materials Consumed		–
(b) Purchases of Stock-in-trade		18,50,000
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade:		
Opening Stock	7,50,000	
Closing Stock	(9,50,000)	(2,00,000)
(d) Employee Benefits Expense:		
Wages	9,79,800	
Salaries	2,02,250	11,82,050
(e) Finance Costs:		
Debenture Interest Paid	1,80,000	
Provision for Debenture Interest	1,80,000	3,60,000

Particulars		₹
(f) Depreciation and Amortisation Expense		4,95,000
(g) Other Expenses		
General Expenses	68,350	
Provision for Bad and Doubtful Debts	29,600	
Preliminary Expenses Written off	5,000	1,02,950
Total Expenses		**37,90,000**
5. Profit / (Loss) before Exceptional and Extraordinary Items and Tax (3) - (4)		3,60,000
6. Exceptional Items		–
7. Profit / (Loss) before Extraordinary Items and Tax (5) - (6)		3,60,000
8. Extraordinary Items		–
9. Profit / (Loss) before Tax (7) - (8)		3,60,000
10. Tax Expense:		
Tax Expense for Current Year		1,80,000
11. Profit /(Loss) from Continuing Operations (9) - (10)		**1,80,000**
12. Profit or Loss from Discontinuing Operations		**Nil**
13. Profit or Loss for the Period (11) + (12)		**1,80,000**
Earnings per Share (of ₹10/- each):		
(a) Basic		
(i) Continuing Operations		0.45
(ii) Total Operations		0.45

Johri Albhushan Bhandari Co Ltd.
Balance Sheet as on 31 March, 2017

	Particulars	*Notes*	₹
A	**Equity and Liabilities**		
1.	Shareholders' Funds		
	(a) Share Capital	1	39,25,000
	(b) Reserves and Surplus	2	2,55,000
2.	Non-current Liabilities	3	30,00,000
3.	Current Liabilities	4	11,30,000
			83,10,000
B	**Assets**		
1.	Non-current Assets	5	61,27,000
2.	Current Assets	6	21,83,000
			83,10,000

Notes to Accounts:

	Particulars	*Notes*	₹
1.	**Share Capital**		
	Authorised Share Capital		
	......Equity Share of ₹10 each		....
	Issued, Subscribed & Paid-up Capital		
	4,00,000 Equity Shares of ₹10 each		40,00,000
	Less: Calls in Arrears		75,000

	Particulars	*Notes*	₹
			39,25,000
2.	**Reserves & Surplus**		
	General Reserve		2,50,000
	Profit & Loss Account Balance from Previous Year	2,62,500	
	Profit for the Current Year	1,80,000	
		4,42,500	
	Less: Interim Dividend Paid	(3,92,500)	
		50,000	
	Less: Preliminary Expenses Written off*	(45,000)	5,000
			2,55,000
3.	**Non-current Liabilities**		
	Long-term Borrowings		
	Secured 12% Debentures		30,00,000
			30,00,000
4.	**Current Liabilities**		
	(a) Short-term Borrowing:		
	Bills Payable		3,70,000
	Interest Outstanding on 12% Debentures		1,80,000
	(b) Trade Payables		4,00,000
	(c) Short-term Provision:		
	Provision for Taxation		1,80,000
			11,30,000
5.	**Non-current Assets**		
	Fixed Assets		
	(i) Tangible Assets		
	Premises		30,72,000
	Plant		33,00,000
			63,72,000
	Less: Accumulated Depreciation		4,95,000
			58,77,000
	(ii) Intangible Assets:		
	Goodwill		2,50,000
			61,27,000
6.	**Current Assets**		
	Inventories (Closing Stock)		9,50,000
	Trade Receivables	8,70,000	
	Less: Provision	43,500	8,26,500
	Cash at Bank		4,06,500
			21,83,000
	Contingent Liability		
	Claim for workmen's compensation not acknowledged as debt		₹25,000

* As per AS 26: Intangible Asset viz Preliminary Expenses has to be written off against profit and not to be carried forward.

NOTES

Illustration 7.8: Sherry Engineering Ltd. have authorised capital of ₹50 lakh divided into 5,00,000 equity shares of ₹10 each. Their books show the following balances as on 31st December, 2017.

Particulars	₹	*Particulars*	₹
Stock 1.1.2017	6,65,000	Equity Share Capital	
Discounts & Rebates	30,000	(2,00,000 Shares of ₹10 each)	20,00,000
Carriage Inwards	57,500	4% Debentures (Repayable	
Patterns	3,75,000	after 10 years)	5,00,000
Rates, Taxes and Insurance	55,000	Bank Overdraft	7,57,000
Furniture & Fixtures	1,50,000	Sundry Creditors (for goods)	2,40,500
Material Purchased	12,32,500	Sales	36,17,000
Wages	13,05,000	Rent (Cr.)	30,000
Coal and Coke	63,000	Transfer Fees	6,500
Freehold Land	12,50,000	Profit & Loss A/c (Cr.)	67,000
Plant & Machinery	7,50,000	Land	12,50,000
Engineering Tools	1,50,000		
Goodwill	3,75,000		
Sundry Debtors	2,66,000		
Bills Receivables	1,34,500		
Advertisement	15,000		
Commission & Brokerage	67,500		
Business Expenses	56,000		
Bank Current A/c	20,000		
Cash in Hand	8,000		
Debenture Interest			
(for half-year 31.6.2017)	10,000		
Interest (Banks)	91,000		
Preliminary Expenses	10,000		
Calls in Arrear	10,000		

The stock (valued at cost or market value, whichever is lower) as on 31st Dec. 2017 was ₹7,08,000. Outstanding liabilities for wages ₹25,000 and business expenses ₹25,000. Dividend declared @ 10% on paid-up capital.

Charge depreciation: Plant and Machinery @ 5%; Engineering Tools @ 20%; Patterns @ 10%; and Furniture & Fixtures @ 10%. Provide 2% on debtors as doubtful debts after writing off ₹21,500 as bad debts. Write-off preliminary expenses ₹5,000 and create debenture redemption reserve ₹50,000. Provide ₹2,40,000 for income tax.

You are required to prepare: Profit & Loss Statement for the year ending 31st December 2017; and Balance Sheet as on that date.

Solution:

Sherry Engineering Ltd.
Statement of Profit & Loss Account
for the year ended the 31st Dec., 2017

Particulars		₹
1. Revenue from Operations		
Sales		36,17,000
2. Other Income		
Rent		30,000
Transfer Fees		6,500
3. Total Revenue (l)+(2)		36,53,500
4. Expenses:		
Material Consumed:		
Purchases Material	12,32,500	
Carriage Inwards	57,500	12,90,000
Changes in Inventories of Finished Goods		
(Opening Stock 6,65,000 – Closing Stock 7,08,000)		(43,000)
Employee Benefit Expenses:		
Wages		13,30,000
Finance Cost:		
Interest on Debentures	20,000	
Interest to Bank	91,000	1,11,000
Depreciation:		
Plant & Machinery	37,500	
Engineering Tools	30,000	
Patterns	37,500	
Furniture & Fixtures	15,000	1,20,000
Other Expenses:		
Coal & Coke	63,000	
Discount & Rebates	30,000	
Rates, Taxes & Insurance	55,000	
Advertisement	15,000	
Commission & Brokerage	67,500	
Business Expenses	81,000	
Repairs	46,500	
Bad debts	47,000	
Provision for Doubtful Debts	4,890	4,09,890
5. Total Expenses		32,17,890
6. Profit before Tax (3)-(5)		4,35,610
7. Provision for Income Tax		2,40,000
8. Profit after Tax (6)-(7)		1,95,610

Balance Sheet

Particulars	Notes	₹
l. Equity and Liabilities		
1. Shareholders' Funds		
Share Capital	1	19,90,000
Reserves and Surplus	2	58,610
2. Share application money pending allotment		–

3. Non-Current Liabilities	3	5,00,000
4. Current Liabilities	4	14,96,500
Total		40,45,110
II. Assets		
1. Non-Current Assets	5	29,30,000
2. Current Assets	6	11,15,110
Total		40,45,110

Note to Accounts

Note 1: Share Capital

Particulars		₹
Authorised Capital:		
.......Equity Shares of ₹ 10 each		....
Issued Capital:		
2,00,000 Equity Shares of ₹ 10 each		20,00,000
Subscribed Capital:		
2,00,000 Equity Shares of ₹ 10 each	20,00,000	
Less: Calls in Arrears	10,000	19,90,000

Note 2: Reserves and Surplus

Particulars		₹
1. Surplus as per *P&L* Statement	1,95,610	
P&L Balance from last year	67,000	
	2,62,610	
Less: Appropriations:		
Preliminary Expenses written off	(5,000)	
Transfer to Debenture Redemption Reserve	(50,000)	
Proposed Dividend	(1,99,000)	8,610
2. Debenture Redemption Reserve		50,000
TOTAL		58,610

Note 3: Non-Current Liabilities

Particulars	₹
(a) Long-term Borrowings	
4% Debentures	5,00,000
TOTAL	5,00,000

Note 4: Current Liabilities

Particulars	₹
(a) Short-term Borrowings:	
Bank Overdraft	7,57,000
(b) Trade Payables:	
Sundry Creditors	2,40,500

(c) Other Current Liabilities:		
Outstanding Liabilities for		
Wages	25,000	
Business Expenses	25,000	
Interest on Debentures	10,000	60,000
(d) Short term Provisions:		
Provision for Income Tax	2,40,000	
Proposed Dividend	1,99,000	4,39,000
TOTAL		14,96,500

Note 5: Non-Current Assets

Particulars		₹
Fixed Assets		
Tangible:		
Land		12,50,000
Plant & Machinery	7,50,000	
Less: Depreciation	37,500	7,12,500
Engineering Tools	1,50,000	
Less: Depreciation	30,000	1,20,000
Furniture & Fixtures	1,50,000	
Less: Depreciation	15,000	1,35,000
Intangible:		
Goodwill	3,75,000	
Patterns	3,37,500	7,12,500
TOTAL		29,30,000

Note 6: Current Assets

Particulars		₹
(a) Current Investments		–
(b) Inventories		7,08,000
(c) Trade Receivables		
Sundry Debtors		2,39,610
(d) Cash and Cash Equivalents		
Cash in Hand	8,000	
Cash at Bank	20,000	28,000
(e) Short-term loans and advances		
Bills Receivable		1,34,500
(f) Other Current Assets:		
Preliminary Expenses		
(to be written off next year)		5,000
TOTAL		11,15,110

Illustration 7.9: The Cosmos Co. Ltd. has an authorised capital of 1,00,000 equity shares of ₹100 each and 50,000 6% preference shares of ₹100 each. The following balances have been extracted on 31.12.2017 from the books of the company:

Particulars	₹	*Particulars*	₹
Subscribed Capital:		Plant & Machinery	1,72,00,000
Equity Shares	80,00,000	Furniture & Fittings	
Preference Shares	20,00,000	₹1,47,500	1,17,500
		Less: Depreciation:	
		₹30,000	
Unexpired Insurance	80,000	General Reserve	27,00,000
Dividend Equalisation Reserve	29,10,750	Book Debts of which ₹2,87,000 are Doubtful	48,10,000
Loan to Director	75,000		
Provision for Doubtful Debts	2,66,000	Management Expenses	16,00,000
Sundry Creditors	4,11,250	Unclaimed Dividend	89,000
Investment in Shares		Final Call unpaid on 2,500 Shares	62,500
of Other Companies	8,50,000	Dividend Accrued on Investment	
Plant & Mach.-Depreciation A/c	37,00,000	in Shares	26,500
P&L A/c (Cr.)	1,29,000	Dividend from Investments	78,900
Purchases	57,92,000	Cash and Bank Balance	3,60,850
		Sales	1,11,89,450

You are required to prepare the profit and loss account and the balance sheet of the company in a form which complies with the requirements of the Companies Act, 2013 after taking the following information into consideration and making necessary assumptions:

(i) The Articles of Association of the company provides as under:

(a) Depreciation at the rate of 33⅓% should be charged to profit and loss account on the original cost of the plant and machinery; and

(b) In the event of inadequacy of profits, dividend equalisation reserve should be made use of to the extent it is necessary to make good the deficiency in the proposed amount of dividend.

(ii) Additional machinery was acquired at a cost of ₹36,00,000 on 1st May 2015. It is fully destroyed by fire on 1st September 2017. The insurance company agreed to settle the claim for ₹10,00,000.

(iii) The equity shares on which the final call was in arrears were forfeited by the board during the year and have not been reissued.

(iv) Furniture is to be depreciated @ 10% on original cost.

(v) In the profit and loss account of the year 2015, a provision of ₹1,00,000 was made in respect of a claim for damages. This claim was settled in September, 2017 for ₹90,000 and the balance of provision is included in sundry creditors.

(vi) Directors propose to pay preference dividend and equity dividend @ 5%, Ignore taxation.

Solution:

Cosmos Co. Ltd.
Statement of Profit and Loss for the year ended 31 December, 2017

Particulars		₹
1. Revenue from Operations (Gross)		1,11,89,450
Less: Excise Duty		–
Revenue from Operations (Net)		1,11,89,450
2. Other Income:		
Dividend from Investments		78,900
3. Total Revenue (1) + (2)		1,12,68,350
4. Expenses		
(a) Cost of Materials Consumed		–
(b) Purchases of Stock-in-trade		57,92,000
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade		–
(d) Employee Benefits Expense		–
(e) Finance Costs		–
(f) Depreciation and Amortisation Expense:		
Plant & Machinery	53,33,333	
Furniture and Fixtures	14,750	53,48,083
(g) Other Expenses:		
Management Expenses		16,00,000
Total Expenses		1,27,40,083
5. Profit / (Loss) before Exceptional and Extraordinary Items and Tax (3) – (4)		(14,71,733)
6. Exceptional Items:		
Profit from Sale of Machinery		2,00,000
7. Profit / (Loss) before Extraordinary Items and Tax (5) – (6)		(12,71,733)
8. Extraordinary Item		–
9. Profit / (Loss) from Continuing Operations		(12,71,733)

Cosmos Co. Ltd.
Balance Sheet as on 31st December, 2017

Particulars	*Notes*	₹
I. Equity and Liabilities		
1. Shareholders' Funds		
Share Capital	1	99,37,500
Reserves & Surplus	2	39,70,517
2. Share application money pending allotment	–	–
3. Non-current Liabilities		–
4. Current Liabilities	3	9,97,750
TOTAL		1,49,05,767
II. Assets		
1. Non-current Assets	4	83,19,417
2. Current Assets	5	65,86,350
TOTAL		1,49,05,767

Notes to Accounts

Note 1: Share Capital

Particulars		₹
Share Capital		
Authorised: 1,00,000 Equity Shares of ₹ 100 each		1,00,00,000
50,000 Preference		
Shares of ₹ 100 each		1,50,00,000
Issued, Subscribed: 80,000 Equity Shares of ₹ 100 each		
		80,00,000
20,000 6% Preference Shares of ₹100 each Paid up:		20,00,000
77,500 Equity Shares of ₹100 each	77,50,000	1,00,000
Add: Forefeited Shares	1,87,300	79,37,300
20,000 6% Preference Shares of ₹100 each		20,00,000
	TOTAL	99,37,500

Note 2: Reserves and Surplus

General Reserve		27,00,000
Dividend Equalisation Reserve	29,10,750	
Less: Utilized for Dividends	3,68,500	25,42,250
P&L Account Balance from Previous Year	1,29,000	
Loss for the Current Year	(12,71,733)	
Provision not Required	10,000	
Tr. from Dividend Equalisation Reserve	3,68,500	
Proposed Dividend:		
Preference Shares	(1,20,000)	
Equity Shares	(3,87,500)	(12,71,733)
TOTAL		39,70,517

Note 3: Current Liabilities

(a) Short-term Borrowings		–
(b) Trade Payables		
Sundry Creditors	4,11,250	
Less: Claims no longer required	(10,000)	4,01,250
(c) Other Current Liabilities		
Unclaimed Dividend		89,000
(d) Short-term Provisions:		
Proposed Dividend: Preference Shares	1,20,000	
Proposed Dividend: Equity Shares	3,87,500	5,07,500
TOTAL		9,97,750

Note 4: Non-current Assets

Particulars		`
(a) Fixed Assets		
(i) Tangible Assets		
Plant & Machinery	73,66,667	
Furniture and Fixture	1,02,750	
(ii) Intangible Assets	–	74,69,417

(b) Non-current Investments		
Shares of other Companies		8,50,000
TOTAL		83,19,417

Note 5: Current Assets

(a) Current Investments		
(b) Inventories		
(c) Trade Receivables	48,10,000	
Less: Provision	(2,66,000)	45,44,000
(d) Cash and Cash Equivalents		8,60,850
(e) Short-term Loans and Advances		
Loans to Directors		75,000
(f) Other Current Assets:		
Insurance Claims	10,00,000	
Unexpired Insurance	80,000	
Dividend Accrued on Investments	26,500	11,06,500
TOTAL		65,86,350

Working Notes:

1. *Profit on Plant and Machinery*

Original Cost			36,00,000
Less: Depreciation:	2015: 8 months	8,00,000	
	2016: 1 year	12,00,000	
	2017: 8 months	8,00,000	28,00,000
	Book Value		8,00,000
Less: Claim admitted			10,00,000
Profit			2,00,000

(Depreciation has been calculated on the machinery from the date of purchase to the date of fire, *i.e.*, for actual use.)

2. *Fixed Assets*

(i) Plant and Machinery		
Balance on 1.1.2017 (cost)		1,72,00,000
Destroyed during the year (cost)		36,00,000
Balance on 31.12.2017 (cost)		1,36,00,000
Less: Depreciation		
Balance on 1.1.2017	37,00,000	
Less: On destroyed machinery	20,00,000	
Balance	17,00,000	
Depreciation during the year 33⅓% on ₹ 1,36,00,000	45,33,333	62,33,333
Net Book Value		73,66,667
(ii) Furniture		
Balance on 31.12.2017 (cost)		1,47,500
Provision for Depreciation 1.1.2017	30,000	
Depreciation during the year, *i.e.*, 10% on ₹1,47,500	14,750	44,750
Net Book Value		1,02,750
Total Net Value of Fixed Assets: – Plant and Machinery		73,66,667
– Furniture		1,02,750
		74,69,417

3. Depreciation on Plant and Machinery	
For the existing Plant and Machinery	45,33,333
For the destroyed machinery	8,00,000
Total	53,33,333

NOTES

7.2.1 Managerial Remuneration

The topic of managerial remuneration has been discussed at length in Unit 3 of this book. Therefore, he will only provide a basic recapitulation of the provisions.

The terms "Managerial Personnel" includes the following categories of persons, i.e., a director, a manager, a managing director or a whole time director.

Section 196(1) specifically provides that notwithstanding anything contained in this Act or any other law or any agreement or instrument, no company shall appoint or employ at the same time more than one of the following categories of managerial personnel, namely:

(i) Managing Director

(ii) Manager

According to Section 197(1), the total managerial remuneration payable by a public company or a private company which is a subsidiary of a public company, to its directors (including whole-time directors and managing directors) and manager in respect of any financial year shall not exceed 11% of the net profits of that company for that financial year computed in the manner laid down in section 198. But directors' remuneration (excluding directors' fees) is not to be deducted from gross profits for computing the overall limit.

Illustration 7.10: The following is the Trial Balance of Ideal Manufactures Ltd. as on 30th September, 2016.

Debit Balances	₹	*Credit Balances*	₹
Opening Stock	1,32,000	Sales	7,76,000
Purchases	1,84,000	Departmental Orders and	
Stores and Spares Consumed	10,000	Items used in Works	90,400
Manufacturing & Miscellaneous		Dividends	1,000
Expenses	1,65,000	Profit on Block Sold	30,000
Salaries, Wages, etc., to Employees	1,90,000	Sundry Receipts	3,000
Freight and Insurance	57,000	Profit and Loss A/c	20,000
Transfer to Repair Reserve	52,000	Prov. for Dep. on Fixed Assets	5,60,000
Interest on Loan	22,500	Share Capital	2,80,000
Depreciation	51,500	Securities Premium	20,000
Interim Dividend	28,000	General Reserve	80,000
Fixed Assets, at Cost:		Development Rebate Reserve	120,000
Opening Balance	12,60,000	Repairs Reserves	40,000
Addition	67,000	Secured Loan	2,30,000

Investments	26,000	Unsecured Loan	50,000
Debtors	1,02,400	Creditors	1,70,000
Interest on Capital during Construction (from last year)	15,000	Provision for Taxation	75,000
Deposits	40,000	Outstanding Expenses for Last Year	5,000
Cash at Bank	1,40,000		
Cash in Hand	2,000		
Managing Director's Remuneration (Minimum)	6,000		
	25,50,400		25,50,400

The following further information is available.

(1) Closing Stock was valued at ₹ 1,47,000.

(2) Managing Director is entitled to 5% remuneration on the net profits of the Company.

(3) Profit on block sold u/s 198 of the Companies Act, 2013, ₹20,000.

(4) Depreciation allowable under Income tax laws ₹65,000.

(5) Current year's Provision for Taxation ₹75,000 is required.

(6) Repairs reserve balance of ₹40,000 has been arrived at as follows:

Opening Balance	₹38,000
Add: Transfer during the year	52,000
	90,000
Less: Actual expenses	50,000
	40,000

(7) Final dividend making a total of 20 per cent on the paid-up capital of the Company less interim dividend already declared has been proposed by the Board of Directors.

(8) Amount of share capital is composed of shares of ₹10 each fully paid.

Prepare the Profit and Loss Account for the year ended 30 September, 2016 and also draw up a Balance Sheet as on that date. Show separately, the computation of Managing Director's remuneration.

Solution:

Ideal Manufacturers Limited
Statement of Profit and Loss
for the year ended 30 September, 2016

Particulars		₹
1. Revenue from operations (Gross)		7,76,000
Less: Excise Duty		–
2. Revenue from Operations (Net)		7,76,000
Other Income		–
Dividend	1,000	
Sundry Receipts	3,000	4,000

Particulars		₹
3. Total Revenue (1) + (2)		7,80,000
4. Expenses		
(a) Cost of Materials Consumed		–
(b) Purchases of Stock-in-trade		1,84,000
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade		
Opening Stock	1,32,000	
Less: Closing Stock	(1,47,000)	(15,000)
(d) Employee Benefits Expense:		
Salaries, Wages and Bonus	1,90,000	
Managing Director's Remuneration	8,109	1,98,109
(e) Finance Costs:		
Interest on Loan		22,500
(f) Depreciation and Amortisation Expenses		51,500
(g) Other Expenses:		
Manufacturing and Miscellaneous Expenses	1,65,000	
Stores and Spares	10,000	
Freight and Insurance	57,000	
Repair Reserve Provision	52,000	
Department Orders and Items used in Works	(90,400)	
Auditors Fee	–	
Travelling and Conveyance	–	1,93,600
Total Expenses		6,34,709
5. Profit / (Loss) before Exceptional and Extraordinary Items and Tax (3)-(4)		1,45,291
6. Exceptional Items		
Profit from Sale of Machinery		20,000
7. Profit / (Loss) before Extraordinary Items and Tax		1,65,291
8. Tax Expense:		
Current Tax Expense		75,000
		75,000
9. Profit / (Loss) from Continuing Operations (7) - (8)		90,291
Earnings per Share (of ₹ 10 each)		
Basic		
(i) Continuing Operations		3.22
(ii) Total Operations		3.22

Working Note:

1. Computation of Managing Director's remuneration.		₹
Net Profit before Managing Director's Remuneration		1,73,682
Add: Expenditure not allowed: Depreciation	51,500	
Repairs Reserve	52,000	1,03,500
		2,77,182
Less: Allowable Expenditure: Depreciation	65,000	
Actual Repairs	50,000	1,15,000
Net Profit for Managing Director's Remuneration		1,66,182
Managing Director's Remuneration @ 5%	₹8,109	

Ideal Manufacturers Limited
Balance Sheet
as on 30th September, 2016

Particulars	Notes	₹
I. Equity and Liabilities		
1. Shareholders' Funds		
(a) Share Capital	1	2,80,000
(b) Reserves & Surplus	2	2,69,291
(c) Money Received Against Share Warrant		–
2. Share Application Money Pending Allotment		–
3. Non-current Liabilities		
Long-term Borrowings		2,30,000
4. Current Liabilities	3	4,45,109
TOTAL		12,24,400
II. Assets		
1. Non-current Assets		
(a) Fixed Assets-Tangible	4	7,67,000
(b) Non-current Investments		26,000
2. Current Assets	5	4,31,400
TOTAL		12,24,400

Notes to Accounts
Note 1: Share Capital

Particulars		₹
Share Capital		
Authorised Equity Shares of ₹10 each		....
Issued, Subscribed & Paid-up: 28,000 Equity Shares of ₹10 each		2,80,000
		2,80,000

Note 2: Reserves & Surplus

Securities Premium Account		20,000
Capital Reserve		10,000
General Reserve		80,000
Development Rebate Reserve		1,20,000
Profit & Loss Account:		
Balance from Last Year	20,000	
Profit for Current Year	90,291	
Interim Dividend	(28,000)	
Proposed Dividend	(28,000)	54,291
Interest on Capital not yet adjusted		(15,000)
		2,69,291

Note 3: Current Liabilities

		₹
(a) Short-term Borrowings		50,000
(assumed all unsecured to be short-term)		
(b) Trade Payables		
Sundry Creditors		1,70,000
(c) Other Current Liabilities		
Outstanding MD's Remuneration	2,109	

Outstanding Expenses	5,000	7,109
(d) Short-term Provisions:		
Repair Reserve/(Provision)		40,000
Provision for Taxation:		
Previous Year	75,000	
Current Year	75,000	1,50,000
(e) Proposed Dividend		28,000
		4,45,109

Note 4: Fixed Assets

		₹
At Cost in the beginning of the Year		12,60,000
Add: Additions at Cost during the Year		67,000
		13,27,000
Less: Provision for Depreciation		5,60,000
		7,67,000

Note 5: Current Assets

		₹
(a) Current Investments		–
(b) Inventories		1,47,000
(c) Trade Receivable		1,02,400
(d) Cash and Cash Equivalents		
Cash in Hand	2,000	
Cash at Bank	1,40,000	1,42,000
(e) Other Current Assets		
Deposit		40,000
		4,31,400

Check Your Progress

1. What are ancillary finance costs?
2. State the purpose of the establishment of Investor Education and Protection Fund.
3. What is dividend distribution tax?
4. List the accounts whose accumulated profits can be used for issue of bonus shares.

7.3 ACQUISITION OF BUSINESS: PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Since we have already discussed the preparation of company final accounts in Unit 3, in this section you will learn about acqulistion of business and preparation of final accounts in such condition.

A company may be formed either to start a completely new business or to acquire an existing business. In the following pages, we are explaining the various accounting problems concerned with the acquisition of an existing business.

Important Terms

Purchase consideration: The term purchase consideration refers to the amount payable by the purchasing company to the vendor of an existing business. There are two important methods for calculating the purchase consideration:

(i) **Net assets method.** Accfording to this method, the purchase consideration is arrived at by adding up the various assets at the value taken over *less* the amount of liabilities taken over by the purchasing company. For example, if the values of the assets taken over are a sum of ₹ 1 lakh while the liabilities are of ₹ 20,000, the net assets of the business would amount to ₹ 80,000.

(ii) **Net payment method.** According to this method, the purchase consideration is arrived at by adding up the various amounts which the purchasing company agrees to pay to the vendor. For example, if the purchasing company agrees to pay ₹ 10,000 in shares, ₹ 5,000 in debentures and ₹ 3,000 in cash, the amount of purchase consideration, according to this method would amount to ₹ 18,000.

Goodwill: The accounting meaning of the term 'goodwill' has already been explained in an earlier unit. In case of acquisition of business by a company, if the amount of purchase consideration is more than the amount of net tangible assets acquired by the company, the excess amount so paid is deemed to have been paid for goodwill. For example, if the company pays a sum of ₹ 1 lakh for net tangible assets of ₹ 80,000, it will be presumed that ₹ 20,000 has been paid by the purchasing company to the vendor for goodwill.

Capital reserve: Capital reserve represents the amount of capital profit made by business. In case the value of net tangible assets acquired by the purchasing company is more than the purchase consideration, the profit so made is a capital profit which will be transferred to capital reserve in the books of the purchasing company.

Accounting Entries

The following journal entries will be passed by the purchasing company in its books in case of acquisition of a business:

(i) For purchase of business:

Business purchase A/c *Dr.*

To Vendor

(With the amount of purchase consideration)

(ii) For assets and liabilities taken over:

Assets taken over (individually) *Dr.*

To Liabilities taken over (individually)

To Business purchase A/c

(Assets and liabilities will be recorded at the values taken over. No note will be taken of goodwill appearing in the books of the vendor. However, if the amount of purchase consideration is more than the assets acquired, the balance will be debited to goodwill account. In case the value of net assets acquired is more than the amount of purchase consideration, the balance will be credited to capital reserve.)

(iii) For payment to vendor:

Vendor *Dr.*

To Share capital A/c

To Securities premium A/c (if issued at premium)

To Debentures A/c

To Bank A/c

(With the respective amounts)

(iv) In case the purchasing company does not take over the debtors and creditors but simply agrees to act as the agent of the vendor for collection of debtors and making payment to the creditors, the following entries will be passed in its books.

(a) Vendor's debtors A/c *Dr.*

To Vendor's suspense A/c

(With the book value of debtors to be collected)

(b) Vendor's suspense A/c *Dr.*

To Vendor's creditors A/c

(With the book value of the creditors to be paid)

(c) Bank A/c (with the actual amount collected) *Dr.*

Vendor's suspense A/c

(with the loss in collections) *Dr.*

To Vendor's debtors A/c

(d) Vendor's creditors A/c *Dr.*

(with actual amount paid)

To Bank A/c

To Vendor's suspense A/c

(with profit made on payment)

(In case of loss in payment of Vendor's Creditors,
Vendor's suspense account will be debited
with the amount of loss.)

(e) Vendor's suspense A/c *Dr.*

To Commission A/c

(For commission earned on collections from debtors and payment to creditors.)

(f) Vendor's suspense A/c *Dr.*

To Bank A/c

(with the amount of payment made to the vendor in settlement of his account)

(v) For interest to vendor. In case the purchasing company does not make payment to the vendor at the agreed time, the vendor is entitled to get interest for the delayed payment. The entry for such interest will be:

Interest to Vendor A/c *Dr.*

To Bank A/c

(The interest to vendor will be written off from the profit and loss A/c)

Illustration 7.11: The balance sheet of Dreamers Ltd. as on 31st March, 2016 stood as under:

Equity & Liabilities	*in lakh ₹*	*Assets*	*in lakh ₹*
Share Capital		Fixed Assets	130
Preference Shares 10%		Investments	24
of ₹ 100 each	30	Current Assets	20
Equity Shares of			
each 10 ₹	60		
General Reserve	36		
Debentures 12%	28		
Current Liabilities	20		
	174		174

Performers Ltd. signified their agreements to takeover the assets and liabilities of Dreamers Ltd. as per the following terms and conditions:

(i) Fixed assets at 90% of the book value.

(ii) Investments at 10% above the par value.

(iii) Current assets and liabilities at book value except that stock-in-trade at cost amounting to ₹ 10 lakh was agreed to be taken over at a discount 20%.

(iv) 12% Debentures are to be discharged at a premium of 15% by issuing 12% debentures of Performers Ltd.

(v) Preference shareholders are to be discharged at a premium of 15% issuing 10% preference shares of ₹ 100 each.

(vi) The equity shareholders in Dreamers Ltd. are to be issued 5 equity shares of ₹ 10 each in Performers Ltd. for every 3 shares held by them.

Work out the consideration for the takeover under:

—Net assets method; and

—Net payment method.

Solution:

Computation of Purchase Consideration

i) **Net Assets Method**)			
:Value of Assets taken over			*in lakh ₹*
Fixed Assets	:	of book value 90%	117.00
Investments	:	above value 10%	26.40
:Current Assets			
Stock in Trade	:	of ₹ 10 lakh 80%	8.00
Others	:	at Par Value	10.00
Total Assets		**(A)**	161.40
:Liabilities taken over			
Debentures 12%	:	to be discharged at) (15% premium	32.20
Current Liabilities at par			20.00
Total Liabilities taken over		**(B)**	52.20
Net value of consideration: (A) – ((B) = ₹ in lakh (161.40 – 52.20			109.20

NOTES

ii) **Net Payment Method**)	*Amount (in lakh ₹)*	Mode of Payment
:For Preference shareholders	34.50	Preference Shares in 10% .Performers Ltd
:For Equity Shareholders Equity Shares for every 5 = shares held 3	100.00	Equity Shares in .Performers Ltd
Total consideration	134.50	

Note: It has been assumed that the debentures have been taken over by Performers Ltd. with other liabilities.

Illustration 7.12: Chetandas Ltd. was registered with a Nominal Capital of ₹ 20,00,000 comprising 1,00,000 Equity and 1,00,000 Preference Shares of ₹ 10 each for purchasing the old established business of Mr. A. Chetandas.

The purchase price was agreed at ₹ 12,00,000 payable as ₹ 3,00,000 in cash, ₹ 4,00,000 in equity shares and ₹ 5,00,000 in preference shares. The Company was to discharge the liabilities of the old firm.

The balance sheet of A. Chetandas on the date of purchase was as under:

A. Chetandas
Summarised Balance Sheet

Liabilities	₹	*Assets*	₹
Capital	10,00,000	Freehold Works	3,60,000
Creditors	1,40,400	Machinery and Plant	3,78,600
Bank Loan	20,000	Sundry Debtors	1,87,640
		Stock	2,24,400
		Cash in Hand	9,760
	11,60,400		11,60,400

The balance of both the classes of the shares were issued to public payable @ ₹ 2.50 per share on application, ₹ 2.50 per share on allotment and ₹ 5 per share on the making of the first and final call. All the shares issued were duly applied for and all the allotment money due was also received. But one shareholder failed to pay the call of ₹ 5 on the 250 shares allotted to him.

Pass the necessary journal entries to record the above the transactions including the cash transactions:

Solution:`

Books of Chetandas Ltd.
Journal

Date	*Particulars*		*Dr. ₹*	*Cr. ₹*
	Business purchase A/c	Dr.	12,00,000	
	To A. Chetandas			12,00,000
	(The amount payable to A. Chetandas for his business)			
	Freehold works A/c	Dr.	3,60,000	
	Machinery and plant A/c	Dr.	3,78,600	

Date	Particulars		Dr. ₹	Cr. ₹
	Sundry debtors A/c	Dr.	1,87,640	
	Stock A/c	Dr.	2,24,400	
	Cash A/c	Dr.	9,760	
	Goodwill A/c	Dr.	2,00,000	
	To Bank loan A/c			20,000
	To Sundry creditors A/c			1,40,400
	To Business purchase A/c			12,00,000
	(Various assets and liabilities of A. Chetandas taken over as per agreement: goodwill ascertained as a balancing figure)			
	Bank A/c	Dr.	2,75,000	
	To Equity Share application A/c			1,50,000
	To Preference Share application A/c			1,25,000
	(Receipt of application money @ ` 2.50 per share on 60,000 Equity shares and 50,000 Preference Shares)			
	Equity Share application A/c	Dr.	1,50,000	
	To Equity Share capital A/c			1,50,000
	(Amount recd. on 60,000 equity shares as application money transferred to equity share capital A/c)			
	Equity Share allotment A/c	Dr.	1,50,000	
	To Equity Share capital A/c			1,50,000
	(Amount due on 60,000 equity shares on allotment @ ` 2.50 per share)			
	Preference Share application A/c	Dr.	1,25,000	
	To Preference capital A/c			1,25,000
	(Being application money recd. on 50,000 shares transferred to Preference Share Capital A/c)			
	Preference Share allotment A/c	Dr.	1,25,000	
	To Preference Share capital A/c			1,25,000
	(Amount due on 50,000 preference shares for allotment @ ` 2.50 per share)			
	Bank A/c	Dr.	2,75,000	
	To Equity Share allotment A/c			1,50,000
	To Preference Share allotment A/c			1,25,000
	(Receipt of allotment money @ ` 2.50 per share on 60,000 Equity and 50,000 preference share)			
	A. Chetandas	Dr.	12,00,000	
	To Bank A/c			3,00,000
	To Equity Share capital A/c			4,00,000
	To Preference Share capital A/c			5,00,000
	(Discharge of the purchase consideration due to A. Chetandas in the form of Cash, Equity shares and Preference shares)			
	Equity Share first and final call A/c	Dr.	3,00,000	

NOTES

Date	Particulars		Dr. ₹	Cr. ₹
	To Equity Share capital A/c			3,00,000
	(Amount due on 50,000 shares for the call of ` 5 per share)			
	Preference Share first and final call A/c	Dr.	2,50,000	
	To Preference Share capital A/c			2,50,000
	(Amount due on 50,000 shares for the call of ` 5 per share)			
	Bank A/c	Dr.	5,48,750	
	To Equity Share first and final A/c			2,98,750
	To Preference Share first and final call A/c			2,50,000
	(Amount collected on the First and Final Call on both classes of shares less ` 5 on 250 shares (assumed) equity shares)			

Books of A. Chetandas
Journal

Date	Particulars		Dr. ₹	Cr. ₹
	Chetandas Ltd.	Dr.	12,00,000	
	Bank loan A/c	Dr.	20,000	
	Sundry creditors A/c	Dr.	1,40,400	
	To Freehold works A/c			3,60,000
	To Machinery and plant A/c			3,78,600
	To Sundry debtors A/c			1,87,640
	To Stock A/c			2,24,400
	To Cash in hand A/c			9,760
	To Capital A/c			2,00,000
	(Various assets and liabilities transferred to Chetandas Ltd. for ` 12,00,000–Excess amount of ` 2,00,000 credited to Capital A/c)			
	Cash A/c	Dr.	3,00,000	
	Equity Shares in Chetandas Ltd.	Dr.	4,00,000	
	Preference Shares in Chetandas Ltd.	Dr.	5,00,000	
	To Chetandas Ltd.			12,00,000
	(Receipt of Cash, Equity shares and Preference shares in discharge of purchase consideration)			
	Capital A/c	Dr.	12,00,000	
	To Cash A/c			3,00,000
	To Equity Shares in Chetandas Ltd.			4,00,000
	To Preference Shares in Chetandas Ltd.			5,00,000
	(Cash, Equity shares and Preference shares received from Chetandas Ltd. handed over to the proprietor)			

Illustration 7.13: *A* Ltd. was incorporated for taking over the business of *B* from 1st April, 2016. The following is the balance sheet of *B* as on 31st March, 2016:

Liabilities	₹	*Assets*	₹
Capital	1,00,800	Land and building	1,60,000
Loans	1,20,000	Plant and machinery	28,000
Creditors	71,200	Furniture	20,000
		Sundry debtors	84,000
	2,92,000		2,92,000

The company takes over the business with fixed assets and loans on the following terms:

(i) The fixed assets should be depreciated at 10%.

(ii) The value of goodwill is estimated at ₹ 80,000.

The company realised ₹ 80,000 from sundry debtors as the agent of the vendor in full settlement and discharged all the trade creditors by paying ₹ 68,000 for a commission of 3% on the amount collected and 2% on the amount paid.

The creditors accepted 10% preference shares of ₹ 100 each in discharge of the loans.

After realisation of the debts and discharge of the liabilities, the total amount due to the vendor was settled by payment of ₹ 5,440 in cash and the balance in the shape of fully paid equity shares of ₹ 10 each.

Show purchase consideration and pass journal entries in the books of the company. Also give the balance sheet of the company after taking over the business of *B*.

Solution:

Basic Calculations

Computation of Purchase Consideration

	₹
Assets taken over:	
Land and Building	1,60,000
Plant and Machinery	28,000
Furniture	20,000
	2,08,000
Less: Depreciation @ 10%	20,800
	1,87,200
Add: Goodwill	80,000
	2,67,200
Less: Loans	1,20,000
Purchase consideration	1,47,200

A Ltd.

Journal Entries

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
2016			
April, 1	Business purchase A/c Dr.	1,47,200	
	To B		1,47,200
	(Being purchase consideration due for taking over the business)		
	Land and building A/c Dr.	1,44,000	
	Plant and machinery A/c Dr.	25,200	
	Furniture A/c Dr.	18,000	
	Goodwill A/c Dr.	80,000	
	To Loans A/c		1,20,000
	To Business purchase A/c		1,47,200
	(Being assets and liabilities takenover)		
	Vendor’s debtors A/c Dr.	84,000	
	To Vendor’s suspense A/c		84,000
	(Being vendor’s creditors to be paid off)		
	Vendor’s suspense A/c Dr.	71,200	
	To Sundry creditors A/c		71,200
	(Being vendor’s creditors to be paid off)		
	Bank A/c Dr.	80,000	
	To Vendor’s debtors A/c		80,000
	(Being collection from vendor’s debtors)		
	Vendor’s suspense A/c Dr.	4,000	
	To Vendor’s debtors A/c		4,000
	(Being loss on collection of vendor’s debtors)		
	Vendor’s creditors A/c Dr.	68,000	
	To Bank A/c		68,000
	(Being payment to vendor’s creditors)		
	Vendor’s creditors A/c Dr.	3,200	
	To Vendors suspense A/c		3,200
	(Being profit on payment to vendor’s creditors)		
	Vendor’s suspense A/c Dr.	3,760	
	To commission A/c		3,760
	(Being the commission @ 3% on vendor’s debtors collected and @ 2% on payment to vendor’s creditors)		
	Vendor’s suspense A/c Dr.	8,240	
	To B		8,240
	(Being transfer of the balance left net after realisation of debtors and payment to creditors)		

Date	Particulars	Dr. ₹	Cr. ₹
	B Dr.	1,55,440	
	To Equity Share capital A/c		1,50,000
	To Bank A/c		5,440
	(Being allotment of 15,000 Equity Shares of ₹ 10 each as fully paid up to vendors and payment of cash as per agreement dated...)		
	Loans A/c Dr.	1,20,000	
	To 10% Preference Share capital A/c		1,20,000
	(Being issue of 1,200 10% preference share capital for discharge of loans)		

Note:

The commission received on collection of vendor's debtors and payment to vendor's creditors has been treated as a pre-incorporation profit and hence transferred to capital reserve. This amount may be used to write off goodwill to that extent. In such a case the net amount of goodwill (i.e., ₹ 80,000 – ₹ 3,760 = ₹ 76,240) may be shown in the balance sheet.

_A_ Ltd.
Balance Sheet
As on 1st April 2016

Particulars	Notes	₹
I. Equity and Liabilities		
(1) Shareholders' Funds		
Share Capital	1	2,70,000
Reserves & Surplus	2	3,760
		2,73,760
II. Assets		
(1) Non-current Assets	3	
Tangible		1,87,200
Intangible		80,000
(2) Current Assets		
Cash & Cash Equivalents		6,560
		2,73,760

Notes to Accounts

Particulars	₹
1. Share Capital:	
Authorized	
........Equity Shares of ₹ 10 each	-------------
........Preference Shares of ₹ 100 each	-------------
Issued & Subscribed Capital	
Equity Shares	5,00,000
Issued for consideration other than cash	
15,000 Equity Shares of ₹ 10 each	1,50,000
1,200 Preference Shares of ₹ 10 each	1,20,000
	2,70,000

2. Reserves & Surplus: Capital Reserve (Commission received on collection of vendor's debtors and Payment of vendor's creditors)	3,760
3. Non-current assets	
Tangible Assets:	
Land & Building	1,44,000
Plant & Machinery	25,200
Furniture	18,000
	1,87,200
Intangible Assets:	
Goodwill	80,000
	2,67,200

7.3.1 Profits Prior To Incorporation

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 1 April, 2011, agrees to take over a running business from 1 January, 2011 and it closes its accounts on 31 of December, 2011 the company is entitled (or liable) not only to the profit (or loss) made by the business from 1 April to 31 December, but also to the profit (or loss) made by the vendor from 1 January to 31 March. 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, since any such profit or loss should be transferred to capital reserve or written off out of any other capital profit.

While any loss prior to incorporation being of capital nature should be debited to separate account called Loss Prior to Incorporation Account, and should be adjusted against Reserve and Surplus in the Balance Sheet.

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) It can be written off against post-incorporation profit

NOTES

Pre-incorporation Profits can be used for any of the following purposes:

(i) Writing off Goodwill on acquisition

(ii) Writing off Preliminary Expenses

(iii) Writing down over-values assets

(iv) Issuing of bonus shares

(v) Paying up partly paid shares.

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 once the certificate of commencement of business is given, the company's power to carry on the business relates back to the date of incorporation and hence *the date of incorporation should be taken as the relevant date for apportionment of profit between pre- and post-incorporation periods.*

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 without apportioning it between pre- 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 in sales ratio between pre and post-incorporation periods.

(*iv*) Expenses which vary according to time *e.g.* rent, salary, depreciation, interest, etc., should be divided in time ratio between pre- and post-incorporation 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.

NOTES

(*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.

(*vii*) Expenses which may relate to both pre- and post-incorporation periods should be charged to both the periods on time basis. For example, auditor's fee may be charged to both pre and post-incorporation periods. However, since getting accounts audited is compulsory in case of companies, the entire amount of audit fee may be charged solely to the post-incorporation period. Similarly, interest paid to the vendors for delay in payment of purchase consideration to them should be charged over both the pre- and post-incorporation periods depending upon the period up to which the interest has been paid.

(*viii*) Profit made during pre-incorporation period, should be transferred to capital reserve. It is not available for distribution as dividend among the shareholders of the company.

Illustration 7.14. Flat Private Limited was incorporated on 1 July, 2011, to take over the running business of Mr. Round with effect from 1 April, 2011. The following Profit and Loss account for the year ended 31st March 2012 was drawn up:

Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Commission	2,625	By Gross Profit	98,000
To Advertisement	5,250	By Bad Debt realised	500
To Managing Director's Remuneration	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, 2011, onwards was double than that of the previous months.

(*ii*) Rent for the first three months was paid @ ₹200 p.m. and thereafter at a rate increased by ₹50 p.m.

(*iii*) Bad Debts ₹350 related to sales effected after 1 September, 2011 and the realisation of bad debts was in respect of debts written off during 2009.

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

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

Solution:

Flat Private Limited
Statement of Profit and Loss Account
for the Year ended 31 March, 2012

	Particulars	*Basis*	*Pre Incorporation* ₹	*Post Incorporation* ₹	*Total* ₹
1.	Revenue from Operations (Gross Profit)	Turnover	14,000	84,000	98,000
2.	Expenses:				
	Employee Beneficial Expense:				
	Salaries	Time	4,500	13,500	18,000
	Managing Director's Remuneration	Actual	–	9,000	9,000
	Depreciation & Amortization Expense	Time	700	2,100	2,800
	Other Expenses:				
	Commission	Turnover	375	2,250	2,625
	Advertisement	Turnover	750	4,500	5,250
	Insurance	Time	150	450	600
	Preliminary Expenses	Actual	–	700	700
	Rent	Actual	600	2,250	2,850
	Taxes	Time	38	112	150
	Discount	Turnover	50	300	350
	Bad Debts	Actual	386	864	1,250
	Bad Debts Realised	Actual	(500)	–	(500)
3.	Total		7,049	36,026	43,075
4.	Net Profit (1) – (2)		6,951	47,974	54,925
5.	Grand Total (3) + (4)		14,000	84,000	98,000

Pre-incorporation Profit of ₹6,971 is capital profit, and hence not available for dividends. It should be transferred to Capital Reserve.

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 therefore relates to the pre-incorporation period and ₹514 to post-incorporation period.

Illustration 7.15. Sai Deep Ltd., was incorporated on 1st August, 2011, to take over the running business of Krishna Bros. with effect from 1st April, 2011. The company received the certificate for commencement of business on 1st October, 2011. The following Profit & Loss Account was prepared for the year ended 31st March, 2012.

Statement of Profit and Loss
for the year ended 31 March, 2012

	Particulars		₹
	Continuing Operations		
	1. Revenue from Operations (Gross)		8,00,000
	Less: Excise Duty		–
	2. Revenue from Operations (Net)		8,00,000
	3. Other Income: Interest		1,000
	Total Revenue (1) + (2)		8,01,000
	4. Expenses		
	(a) Cost of Materials Consumed		7,20,000
	(b) Purchases of Stock-in-trade	–	
	(c) Changes in Inventories of Finished Goods,		
	Work-in-progress and Stock-in-trade	–	
	(d) Employee Benefits Expense: Office Salaries	21,000	
	Partners Salaries	6,000	
	Directors Charges	1,000	28,000
	(e) Finance Costs:		
	Debenture Interest	1,600	
	Interest on Capital	1,800	3,400
	(f) Depreciation and Amortisation Expense		2,100
	(g) Other Expenses:		
	Advertisement	4,400	
	Printing and Stationery	1,500	
	Travelling Expenses	4,000	
	Office Rent	9,600	
	Electricity Charges	900	
	Auditors Charges	600	
	Bad Debts	1,200	

NOTES

Commission on Sales	4,000	
Preliminary Expenses	700	
		26,900
Total Expenses		7,80,400
5. Profit/ (Loss) before Exceptional and Extraordinary Items and Tax (3) – (4)		20,600
6. Exceptional Items		–
7. Profit/ (Loss) before Extraordinary Items and Tax		20,600
8. Tax Expense:		–
9. Profit/ (Loss) from Continuing Operations		20,600

Additional Information:

(1) Total Sales for the year, which amounted to ₹8,00,000 arose evenly up to the date of certificate of commencement, whereafter they recorded an increase of 2/3 during the year. Gross Profit was at a uniform rate of 10% of selling price throughout the year and a commission of 0.5% was paid on sales.

(2) Office Rent was paid @ ₹8,400 p.a. up to 30th September 2011, and thereafter it was paid @ ₹10,800 p.a.

(3) Travelling Expenses, include ₹1,600 towards sales promotion.

(4) Bad Debts written off.

(*a*) A debt of ₹400 taken over from the vendor.

(*b*) A debt of ₹800 in respect of goods sold in September, 2011.

Depreciation includes ₹600 for assets acquired in the post-incorporation period. Show the "pre" and "post" incorporation results and also state how the results are dealt with.

Solution:

Sai Deep Limited
Statement of Profit and Loss for the year ended 31 March, 2012

Particulars	Basis	1st April 2011 to 31st July, 2012		1st April 2011 to 31st July, 2012		Total 1-4-2011 to 31-3-2012
		Pre Incorporation		Pre Incorporation		
1. Revenue from Operations (Gross)	Actual		2,00,000		6,00,000	8,00,000
Less: Excise Duty			–		–	
Revenue from Operations (Net)			2,00,000		6,00,000	
2. Other Income: Interest			–		1,000	1,000
3. Total Revenue (1 + 2)			2,00,000		6,01,000	8,01,000

Particulars	Basis	1st April 2011 to 31st July, 2012		1st April 2011 to 31st July, 2012		Total 1-4-2011 to 31-3-2012
		Pre Incorporation		Pre Incorporation		
4. Expenses						
(a) Cost of Materials Consumed	Actual		1,80,000		5,40,000	7,20,000
(b) Purchases of Stock-in-trade						
(c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade						
(d) Employee Benefits Expense:						
Office Salaries	Time 1:2	7,000		14,000		
Partners Salaries	Actual	6,000				
Directors Charges	Actual	–	13,000	1,000	15,000	28,000
(e) Finance Costs:						
Debenture Interest	Actual	–	–	–		
Interest on Capital	Actual	–	1,800	–	1,600	3,400
(f) Depreciation and Amortisation Expense	Actual		500		1,600	2,100
(g) Other Expenses:						
Advertisement	Sales	1,100		3,300		
Printing and Stationary	Time 1:2	500		1,000		
Travelling Expenses	Time 1:2	800		1,600		
Sales Promotion	Sales 1:3	400		1,200		
Office Rent	Time	2,800		6,800		
Electricity Charges	Time	300		600		
Auditors Charges	Time 1:2	200		400		
Bad Debts	Actual	400		800		
Commission on Sales	Sales	1,000		3,000		
Prelimnary Expenses	Actual	–	7,500	700	19,400	26,900
Total Expenses			2,02,800		5,77,600	7,80,400
5. Profit/ (Loss) before Exceptional and Extraordinary Items and Tax (3) – (4)			(2,800)		23,400	20,600
6. Exceptional Items			–		–	–
7. Profit / (Loss) before Extraordinary Items and Tax			(2,800)		23,400	20,600

Particulars	Basis	1st April 2011 to 31st July, 2012		1st April 2011 to 31st July, 2012		Total 1-4-2011 to 31-3-2012
		Pre Incorporation		Pre Incorporation		
8. Tax Expense:			–		–	–
Profit/ (Loss) from Continuing Operations			(2,800)		23,400	20,600

NOTES

Note: Pre-incorporation loss has been transferred to goodwill account.

Working Notes:

(*i*) Sales Ratio

Pre-incorporation				*Post-incorporation*							
April	May	June	July	August	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	March
1	1	1	1	1	1	5/3	5/3	5/3	5/3	5/3	5/3

Pre-incorporation Sales: 4, Post incorporation sales: 12.

Therefore, Sales Ratio 4 : 12

(*ii*) Allocation of Office Rent	*Pre*	*Post*	
April to July	8,400 × 4 ÷ 12 = 2,800	10,800 × 6 ÷ 12	= 5,400 Oct. to Mar.
Aug. to March		8,400 × 2 ÷ 12	= 1,400 Aug. to Sept.
			6,800

(*iii*) Allocation of Depreciation		
On post incorporation assets	6008	
Balance ₹1,500 on time ratio 4 : 12	500	1,000

Check Your Progress

5. How is purchase consideration is arrived at by the net payment method?
6. Why is an agreement made to acquire running businesses before its incorporation?
7. What should be taken as the relevant date for apportionment of profit between pre-and post-incorporation periods?

7.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Ancillary finance costs are costs other than normal interest costs. They include costs such as discount on issue of debentures, premium payable on redemption debentures, underwriting costs, etc. These costs being fictitious assets should be written off out of profit at the earliest.

NOTES

2. The Investor Education and Protection Fund should be utilised for promotion of investor's awareness and protection of the interests of investors in accordance with the prescribed rules.
3. In India, a company which has declared, distributed or paid any amount as dividend is required to pay a dividend distribution tax at 15%.
4. Issue of bonus shares can be made out of the accumulated profits lying in one or more of the following accounts: (i) Profit and Loss Account, (ii) General Reserves or Other Reserves created out of accumulated profits, (iii) Debentures Sinking Fund (After redemption of debentures), (iv) Realised Capital Profits, (v) Capital Redemption Reserve Account, and (vi) Premium Received on Issue of Shares.
5. According to the net payment method, the purchase consideration is arrived at by adding up the various amounts which the purchasing company agrees to pay to the vendor.
6. Agreements are made to acquire running businesses before its incorporation 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.
7. The date of incorporation should be taken as the relevant date for apportionment of profit between pre-and post-incorporation periods.

7.5 SUMMARY

- Revised Schedule VI has been replaced by Schedule III of the Companies Act 2013 w.e.f. financial year commencing on or after 2014.
- Special points which needs consideration include the nomenclature, format, proposed dividend, miscellaneous expenditure, cash and cash equivalents, separate disclosures, tax adjustments, dividends, interim dividends, creation of reserves, auditor's remuneration, bonus, political contributions, depreciation, corporate social responsibility, preliminary expenses, etc.
- A company may be formed either to start a completely new business or to acquire an existing business. This requires consideration of purchase consideration, goodwill and capital reserve. There are certain accounting entries in such cases.
- 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.

- The assets and liabilities of the vendor's business are agreed as per the date of its last balance sheet.
- There are certain specified steps to be taken in order to apportion the profit between pre-and post-incorporation periods.

NOTES

7.6 KEY WORDS

- **Schedule III:** It is a schedule of the Companies Act 2013 which presents general instructions about the preparation of financial statements.
- **Purchase consideration:** It refers to the amount payable by the purchasing company to the vendor of an existing business.

7.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Briefly explain the changes that have come with the Schedule III in comparison to the Schedule VI of the Companies Act 1956.
2. List the disclosures that need to be presented in the Statement of Profit and Loss Account as per Schedule III.
3. How are unpaid dividends treated as per Schedule III?
4. Write a short note on the acquisition of business before its incorporation.

Long Answer Questions

1. Describe the treatment of tax adjustments as per Schedule III.
2. Explain the concept of dividend, divisible profits and the rules regarding the payment of dividends as per Schedule III.
3. Discuss the requirements with relation to issue of Bonus Shares.
4. Examine the provisions related to presentation of Depreciation in the financial statements.
5. Describe the accounting entries to be passed by the purchasing company in its book in case of acquisition of a business.
6. Assess the steps to be taken to apportion the profits between pre-and post-incorporation periods.

NOTES

Practical Problems

1. The Auto Parts manufacturing Co. Ltd. was registered with an authorised capital of ₹ 10,00,000 divided into shares of ₹ 10 each, of which 40,000 shares had been issued and fully paid.

The following is the Trial Balance extracted on 31st march 2016:

Particulars	*Dr.* ₹	*Cr.* ₹
Stock	1,86,420	
Purchases and Sales	7,18,210	11,69,900
Returns	12,680	9,850
Manufacturing Wages	1,09,740	–
Sundry Manufacturing Expenses	19,240	–
Carriage inwards	4,910	–
18% Bank Loan (Secured)	–	50,000
Interest on Bank Loan	4,500	–
Office salaries and Expenses	17,870	–
Auditors' Fees	8,600	–
Directors' Remuneration	26,250	–
Preliminary Expenses	6,000	–
Freehold Premises	1,64,210	–
Plant and Machinery	1,28,400	–
Furniture	5,000	–
Loose Tools	12,500	–
Debtors and Creditors	1,05,400	62,220
Cash in Hand	19,530	–
Cash at Bank	96,860	–
Advance Payment of Tax	84,290	–
P & L A/c on 1st April, 2015	–	38,640
Share Capital	–	4,00,000
	17,30,610	17,30, 610

You are required to prepare Trading and Profit & Loss Account for the year ended 31st March, 2016 and a Balance Sheet as at that date after taking into consideration the following adjustments:

(i) On 31st march, 2016 outstanding manufacturing wages and outstanding office salaries stood at ₹, 1,890 and ₹ 1,200 respectively. On the same date stock was valued at ₹ 1,24,840 and loose tools at ₹ 10,000.

(ii) Provide for interest on Bank loan for 6 months.

(iii) Depreciation on Plant and Machinery is to be provided at 15%, while on Office Furniture @ 10%.

(iv) Write off one-third of balance of preliminary expenses.

(v) Make a provision of Income Tax @ 50%.

(vi) the directors recommended a maiden (first) dividend @ 15% for the year ending 31st March, 2016 after a transfer of 5% of net profits to General Reserve.

[**Ans.** Gross Profit ₹ 2,51,500, Net Profit ₹ 82,160, Profit taken to B/S after transferring 5% of Net Profit to General Reserve ₹ 56,692, B/S Total ₹ 6,40,160]

2. Smital Cosmetics Limited was registered with an authorised capital of ₹ 20,00,000 divided into 5,000 6 per cent preference shares of ₹ 100 each and 1,50,000 equity shares of ₹ 10 each. On 30 November, 2011 all the preference shares and 1,00,000 equity shares had been issued and were fully paid with the exception of 20,000 of the equity shares on which only ₹ 5 per share had been called-up. The credit balance of the profit and loss account after paying the dividends and making appropriations sanctioned at the general meeting was ₹ 18,920.The directors made the financial of ₹ 5 per share on the partly paid equity shares on 1st July 2012 and the call was duly paid except by a shareholder holding 1,000 shares. These shares were duly forfeited before the end of the year. In June 2012, interim dividends were declared on both the classes of shares in respect of the results for the half year ended 31 May 2012; dividend on equity shares being at the rate of 10 per cent p.a. calculated on the amounts paid on the shares from time to time.

   In addition to the balances arising from the above, the following stood in the books of the company as on 30th November, 2012.

Particulars	₹
Plant and Machinery	7,69,740
Sundry Debtors	4,20,500
Land	2,58,000
Sundry Creditors	2,56,800
Provision for Doubtful Debts (1 December, 2011)	17,500
Bad Debts Written Off (to be charged against Reserve)	14,120
Stock-in-trade (at cost)	2,93,500
Leasehold Property	3,00,000
Leasehold Redemption Fund (1 December, 2011)	70,800
Policy A/c for Leasehold Redemption (1 December, 2011)	70,800
Directors' Fees	7,850
Provision for Taxation (1 December, 2001)	85,500
5 per cent Debentures (1 December, 2001)	3,00,000
Income Tax Paid during the year	67,850
Salaries	1,47,890
Furniture	24,500
Depreciation Reserve	90,640
Depreciation	45,780
Premium Paid on Leasehold Policy	14,200
General Expenses	79,540
Rates and Taxes	3,100
General Reserve	1,80,000
Goodwill	2,50,000
Trading Profit	4,70,620
Cash and Bank Balances	1,40,560

   You are required to prepare Profit and Loss Account for the year ended 30 November, 2012 and the Balance Sheet as at that date strictly in accordance with the requirements of the Companies Act, 2013.

The following further information must be taken into consideration:

(i) Provision for taxation in respect of the year is to be made at ₹ 70,000. No tax liability in respect of earlier period is outstanding.

(ii) The bad debts provision is to be made upto 3% on Sundry debtors.

(iii) The Policy account for the Redemption of the Lease is to be debited with interest @ 6 per cent p.a. on the balance standing on the account from time to time.

(iv) Depreciation written off to 30 November, 2012 on Plant and Machinery ₹ 84,420 and Furniture ₹ 6,220.

(v) A sum of ₹ 5,000 is to be carried forward to the next year as surplus in Profit and Loss account. The Directors desire to provided for final dividend in regard to both the classes of shares, the rate of dividend on equity shares being 15 per cent p.a. (including interim dividend). The General Reserve is to be made use of to the extent necessary to cover deficit, if any, in respect of the proposed dividend.

(vi) The market value of the stock on hand as at 30 November, 2012 stood at ₹ 2,85,200.

[**Ans**. Net Profit after tax ₹ 69,725, Balance Sheet total ₹ 23,73,095]

3. Following are the balances (rounded off to the *nearest thousand*) from the books of Good Earth Limited as of 31.12.2015:

	₹
Sales	13,39,400
Depreciation	7,100
Other income	5,760
Development rebate reserve	4,680
Investment allowance reserve	8,500
Fixed assets at cost	1,27,740
Investment	380
Interest accrued	50
Purchases	8,96,800
Salaries and wages	69,420
Other expenses	2,25,280
General reserve	51,600
Sundry debtors	1,18,000
Share capital	40,000
Secured loans	26,960
Cash at bank	640
Loans and advances	1,160
Fixed deposits	32,000
Depreciation for doubtful debts	56,000
Provision for doubtful debts	120
Sundry creditors	2,21,550

Calculate the Managing Director's remuneration and prepare in the proper form the Profit and Loss A/c and Balance Sheet as at December 31, 2015 with the help of the following additional information.

(*All figures in ₹ thousands*)

		On 1.1.2015	On 31.12.2015
(i)	Stocks:		
	Raw Material and stores	1,00,040	50,020
	Work-in-progress	90,160	40,080
	Finished goods	1,49,800	1,61,900
(ii)	Depreciation as per I.T. rules	8,000	

(iii) Market value of investments 290

(iv) Sundry debtors due for more than six months

Out of above, provision made this year for doubtful debts. 80

(v) Included in other expenses are:–

(a) Auditors' fee for audit 120

(b) Payment to auditors for other services 40

(vi) Income Tax to be provided at 55%

(vii) Managing Director's remuneration is at 5% of net profits subject to maximum of ₹ 240,000 p.a.

(viii) Provide dividends at 25% on capital and transfer the balance of profits to General Reserve.

(ix) Authorised capital of the company is 6 lakh Equity shares of ₹ 100 each. Out of this, 4 lakh shares have been issued and fully paid.

[**Ans.** Managing Director's Remuneration-₹ 2.40 lakh; Transfer to General Reserve-₹ 166.95 lakh; Total of Balance Sheet 4,438.50 lakh]

4. Ajay and Vijay carried on business as partners, sharing Profits and Losses equally. Their business was that of printers and booksellers. The following is their balance sheet as on 31st December, 2015:

Liabilities		₹	*Assets*		₹
Creditors			Land and Bldg. (at cost)		93,250
Printing deptt.	77,000		Furniture (at cost less Depreciation)		2,500
Books deptt.	13,000	90,000	Debtors:		
Loans		6,000	Printing deptt.	32,000	
Bank overdraft		44,750	Books deptt.	54,000	86,000
Capital:			Stock:		
Ajay		1,31,500	Printing deptt.	1,15,000	
Vijay		81,000	Books deptt.	56,250	1,71,250
			Cash in hand		250
		3,53,250			3,53,250

It was agreed that from 1st January 2016, the business should be taken over by two limited companies *viz* Ajay Printers P. Ltd. (*APPL*) to take over the printing department and Vijay Book Sellers P. Ltd. (*VBPL*) to take over the books department.

The loan-holders agreed to accept 10 per cent debentures of ₹ 10 each for their loans— ₹ 3,600 in *APPL* and ₹ 2,400 in *VBPL*.

APPL took over the land and buildings, furniture, cash and liability to bank. The assets and liabilities were transferred at the book value and the partners were to be paid ₹ 25,000 for the goodwill of printing department and ₹ 20,000 for that of books department.

The whole of the purchase consideration was satisfied by the allotment of fully paid equity shares of ₹ 10 each in the respective companies as under:

Ajay: 11,875 shares in *APPL* and the balance in *VBPL*.

Vijay: 7,960 shares in *VBPL* and the balance in *APPL*.

On the same day, *APPL* raised a mortgage loan of ₹ 50,000 and paid off the bank overdraft. The costs of mortgage was ₹ 1,750.

APPL and *VBPL* also issued respectively 500 and 750 fully paid shares of ₹ 10 each to friends and relatives.

The formation expenses were paid by the respective companies as under:

APPL	₹ 3,250
VBPL	₹ 2,000

You are required to prepare the balance sheet of the two companies after these transactions are carried out.

[**Ans.** Purchase consideration *APPL* ₹ 1,46,250, Balance-Sheet Total ₹ 2,78,250,
Purchase consideration *VBPL* ₹ 1,17,250, Balance-Sheet Total 1,37,750]

5. *X* Ltd. was incorporated on 1st May 2017 to acquire a business as on 1st January, 2017. The first accounts were closed on 30th September, 2017.

The Gross profit for the period was	₹	42,000
Details of other expenses:		
General expenses	₹	7,200
Directors' remuneration	₹	12,000
Preliminary expenses	₹	2,000

Rent up to 30th June was ₹ 6,000 per annum after which it was increased by 40%.

Salary of the manager, who on formation of the company had become a whole time director and whose remuneration has been given above, was agreed to be remunerated at ₹ 5,100 per annum.

The company earned a uniform gross profit. The sales up to September 2017 were ₹ 98,000.

The monthly average of sales for the first four months of the year was one-half of the remaining period.

Show the Profit and Loss account and indicate how you would deal with the pre-incorporation results.

[**Ans.** Pre-incorporation Profit transferred to Capital Reserve ₹ 5,100;
Post-incorporation Profit ₹ 8,900]

6. Adarsh Udyog Ltd. Incorporated on 1st May, 2017, received the certificate to commence business on 31st May, 2017. It had acquired a running business from Gupta and Co. with effect from 1st January, 2017. The purchase consideration was ₹ 50,00,000 of which ₹ 10,00,000 was to be paid in cash and ₹ 40,000 in the form of fully paid shares.

The company also issued shares for ₹ 40,00,000 for cash. Machinery costing ₹ 25,00,000 was then installed. Assets acquired from the vendors were: Machinery ₹ 30,00,000; Stock ₹ 6,00,000 and Patents ₹ 4,00,000.

During the year 2017, the total sales were ₹ 1,80,00,000, the sales per month in the first half-year being one-half of what they were in the latter half-year.

The net profit of the company, after charging the following expenses, was ₹ 10,00,000:

	₹
Depreciation	5,40,000
Audit fees	26,000
Directors' fees	60,000
Preliminary expenses	10,000
Office expenses	2,40,000
Selling expenses	1,98,000
Interest to vendors	50,000

Ascertain the pre-incorporation and post-incorporation amounts of profit and prepare the balance sheet of the company as on 31st December, 2017. The Closing Stock was valued at ₹ 7,00,000.

(**Ans**: Profit: Pre-incorporation Period ₹ 4,72,000, Post-incorporation Period ₹ 16,52,000, Balance Sheet Total ₹ 88,72,000)

7. *X* Co. Ltd. was incorporated on 1st July, 2016 to take over the business of Mr. *A* as and from 1st April, 2016. Mr. *A*' Balance Sheet, as at that date, was as under:

Liabilities	₹	*Assets*	₹
Trade Creditors	36,000	Building	80,000
Capital	1,94,000	Furniture & fittings	10,000
		Debtors	90,000
		Stock	30,000
		Bank	20,000
	2,30,000		2,30,000

Debtors and Bank balance are to be retained by the vendor, and creditors are to be paid off by him. Realisation of debtors will be made by the company on a commission of 5% on cash collected. The company is to issue *A* with 10,000 equity shares of ₹ 10 each, ₹ 8 per share paid up and cash of ₹ 56,000.

The company/issued to the public for cash 20,000 equity shares of ₹ 10 each on which by 31st March, 2017 ₹ 8 per share was called and paid up except in the case of 1,000 shares on which the 3rd call of ₹ 2 per share had not been realised. In the case of 2,000 shares, the entire face value of the shares had been realised. The share issue was underwritten for 2% commission, payable in shares fully paid up.

In addition to the balances arising out of the above, the following balances were shown by the books of account of *X* Co. Ltd. on 31st March, 2017:

	₹
Discount (including ₹ 1,000 allowed on vendor's debtors)	6,000
Preliminary Expenses	10,000
Directors' Fees	12,000
Salaries	48,000
Debtors (including vendor's debtors)	1,60,000
Creditors	48,000
Purchases	3,20,000
Sales	4,60,000

Stock on 31st March, 2017 was was ₹ 52,000. Depreciation at 10% on Furniture and Fittings and at 5% on Building is to be provided. Collections from debtors belonging to the vendor were ₹ 60,000 in the period.

Prepare the Trading and Profit & Loss Account for the period ended 31st March, 2017 of *X* Co. Ltd. and its Balance Sheet as at that date.

[**Ans.** Profit: Pre-incorporation ₹ 26,000, Post-incorporation ₹ 69,000, Balance Sheet Total ₹ 3,73,000]

7.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

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UNIT 8 AMALGAMATION AND ABSOPRTION

NOTES

Structure

8.0 Introduction
8.1 Objectives
8.2 Amalgamation and Absorption
8.2.1 Applicability of AS 14 and Amalgamation
8.2.2 Advantages
8.2.3 Purchase Consideration Including Net Present Value Method
8.2.4 Types of Amalgamation
8.3 Accounting Entries in the Books of Companies
8.4 Journal Entries in the Books of Transferor and Transferee Companies and Revised Balance Sheet
8.5 Answers to Check Your Progress Questions
8.6 Summary
8.7 Key Words
8.8 Self Assessment Questions and Exercises
8.9 Further Readings

8.0 INTRODUCTION

The term reconstruction means reorganizing the capital structure of a company including the reduction of claims of both the shareholders and the creditors against the company. Such a reconstruction generally becomes necessary on account of bad financial position of the company. It may be ‘‘external’’ as well as ‘‘internal’’. In case of external reconstruction, a new company is formed to 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. In case of internal reconstruction, the capital of a company is reorganized to infuse new life in the company. It includes both alteration and reduction of share capital. Accounting entries in respect of internal reconstruction have been explained in the next unit.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the applicability of AS 14 and amalgamation
- Explain the advantages of amalgamation
- Examine the types of amalgamations

8.2 AMALGAMATION AND ABSORPTION

Under the Companies Act, 2013, the term amalgamation includes absorption for all purposes. In S.S. Somayajulu v. Hop Prudhommee and Co. Ltd. amalgamation has been explained as "a state of things under which either two companies are joined so as to form a third entity or one is absorbed into or blended with another." Thus, according to law, in case of amalgamation, a new company may not be formed. AS 14 calls such amalgamation as "amalgamation in the nature of purchase." However, when a new company is formed, AS 14 calls it as "amalgamation in the nature of merger."

Scheme of Merger or Amalgamation under the Companies Act.

Section 233 of the Companies Act, 2013 provides as under for a scheme of merger or amalgamation between two or more companies:

1. Preparation of Scheme

(i) A notice of the proposed scheme inviting objections or suggestions, if any, from the Registrar and official liquidators where registered office of the respective companies are situated or persons affected by the scheme within thirty days is issued by the transferor company or companies and the transferee company;

(ii) The objections and suggestions received are considered by the companies in their respective general meetings and the scheme is approved by the respective members or class of members at a general meeting holding at least ninety per cent of the total number of shares;

(iii) Each of the companies involved in the merger files a declaration of solvency, in the prescribed form, with the Registrar of the place where the registered office of the company is situated; and

(iv) The scheme is approved by majority representing nine-tenths in value of the creditors or class of creditors of respective companies indicated in a meeting convened by the company by giving a notice of twenty-one days along with the scheme to its creditors for the purpose or otherwise approved in writing.

2. Filing of Scheme

(i) The transferee company shall file a copy of the scheme so approved in the manner as may be prescribed, with the Central Government, Registrar and the Official Liquidator where the registered office of the company is situated,

(ii) On the receipt of the scheme, if the Registrar or the Official Liquidator has no objections or suggestions to the scheme, the Central Government shall register the same and issue a confirmation thereof to the companies.

3. Objection to the Scheme

(i) If the Registrar or Official Liquidator has any objections or suggestions, he may communicate the same in writing to the Central Government within a period of thirty days: Provided that if no such communication is made, it shall be presumed that he has no objection to the scheme.

(ii) If the Central Government after receiving the objections or suggestions or for any reason is of the opinion that such a scheme is not in public interest or in the interest of the creditors, it may file an application before the Tribunal within a period of sixty days of the receipt of the scheme under para 2 (i) stating its objections and requesting that the Tribunal may re-consider the scheme.

(iii) On receipt of an application from the Central Government or from any person, if the Tribunal, for reasons to be recorded in writing, is of the opinion that the scheme should be reconsidered it may confirm the scheme by passing such order as it deems fit: Provided that if the Central Government does not have any objection to the scheme or it does not file any application under this section before the Tribunal, it shall be deemed that it has no objection to the scheme.

NOTES

4. Consequence of Confirmation of Scheme

(i) A copy of the order confirming the scheme shall be communicated to the Registrar having jurisdiction over the transferee company and the persons concerned and the Registrar shall register the scheme and issue a confirmation thereof to the companies and such confirmation shall be communicated to the Registrars where Transferor Company or companies were situated.

(ii) The registration of the scheme shall be deemed to have the effect of dissolution of the transferor company without process of winding up.

5. Power of the Central Government

The Central Government may provide for the merger or amalgamation of companies in such manner as may be prescribed.

Vendor and Purchasing Companies

The companies involved in case of amalgamation, absorption or external reconstruction can be classified, for accounting purposes, as follows:

Vendor company or companies. In the case of amalgamation, the companies to be amalgamated are called the vendor companies. Similarly, in case of absorption, the company to be absorbed is the vendor company. In case of external reconstruction, the company to be reconstructed is the vendor company. The vendor companies are wound up after sale of their businesses.

Purchasing company. The company purchasing or taking over the business is termed as the purchasing or vendee company. It may already be an existing company as is the case with absorption/amalgamation, or a newly formed company as is the case with external reconstruction.

8.2.1 Applicability of AS 14 and Amalgamation

Basically the term 'amalgamation' is used when two or more existing companies go into liquidation and a new company is formed to take over their business. But the term 'absorption' is used when one or more existing companies go into liquidation and some existing company takes over or purchases their businesses.

The above concepts have been modified by the Accounting Standard 14 (AS 14) "Accounting for Amalgamation" issued by the Institute of Chartered Accountants of India. This Standard is applicable in respect of accounting periods commencing on or after 1.4.1995. This standard specifies the procedure of accounting for amalgamation and the treatment of any resultant goodwill or reserves. The following terms are used in this standard with the meanings specified:

(a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 2013, 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 into which a transferor company is amalgamated.

(d) Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

In fact, amalgamation may take the shape of merging of one company with another or merging of two or more companies to form a new company. As stated above, amalgamation means merging of two or more companies to form a new company and absorption means taking over of the business of one or more companies by another company. However, in terms of Accounting Standard-14, this distinction between amalgamation and absorption is of no significance.

Accounting problems of amalgamation are dealt with in AS-14 according to the type of amalgamation.

8.2.2 Advantages

The following points can be considered to be the benefits or advantages of amalgamation:

- Business choose amalgamation so as to eliminate aggressive competition in the market.
- It helps in controlling the prices in the market.
- It can help companies diversify their operations.
- It helps firms improve their research and development activities.
- It assists companies in reducing their costs of operations.
- It helps firms increase their market share,
- It allows companies to sort of create monopoly in their segment.
- It assists companies in expanding their operations.
- It allows companies to improve their goodwill.
- It helps companies save tax.

8.2.3 Purchase Consideration including Net Present value Method

The term purchase consideration as you have learnt in Unit 7 refers to the amount payable by the purchasing company to the vendor company for taking over the business of such company.

It may, however, be noted that it is not necessary for the purchasing company to take overall assets and liabilities of the vendor company. It may take over all or some of the assets at such values as may be mutually agreed. Similarly, it may take over some or all or none of the liabilities of the vendor company.

It will be beneficial for the students to understand the difference of the following terms to have a clear understanding about the concept of purchase consideration.

Basic terms

Taking over of business. The term taking over of business means that the purchasing company has agreed to take overall assets and liabilities (payable to third parties) of the vendor company, unless otherwise stated.

Trade liabilities and liabilities. The term 'trade liabilities' means liabilities which are incurred on account of purchasing of goods. They include trade creditors and bills payable. The term 'liabilities' is wider than the term trade liabilities. It include, all outsiders' claims against the company like bank overdraft, debentures, outstanding salaries, etc.

It should be noted that shareholders' claims against the company, such as share capital general reserve, dividend equalization reserve, etc. are not included in the term liabilities of the company. Similarly, funds created out of accumulated profits to meet certain contingencies are not liabilities of the business. For example, a company may create an "insurance fund" to meet any loss on account of an unforeseen event such as fire, theft, etc. Similarly, it may create an "accident fund" or a "workmen's compensation fund" to meet any loss that the company may have to suffer on account of paying compensation to any worker for injuries suffered by him during and in the course of employment. In case, the company does not suffer any loss on account of events mentioned above, any balance to the credit of these funds represents accumulated profits and forms a part of shareholders' funds.

Taking over liabilities and paying of liabilities: There is a difference between 'taking over' of a liability and 'paying of' of a liability. In case the purchasing company takes over a liability, it means such liability will be now that of purchasing company and it will appear in its balance sheet. It will be paid at such time and on such terms as may be mutually agreed later by the parties concerned. In any case, the liability is not immediately payable.

In case the purchasing company has agreed to pay a liability it means (*i*) the liability is immediately payable; and (*ii*) it is payable through the vendor company. In other words, the purchasing company will pay sufficient money to the vendor company for paying of such a liability which the purchasing company has agreed to pay. The amount so paid will become a part of the purchase consideration. Such a liability will not appear in the balance sheet of the purchasing company, prepared after acquiring the business of the vendor company.

For the convenience of the students, we are giving an exhaustive list of items which may constitute liabilities, trade liabilities, provisions', accumulated profits and losses.

Liabilities	*Trade Liabilities*	*Provisions*	*Accumulated Profits*	*Accumulated Losses*
Debentures (or creditors)	Trade Creditors Depreciation	Provision for Compensation	Workmen's Expenses Fund*	Preliminary
Loans				
Workmen's Savings Bank A/c	Bills Payable	Provision for Doubtful Debts	Workmen's Accident Fund*	Discount on Issue of Shares and Debentures
Workmen's Profit Sharing Fund		Provision for Repairs and Renewals	Insurance Fund*	Underwriting Commission
Employees' A/c		Investment	Debentures	Profit and Loss
Providend Fund		Fluctuation Fund	Sinking Fund	(debit)
Tax Payable		Provision for Taxation	Dividend Equalisation Fund	
Unclaimed			Development	

Dividend	Rebate Reserve
Outstanding Expenses	
Trade Creditors	Investment Allowance Reserve
Bills Payable	Capital Redemption Reserve
Bank Overdraft	Shares Forfeited A/c
	Profit and Loss A/c (credit)

*Excess of any existing liability.

The following points are important in this connection:

(*i*) In case a company is maintaining a Workmen's Compensation Fund or Insurance Fund, any liability which may be existing on the date of the acquisition of the business will be charged against the fund. Any credit balance in these funds will be taken as accumulated profits and transferred to the shareholders account.

Example. A company has a Workmen's Compensation Fund of ₹10,000 against which the liability of ₹2,000 is existing on the date of its acquisition. The following accounting entries will be passed in its books:

(*a*) For charging the liability

Workmen Compensation Fund A/c	Dr.	10,000	
To Liability for Workmen's Compensation A/c			2,000
To Equity Shareholders A/c			8,000

(*b*) For payment of liability

Liability for Workmen's Compensation A/c	Dr.	2,000	
To Bank			2,000

(*ii*) Development Rebate Reserve or Investment Allowance Reserve is allowed, to encourage capital investment in machinery and equipment. In India, Investment Allowance was allowed at 20% of the cost of the new machinery and equipment for calculation of Income Tax liability for the year in which such assets were put into service. However, it was discontinued w.e.f. 1st April, 1990.

The Finance Act, 2013 again made this benefit available inserting a new section 32AC (1) in the Income Tax Act 1961, to provide a tax incentive by way by investment allowances to encourage huge investment in plant or machinery. According to this section a manufacturing company is entitled to an investment allowance @ 15% of the actual cost of new plant and machinery acquired and installed during the financial years 2013-14 and 2014-15, if the actual cost of new plant and machinery exceeds ₹ 100 cores. This incentive was discontinued w.e.f. finaical commencing on or after 1st April, 2015. The Financial Act, 2016 inserted clause (1A) under secton 32AC providing investment allowance @15% of the cost of new plant and machinery installed in

NOTES

any previous year on or before 31st March, 2017, if the cost of such new plant and machinery exceeds ₹ 25 crores.

However this benefit is not available to any company who was eligible for the investment allowance benefit as per section 32AC (1). Moreover no benefit will accrue for such investment in any financial year commencing on or after 1st April, 2017 (A.Y. 2017-18).

The amount allowed as Investment Allowance is charged to the Profit and Loss Account and credited to Investment Allowance Reserve Account. This amount is usually not available for distribution by way of dividend amongst shareholders for a specific period. The same is true for other Statutory Reserves *viz*. Export Profit Reserve. In case a company sells its business, the purchasing company may have to maintain Investment Allowance Reserve (Statutory Reserve) in its books in respect of assets taken over, as per the tax laws. However, such allowance is a part of accumulated profits and therefore is to be transferred to the equity shareholders account in the books of the vendor company. The following journal entry may be passed:

Investment Allowance Reserve A/c Dr.
To Equity Shareholders A/c
(with full amount of investment allowance reserve)

The amount of Investment Allowance Reserve to be maintained in the books of purchasing company is credited in its books while recording purchase of business. The amount is debited to a new account called Amalgamation Adjustment Account. This is continued till it is required under Statutes. When it is not required the entry is reversed.

Calculation of Purchase Considerations

As you have learnt in Unit 7, Purchase consideration can be calculated by different methods. The method to be adopted by students in an examination problem will depend upon the information given.

The following are the different methods for calculating or ascertaining the amount of purchase consideration:

1. Direct ascertainment method. The question may directly state the amount of purchase consideration. For example, it may be provided that the purchasing company agrees to take over the business of the vendor company for a sum of ₹1 lakh. In such a case the purchase consideration will be taken as ₹1 lakh. No calculations are required in such a case.

2. Net payment method. In this case, the purchase consideration is to be calculated by adding the different amounts which the purchasing company has agreed to pay to the vendor company. The payments by the purchasing company are for different parties interested in the vendor company. For example, if the purchasing company agrees to pay ₹1 lakh in shares for shareholders, ₹1 lakh in debentures for debenture-holders and ₹50,000 in cash for the creditors of the vendor company, the amount of consideration would be a sum of ₹2,50,000.

3. Net assets method. In case of this method, the purchase consideration is calculated by finding out the net assets of the company. The term net assets refers to vendor company's assets, less liabilities taken over by the purchasing company. For this purpose assets and liabilities are to be taken at the values mutually agreed.

Illustration 8.1: A Ltd. takes over the business of B Ltd. at the following values:

Fixed Assets	₹3,00,000
Current Assets	₹1,00,000
Debentures	₹50,000
Current Liabilities	₹1,00,000

Calculate the amount of purchase consideration.

Solution:

The amount of purchase consideration has been calculated as follows:

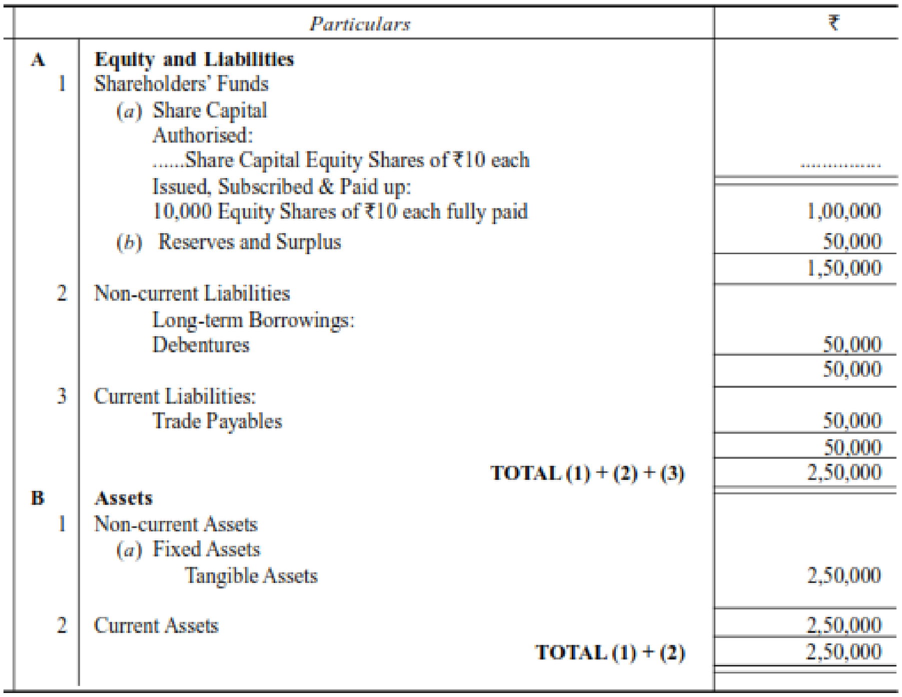
Assets taken over:			₹3,00,000
Fixed Assets			1,00,000
Current Assets			4,00,000
Less: Liabilities taken over:	Debentures	50,000	
	Current Liabilities	1,00,000	1,50,000
	Purchase Consideration		2,50,000

4. Shares exchange method. In case of this method, the purchase consideration is ascertained on the basis of the ratio in which the shares of the purchasing company are to be exchanged for the shares of the vendor company. This exchange ratio is generally determined on the basis of the value of each company's shares.

NOTES

Illustration 8.2: Following is the Balance Sheet of A Ltd.

A Ltd.
Extracts from Balance Sheet as at 31 March, 2012



		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Funds	
		(*a*) Share Capital	
		Authorised:	
		......Share Capital Equity Shares of ₹10 each	....
		Issued, Subscribed & Paid up:	
		10,000 Equity Shares of ₹10 each fully paid	1,00,000
		(*b*) Reserves and Surplus	50,000
			1,50,000
	2	Non-current Liabilities	
		Long-term Borrowings:	
		Debentures	50,000
			50,000
	3	Current Liabilities:	
		Trade Payables	50,000
			50,000
		TOTAL (1) + (2) + (3)	2,50,000
B		**Assets**	
	1	Non-current Assets	
		(*a*) Fixed Assets	
		Tangible Assets	2,50,000
	2	Current Assets	2,50,000
		TOTAL (1) + (2)	2,50,000

A Ltd. is to be taken over by B Ltd. Each share of A Ltd. has a market value of ₹15, while that of B Ltd. has a market value of ₹30. The purchase consideration is to be satisfied in the form of shares to be issued by B Ltd. You are required to ascertain the amount of purchase consideration.

Solution:

Each share of B Ltd. has a market value of ₹30, while that of A Ltd. has a market value of ₹15. It means for every two shares of A Ltd., B Ltd. will issue one share. The amount of purchase consideration can, therefore, be ascertained as follows:

10,000 ÷ 2 = 5,000 shares issued at ₹30 = ₹1,50,000

In case B Ltd. decides to issue shares at par, the amount of purchase consideration would be ₹50,000 (i.e. 5,000 shares × ₹10).

Shares at par or market value

The shares issued towards payment of purchase consideration may be taken at par or market value as per the directions of the question or the circumstances as apparent from the question. In the absence of any specific or implied direction, the students may make their own presumptions and give a note to that effect. Consider the following illustration.

Illustration 8.3:

(i) P Ltd. agrees to issue three shares of ₹10 each, ₹4 paid up for every 2 shares of V Ltd. V Ltd. has a share capital of ₹10,000 shares of ₹10 each, ₹8 paid up.

(ii) P Ltd. agrees to issue three shares of ₹10 each ₹5 paid up (market price ₹8) for every 2 shares (market price ₹12) of V Ltd. V Ltd. has a share capital of 10,000 shares of ₹10 each, ₹8 paid up.

(iii) P Ltd. agrees to take over the business of V Ltd. The market price of each share of P Ltd. is ₹20 (face value ₹10) while that of V Ltd. is ₹15. The issued share capital of V Ltd. consists of 10,000 equity shares of ₹10 each fully paid up.

(iv) P Ltd. agrees to issue three shares of 10 each at a market price of ₹15 per share for every 2 shares of ₹10 each (market price ₹20) of V Ltd. The issued share capital of V Ltd. consists of 10,000 shares of ₹10 each, fully paid up.

Calculate the amount of purchase consideration in each of the above cases.

Solution:

(i) In this case there is no reference of market value in the question. The amount of purchase consideration may, therefore, be computed as follows:

Shares in P Ltd.:

[(10,000 □ 2) × 3] = 15,000 shares of ₹10 each, ₹5 paid up = ₹75,000

(ii) In this case reference to market value of shares will have no relevance in computation of purchase consideration. The shares are being issued by the purchasing company at paid up value.

Shares in P Ltd.:

[(10,000 □ 2) □ 3] = 15,000 shares of ₹10 each, ₹5 paid up = ₹75,000]

(iii) In this case the market price of the shares of each of the companies will determine the share exchange ratio

P Ltd. Market Price ₹20

V Ltd. Market Price ₹15

This means for every 4 shares of V Ltd., P Ltd., will issue its 3 shares.

However, in the absence of any specific or implied instructions in the question, the purchase consideration may be computed on the basis of face value or market value of shares.

(a) If shares are presumed to have been issued by P Ltd. at par or face value:

Shares in P Ltd.:

[(10,000 □ 4) × 3] = 7,500 shares at ₹10 each = ₹75,000

(b) If shares are presumed to have been issued by P Ltd. at market value:

Shares in P Ltd.:

7,500 at ₹20 each = ₹1,50,000

(iv) In this case P Ltd. is issuing shares at market price. This has been specified in the question. Since the share exchange ratio has been already agreed upon, the information as to market price of the shares of V Ltd. has no significance. The purchase consideration may therefore be computed as follows:

Shares in P Ltd.:

[(10,000 ¸ 2) × 3] = 15,000 shares at ₹15 per share = ₹2,25,000 •

Share fractions

It is a common practice to issue shares as a form of payment of purchase consideration by the purchasing company to the vendor company. However, sometimes on account of the share exchange ratio it may not be possible for the purchasing company to issue whole number of shares to the shareholders of the vendor company. In other words, there may be a problem of share fractions. Since shares can be issued only in whole numbers, the purchasing company pays cash for share fractions at a price mutually agreed for the whole share.

This can be understood with the following example:

Example. The purchasing company agrees to issue four shares of ₹10 each for every three shares of ₹10 each of the vendor company. The total number of shares of the vendor company are 10,000.

The market price of each share of the purchasing company is ₹15.

In this case, the total number of shares to be issued by the purchasing company to the vendor company will amount to 10,000 × 4/3 = 13,333 1/3. There is a fraction of 1/3 of a share. The purchase consideration would, therefore, be satisfied as follows:

In shares	13,333 @ ₹15 each	1,99,995
In cash 15 × (1/3)		5
		2,00,000

Note: In the absence of any specific instruction in the question, it is presumed that the cash for a fraction of a share will be paid on the basis of the market price of the share.

8.2.4 Types of Amalgamation

Amalgamation for accounting purposes can be classified into two categories:

(*i*) Amalgamation in the nature of merger, and

(*ii*) Amalgamation in the nature of purchase.

Amalgamation in the nature of merger This is a type of amalgamation which satisfies all the following conditions:

(*a*) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(*b*) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(*c*) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(*d*) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(*e*) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

In this type of amalgamation, there is a genuine pooling of assets and liabilities of the combining entities. In addition, equity shareholders of the combining entities continue to have a proportionate share in the combined entity. The accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies.

Amalgamation in the nature of purchase: This can be described as an amalgamation which does not satisfy any one or more of the conditions specified for 'amalgamation in the nature of merger'.

Check Your Progress

1. Mention the categories in which companies involved in amalgamation, absorption or external reconstruction classified?
2. In which type of amalgamation is there a genuine pooling of assets?

8.3 ACCOUNTING ENTRIES IN THE BOOKS OF COMPANIES

NOTES

Regarding recording of transactions in the books of account there is no difference whether it is a case of amalgamation, absorption or external reconstruction. In each case there are two parties involved, *i.e.* the vendor company or companies and the purchasing company as shown below:

Combination	*Vendor Company or Companies*	*Purchas-*
ing Company		
Amalgamation in the	Two or more existing companies to	New company formed
for		
nature of merger*	be liquidated	the purpose of taking
over		
		the business
Absorption	One or more companies to be	Existing company taking
(or amalgamation in	liquidated	over the business
the nature of purchase)*		
External	Only one existing company to be	A new company formed
to		
Reconstruction	liquidated	take over the business

* Please refer to AS: 14

In the following pages we are giving the accounting entries to be passed in the books of both the vendor company(s) and the purchasing company.

Books of Vendor Company

Since, the vendor company has to wind up its business, it will dispose of all its assets, make payment of all of its liabilities and distribute the surplus if any among its shareholders. The accounting entries to be passed in its books are as follows:

(*i*) For transfer of Assets:

Realisation A/c	Dr.
To Sundry Assets	

(Each asset should be credited individually at its book value. All assets have to be transferred. Of course, Cash or Bank balance will not be transferred, if it has not been taken over by the purchasing company since it is already a realised amount. Similarly, fictitious assets such as debit balance in the profit and loss account, preliminary expenses, etc. will not be transferred. Such assets will be directly transferred to the equity shareholders account. The objective of passing this entry is to close accounts of all assets.)

(*ii*) For transfer of liabilities:

Sundry Liabilities	Dr.
To Realisation A/c	

(Each liability should be debited individually at its book value. Only such liabilities are to be transferred which have been taken over by the purchasing company. Items representing shareholders' funds do not constitute liabilities for this purpose.).

(*iii*) For purchase consideration due:

Purchasing Company	Dr.
To Realisation A/c	
(With the amount of purchase consideration)	

NOTES

(*iv*) For receipt of purchase consideration:

Shares in Purchasing Company	Dr.
Debentures in Purchasing Company	Dr.
Bank	Dr.
To Purchasing Company	

(The shares and debentures are to be recorded at the price at which they have been received from the purchasing company.)

(*v*) For payment of liabilities not taken over by the purchasing company;

Sundry Liabilities (not taken over)	Dr.
To Bank/Shares in Purchasing Company	

(Liabilities not taken over by the purchasing company will be paid by the vendor company. Any profit or loss on payment of such liability will be transferred to Realisation Account.)

(*vi*) For money due to preference shareholders:

Preference Share Capital A/c	Dr.
To Preference Shareholders A/c	

(*vii*) For payment to preference shareholders:

Preference Shareholders A/c	Dr.
To Bank/Shares in Purchasing Company	

(In case preference shareholders are paid less or more than what is due to them as per the books of the vendor company, any profit or loss on payment to them will be transferred to the realisation account. Alternatively, the amount may be transferred to equity shareholders account.)

(*viii*) For liquidation expenses: There can be three situations:

(*a*) The vendor company may have to meet the liquidation expenses. In such a case, will be as follows:

Realisation A/c	Dr.
To Bank	

(*b*) The purchasing company may agree to pay to the vendor company a fixed amount by way of liquidation expenses. In such a case, the amount payable as liquidation expenses will be included in the amount of purchase consideration. On payment of such expenses by the vendor company, entry as given in (*a*) above will be passed in the books of the vendor company.

(*c*) The purchasing company may agree to reimburse the vendor company to the extent of liquidation expenses incurred by it. In such a case, the following entries will be passed:

(1) On payment of liquidation expenses:

Purchasing Company	Dr.
To Bank	

(2) On reimbursement from the purchasing Company:

Bank A/c	Dr.
To Purchasing Company	

Alternatively, in cases, (*b*) and (*c*), no entry may be passed in the books of the vendor company. However, this is not advisable.

(*ix*) For transfer of profit on realisation:

Realisation A/c	Dr.
To Equity Shareholders A/c	

(In case of loss the entry will be reversed.)

(*x*) For transfer of equity share capital reserves, etc.:

Equity Share Capital A/c	Dr.
General Reserve	Dr.
Accumulated Profits	Dr.
To Equity Shareholders A/c	

(*xi*) For transfer of fictitious assets:

Equity Shareholders A/c
To Profit and Loss A/c (Debit balance)
To Preliminary Expenses A/c
To Expenses on Issue of Shares A/c

(*xii*) For payment to equity shareholders:

Equity Shareholders A/c	Dr.
To Shares in Purchasing Company	
To Bank	

Books of Purchasing Company

(*i*) For purchase consideration due:

Business Purchase A/c	Dr.
To Liquidator of Vendor Company	

(With the amount of purchase consideration)

(*ii*) For taking over assets and liabilities:

Assets taken over	Dr.
To Liabilities taken over	
To Business Purchase A/c	

(Each asset and liability is to be debited or credited individually at the values taken over and not at the values at which they are appearing in the books of the vendor company. Goodwill if any, appearing in the vendor company's books, should not be recorded here. In case, the value of net assets is more than the amount of purchase consideration, the balance should be credited to capital reserve. In case the purchase consideration is more than the value of the net assets the balance should be debited to goodwill.)

(*iii*) For payment of Purchase consideration:

Liquidator of Vendor Company	Dr.
To Share Capital	
To Share Premium	
To Debentures	
To Bank	

(In case the share or debentures have been issued at premium or discount, the relevant premium or discount account should be credited or debited, as the case may be.)

(*iv*) **For liquidation expenses.** The entry for liquidation expenses, when payable by the purchasing company, is as follows:

(*i*) *If the purchasing company agrees to pay a fixed amount by way of liquidation expenses to the vendor company.* In such a case the amount of liquidation expenses will be included in the purchase consideration and no separate entry will be required.

(*ii*) *If the purchasing company agrees to reimburse the vendor company to the extent of liquidation expenses.* In such a case the amount of liquidation expenses will not be included in the amount of purchase consideration. The following entry will be passed separately on payment of such expenses:

Goodwill/Capital Reserve	Dr.
To Bank	

(The amount of liquidation expenses will be debited to goodwill or capital reserve account, as calculated under entry (*ii*) discussed above.)

NOTES

8.4 JOURNAL ENTRIES IN THE BOOKS OF TRANSFEROR AND TRANSFEREE COMPANIES AND REVISED BALANCE SHEET

It may be noted that the Accounting Standard deals with the accounting mechanism only in the books of the transferee company. So far as the books of the transferor company are concerned, the normal procedure of accounting through the realisation account, as stated in the preceding pages, will be followed in both the methods of amalgamation. The accounting procedures will differ depending upon the type of amalgamation.

There are two main methods of accounting for amalgamation in the books of the transferee company:

(*i*) The Pooling of Interests Method, and (*ii*) The Purchase Method.

Pooling of interests method: This method of accounting is applicable for amalgamation in the nature of Merger. In this case, the amalgamation is accounted for as if the separate businesses of the amalgamating companies were intended to be carried on by the transferee (*i.e.* amalgamated) company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies. The following factors should be taken into consideration while making accounting entries in this method:

(*a*) In the books of the transferee company, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation), of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve, if any. This reflects the fact that the entries are simply merged together. However, if the purchase consideration is more than the net assets, the excess may be charged to *P* & *L* Account or Goodwill. In a reverse case the balance in *P* & *L* Account or Revenue Reserves will be appropriately adjusted.

(*b*) The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted against the reserves of transferee company.

The following journal entries are appropriate for incorporating the financial statements of the transferor company in the books of the transferee company:

1. On amalgamation of the business:

Business Purchase A/c	Dr.	With the amount of
To Liquidator of Transferor Company		purchase consideration

2. When assets, liabilities and reserves are taken over from the transferor company and incorporated in the books:

Sundry Assets (individually)	Dr.	book value
To Sundry Liabilities (individually)		book value
To Profit and Loss A/c		book balance
To Reserves		book balance
To Business Purchase A/c		purchase consideration

The difference between the debits and credits is adjusted in the reserves of the transferee company.

3. When the purchase consideration is satisfied:

Liquidator of Transferor company	Dr.	
To Share Capital		issued
To Securities Premium		premium amount
To Cash/Bank		for fractional shares and for dissenting shareholders
To Non-cash. Considerations*		fair value for dissenting shareholders

Instead of passing the above entries one combined entry is appropriate.

Sundry Assets	Dr.	book value
To Sundry Liabilities		book value
To Profit and Loss A/c		book balance
To Reserves		book balance
To Share Capital		issued
To Securities Premium (or debit discount on issue of shares)		premium amount
To Cash/Bank		for fractional shares and for dissenting shareholders
To Non-cash considerations*		fair value for dissenting shareholders

The difference between the above-mentioned debits and credits is adjusted against the reserves in books of transferee company.

4. If the liquidation expenses of the transferor company are borne by the transferee company it may be charged against the profit and loss account of the combined entity.

Profit and Loss A/c	Dr.	With the amount of
To Bank		expenditure

5. With the formation expenses of the transferee company.

Preliminary Expenses A/c	Dr.	With the amount of
To Bank		expenditure

Purchase method. This method of accounting is applicable for amalgamation in the nature of purchase. The following factors should be considered while making accounting entries in this method:

(*a*) In the books of the transferee company the assets and liabilities of the transferor company should be incorporated at their existing carrying amount or the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values.

(*b*) The reserves (whether capital or revenue arising on revaluation) of the transferor company other than the statutory reserves should not be included in the financial statements of the transferee company.

(*c*) Any excess of the purchase consideration over the value of net assets of the transferor company should be treated as goodwill and debited to goodwill account. On the other hand, if the purchase consideration is lower than the value of net assets acquired, the difference should be credited to capital reserve.

(*d*) If it becomes necessary to carry forward any statutory reserve of the transferor company in the books of the transferee for legal compliance, it is accounted by debiting "Amalgamation Adjustment Account" and crediting "Statutory Reserve Account."

(*e*) The Amalgamation Adjustment account should be disclosed under the heading Reserves & Surplus (negative) in the balance sheet. When the identity of the statutory reserve is no longer required to be maintained, both Statutory Reserve Account and Amalgamation Adjustment Account should be reversed.

Thus, the accounting entries in the books of transferee company to be passed can be summarised as follows:

(1) For taking over assets and liabilities:

Sundry Assets (individually)	Dr.	fair value/book value
To Sundry Liabilities (individually)		fair value/book value
To Share Capital		issued
To Securities Premium (or debit discount on issue of shares)		premium amount
To Cash/Bank		
To Non-cash Considerations		fair value

The difference between the above-mentioned debits and credits is debited to goodwill account or credited to capital reserve as the case may be.

(2) When Statutory Reserve is maintained:

Amalgamation Adjustment A/c	Dr.	with the amount of
To Statutory Reserve A/c (by name)		statutory reserve

(3) When Statutory Reserve is to be cancelled:

Statutory Reserve A/c (by name)	Dr.	with the amount of
To Amalgamation Adjustment A/c		Statutory Reserve

Illustration 8.4: (Merger). The following was the Balance Sheet of *V* Ltd. as on 31st March, 2012:

Particulars	*Note No.*	*Amount (₹ in lakhs)*
Equity and Liabilities		
(1) Shareholders' Funds		
(*a*) Share Capital	1	1,150
(*b*) Reserves and Surplus	2	(87)
(2) Non-current Liabilities		
Long-term Borrowings: 10% Secured Debentures	3	600
(3) Current Liabilities		
Trade Payables		200
TOTAL		1,863

Assets		
(1) Non-current Assets:		
Tangible Assets	4	1,152
(2) Current Assets:		
Inventories		380
Trade Receivables		256
Cash and Cash Equivalents	5	75
TOTAL		1,863

Notes to Accounts	*(in ₹ lakhs)*
(1) Share Capital	
Authorised:	
.... Shares of ₹10 each	....
Issued, Subscribed and Paid-up:	
80 lakhs Equity Shares of ₹10 each, fully Paid-up	800
35 lakhs, 12% Cumulative Preference Shares of ₹10 each fully paid	350
TOTAL	1,150
(2) Reserves and Surplus	
Profit & Loss Account	(87)
TOTAL	(87)
(3) Current Liabilities:	
Trade Payables	170
Outstanding Debenture Interest	30
TOTAL	200
(4) Tangible Assets	
Land and Buildings	445
Plant and Machinery	593
Furniture, Fixtures and Fittings	114
TOTAL	1,152
(5) Cash and Cash Equivalents	
Balance at Bank	69
Cash in Hand	6
TOTAL	75

On 1st April, 2012, *P* Ltd. took over the entire business of *V* Ltd, on the following terms:

V Ltd.'s equity shareholders would receive 4 fully paid equity shares of *P* Ltd. of ₹10 each issued at a premium of ₹2.50 each for every five shares held by them in *V* Ltd.

Preference shareholders of *V* Ltd. would get 35 lakh 13% Cumulative Preference Shares of ₹10 each fully paid up in *P* Ltd., in lieu of their present holding.

All the debentures of *V* Ltd. would be converted into equal number of 10.5% Secured Cumulative Debentures of ₹100 each, fully paid up after the take over by *P* Ltd., which would also pay outstanding debenture interest in cash.

Expenses of amalgamation would be borne by *P* Ltd. Expenses came to be 12 lakhs, *P* Ltd. discovered that its creditors included ₹7 lakhs due to *V* Ltd. for goods purchased. Also *P* Ltd.'s stock included goods of the invoice price of ₹5 lakhs earlier purchased from *V* Ltd., which had charged profit @ 20% of the invoice price.

You are required to:

(*i*) Prepare Realisation A/c in the books of *V* Ltd.

(*ii*) Pass journal entries in the books of *P* Ltd. assuming it to be an amalgamation in the nature of merger.

NOTES

Solution:

(*i*) **Books of *V* Ltd.**

Realisation Account (₹ *in lakhs)*

Particulars	₹	*Particulars*	₹
To Land and Buildings A/c	445	By 10% Secured Cumulative Debentures A/c	600
To Plant and Machinery A/c	593	By Outstanding Debenture Interest A/c	30
To Furniture, Fixtures & Fittings A/c	114	By Trade Payables A/c	170
To Inventories A/c	380	By *P* Ltd. A/c (*WN*)	1,150
To Trade Receivables A/c	256		
To Bank A/c	69		
To Cash in Hand A/c	6		
To Equity Shareholders' A/c (Profit on Realisation)	87		
	1,950		1,950

(*ii*) **Books of *P* Ltd.**

Journal Entries (₹ *in lakhs)*

Particulars		*Dr.* ₹	*Cr.* ₹
Business Purchase A/c	Dr.	1,150	
To Liquidator of *V* Ltd.			1,150
(Being purchase consideration due)			
Land and Buildings A/c	Dr.	445	
Plant and Machinery A/c	Dr.	593	
Furniture, Fixtures & Fittings A/c	Dr.	114	
Inventories A/c	Dr.	380	
Trade Receivables A/c	Dr.	256	
Bank A/c	Dr.	69	
Cash in Hand A/c	Dr.	6	
Profit and Loss A/c	Dr.	87	
To 10% Debentures A/c			600
To Outstanding Debenture Interest A/c			30
To Trade Payables A/c			170
To Business Purchase A/c			1,150
(Being assets and liabilities taken over from *V* Ltd. under the scheme of amalgamation in the nature of merger)			
Liquidators of *V* Ltd. A/c	Dr.	1,150	
To Equity Share Capital A/c			640
To 13% Cumulative Preference Shares A/c			350
To Securities Premium A/c			160
(Being discharge of consideration, by allotment of 64 lakhs equity shares of ₹10 each at a premium of ₹2.50 per share and 35 lakhs, 13% cumulative preference shares of ₹10 each at par)			
10% Secured Cumulative Debentures A/c	Dr.	600	
To 10.5% Secured Cumulative Debentures A/c			600
(Being 10% Secured Cumulative Debentures of *V* Ltd. converted into 10.5% Secured Cumulative Debentures of *P* Ltd.)			
Outstanding Debenture Interest A/c	Dr.	30	
To Bank A/c			30
(Being outstanding debenture interest paid in cash by *P* Ltd.)			
Goodwill A/c*	Dr.	2	
To Bank A/c			2
(Being amalgamation expenses met by *P* Ltd.)			

Trade Payables A/c	Dr.	7	
To Trade Receivables A/c			7
(Being settlement of mutual liability)			
Profit and Loss A/c	Dr.	1	
To Inventories A/c (5 × 20%)			1
(Being unrealized profit on stock eliminated from the inventories of *P* Ltd.)			

Working Note:

Computation of Purchase Consideration payable by *P* Ltd.

(₹ in lakhs)

Payment to Preference Shareholders:	
13% Cumulative Preference Shares of ₹10 each (35 lakhs shares × ₹10)	350
Payment to Equity Shareholders: (80 lakhs shares × 4/5)= 64 lakhs equity shares @ ₹10	640
Securities Premium (64 lakhs equity shares @ ₹2.5)	160
Total Purchase Consideration	1,150

Illustration 8.5. (Merger & Purchase). *A* Ltd. acquires *B* Ltd. for a consideration of ₹38,00,000 to be satisfied in the form of fully paid equity shares of ₹10 each. The balance sheets of the two companies on 31st March, 2012, the date of acquisition, were as follows:

***A* Ltd. and *B* Ltd.**

Balance Sheet as at 31 March, 2012

	Particulars	*A Ltd. (₹)*	*B Ltd. (₹)*
A	**Equity and Liabilities**		
1	Shareholders' Funds		
	(*a*) Share Capital:		
	Authorised:		
	....Equity Shares of ₹10 each		....
	Issued, Subscribed & Paid up:		
	4,00,000, Equity Shares ₹10 fully paid up	40,00,000	
	2,50,000, Equity Shares of ₹10 fully paid up		25,00,000
	(*b*) Reserves and Surplus:		
	General Reserve	15,00,000	3,00,000
	Development Rebate Reserve	3,00,000	1,00,000
	Export Profit Reserve	6,00,000	4,00,000
	Profit and Loss Account	12,00,000	9,00,000
		–	
		76,00,000	42,00,000
2	Current Liabilities:		
	Trade Payables	20,00,000	16,00,000
		20,00,000	16,00,000
	TOTAL (1) + (2)	96,00,000	58,00,000
B	**Assets**		
1	Non-current Assets	–	–
2	Current Assets	96,00,000	58,00,000
		96,00,000	58,00,000
	TOTAL (1) + (2)	96,00,000	58,00,000

You are required to pass the necessary journal entries in the books of *A* Ltd. (transferee company, when amalgamation is by way of (*i*) merger and (*ii*) by way of purchase). Also prepare the resultant Balance Sheets presuming that the Development Rebate Reserve and Export Profit Reserve are required to be continued.

NOTES

Solution:

(*i*) **When amalgamation is by way of merger** In such a case accounting entries are passed according to "pooling of interests" method.

Books of *A* Ltd.

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Business Purchase A/c	Dr.	38,00,000	
	To Liquidator of *B* Ltd.			38,00,000
	(Being purchase consideration due)			
	Sundry Assets A/c	Dr.	58,00,000	
	General Reserve A/c (bal. figure)	Dr.	13,00,000	
	To Sundry Liabilities			16,00,000
	To Profit and Loss A/c			9,00,000
	To Export Profit Reserve A/c			4,00,000
	To General Reserve A/c			3,00,000
	To Development Rebate Reserve A/c			1,00,000
	To Business Purchase A/c			38,00,000
	(Being merger of assets and liabilities of company of *B* Ltd. with *A* Ltd.)			
	Liquidator of *B* Ltd.	Dr.	38,00,000	
	To Equity Share Capital A/c			38,00,000
	(Being settlement of purchase consideration)			

***A* Limited (after Amalgamation by way of Merger)**

Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Funds	
		(*a*) Share Capital	
		Authorised:	
		...Equity Shares of ₹10 each	....
		Issued, Subscribed & Paid-up:	
		7,80,000, Equity Shares ₹10 fully Paid-up	78,00,000
		(*b*) Reserves and Surplus	
		General Reserve	5,00,000
		Development Rebate Reserve	4,00,000
		Export Profit Reserve	10,00,000
		Profit and Loss Account	21,00,000
			1,18,00,000
		(*c*) Money Received Against Share Warrants	
	2	Current Liabilities:	
		Trade Payables	36,00,000
			36,00,000
		TOTAL (1) + (2)	1,54,00,000
B		**Assets**	
	1	Non-current Assets	–
	2	Current Assets	1,54,00,000
		TOTAL (1) + (2)	1,54,00,000

NOTES

(*ii*) **When amalgamation is by way of purchase** In such a case the accounting entries are passed as per "the purchase method".

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	Business Purchase A/c	Dr.	38,00,000	
	To Liquidator of *B* Ltd.			38,00,000
	(Being purchase consideration due to *B* Ltd.)			
	Current Assets	Dr.	58,00,000	
	To Sundry Liabilities			16,00,000
	To Business Purchase A/c			38,00,000
	To Capital Reserve			4,00,000
	(Being taking over of assets and liabilities of *B* Ltd.)			
	B Ltd.	Dr.	38,00,000	
	To Equity Share Capital A/c			38,00,000
	(Being payment of purchase consideration)			
	Amalgamation Adjustment A/c	Dr.	5,00,000	
	To Development Rebate Reserve Account			1,00,000
	To Export Profit Reserve A/c			4,00,000
	(Being carrying forward of statutory reserves in the books of transferee company)			

_A_ Limited (after Amalgamation by way of purchase)
Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Funds	
		(*a*) Share Capital:	
		Issued, Subscribed: 7,80,000, Equity Shares ₹10 fully Paid up	78,00,000
		(*b*) Reserves and Surplus:	
		General Reserve	15,00,000
		Capital Reserve	4,00,000
		Development Rebate Reserve	4,00,000
		Export Profit Reserve	10,00,000
		Profit and Loss Account	12,00,000
		Amalgamation Adjustment Account	(5,00,000)
			1,18,00,000
	2	Current Liabilities	
		Trade Payables	36,00,000
			36,00,000
		TOTAL (1) + (2)	1,54,00,000
B		**Assets**	
	1	Non-current Assets	–
	2	Current Assets	1,54,00,000
			1,54,00,000
		TOTAL (1) + (2)	1,54,00,000

Check Your Progress

3. Mention the journal entry in the books of vendor company for transfer of liabilities.
4. What is the journal entry to be passed if the purchasing company agrees to pay a fixed amount by way of liquidation expenses to the vendor company?
5. In which type of amalgamation is the pooling of interest method followed?

8.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. Companies involved in amalgamation, absorption or external reconstruction are classified as vendor and purchasing companies.
2. In the amalgamation in the nature of merger, there is genuine pooling of assets and liabilities of the combining entities.
3. The following is the journal entry in the books of vendor company for transfer of liabilities:

   Sundry Liabilities Dr.

   To Realisation A/c
4. If the purchasing company agrees to pay a fixed amount by way of liquidation expenses to the vendor company. In such a case the amount of liquidation expenses will be included in the purchase consideration and no separate entry will be required.
5. The pooling of interest method is applicable for amalgamation in the nature of merger.

8.6 SUMMARY

- Under the Companies Act 2013, the term amalgamation includes absorption for all purposes.
- Section 233 of the Companies Act 2013, provides as under for a scheme of merger or amalgamation between two or more companies.
- The companies involved in case of amalgamation, absorption or external reconstruction can be classified as vendor company and purchase company.
- The Accounting Standard 14 issued by the Institute of Chartered Accountants of India specified the procedure for accounting for amalgamation and the treatment of any resultant goodwill or reserves.
- While amalgamation may take place in case of merging of one company with another or merging of two or more companies to form a new company; absorption means taking over the business of one or more companies by another company.
- As per AS 14 the distinction between amalgamation and absorption is of no significance.
- Purchase consideration refers to the amount payable by the purchase company to the vendor company for taking over the business of such company.
- It may take the form net present value method or net asset method.
- Amalgamation may be classified as amalgamation in the nature of merger and amalgamation in the nature of purchase.

- Regarding recording of transactions in the books of account there is no difference whether it is a case of amalgamation, absorption or external reconstruction.
- The two main methods of accounting for amalgamation in the books of transferee company are: the pooling of interests method and purchase method.

8.7 KEY WORDS

- **Amalgamation:** It is a term which is used when two or more existing companies go into liquidation and a new company is formed to take over their business.
- **Absorption:** It is term used when one or more existing companies go into liquidation and some existing company takes over or purchase their businesses.

8.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the categories of amalgamations?
2. What does the AS 14 say about amalgamation and absorption?
3. List the accounting entries to be passed in the books of the transferee company.

Long Answer Questions

1. Describe the scheme of amalgamation or merger under the Companies Act 2013.
2. Explain the journal entries to be made in the books of vendor and purchasing companies in case of amalgamation or absorption.
3. Discuss the two main methods of accounting for amalgamations in the books of the transferee company.

8.9 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *An Introduction to Accountancy, 12/e.* New Delhi: Vikas Publishing House.

Goyal, V. K. and R Goyal. 2012. *Corporate Accounting.* India: PHI Learning.

Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

BLOCK - III
HOLDING COMPANY ACCOUNTS

NOTES

UNIT 9 EXTERNAL RECONSTRUCTION AND INTERNAL CONSTRUCTION

Structure

9.0 Introduction
9.1 Objectives
9.2 Meaning of External and Internal Reconstruction
9.3 Internal Reconstruction: Accounting Treatment
9.3.1 Alteration of Share Capital
9.3.2 Capital Reduction Account
9.4 Answers to Check Your Progress Questions
9.5 Summary
9.6 Key Words
9.7 Self Assessment Questions and Exercises
9.8 Further Readings

9.0 INTRODUCTION

As mentioned in the previous unit, the changing of the capital structure of a firm is called reconstruction. There can be many different reasons for reconstruction, whether it is to save costs, to eliminate competition, to focus on special segments, to save tax or many more. In the previous unit, you were introduced to the concepts of amalgamation and absorption. In this unit, the concentration will be on internal reconstruction.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning of internal and external reconstruction
- Explain the accounting treatment in case of alteration of share capital
- Describe the accounting treatment in case of capital reduction

NOTES

9.2 MEANING OF EXTERNAL AND INTERNAL RECONSTRUCTION

As it has been explained in Unit 8, the term, reconstruction means reorganizing the capital structure of a company including the reduction of claims of both the shareholders and the creditors against the company. Such a reconstruction generally becomes necessary on account of bad financial position of the company. It may be ‘‘external’’ as well as ‘‘internal’’. In case of external reconstruction, a new company is formed to 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.

Section 319 of the Companies Act, 2013 facilitates amalgamation, absorption and reconstruction of companies. It provides that the liquidator of a company can accept shares, policies or like interest in consideration of the sale of the company’s undertaking to another company with the object of distributing them amongst the members of the transferor company provided the following two conditions are satisfied:

(i) A special resolution is passed by the company to that effect.

(ii) The liquidator purchases the interest of any dissenting member at a price to be determined by agreement or the registered valuer.

The money to the dissenting member should be paid before the company is dissolved and should be raised in such manner as determined by a special resolution.

Amalgamation and External Reconstruction

Amalgamation is different from external reconstitution in the following respects:

(i) Objective The objective of external reconstruction is to reorganise the financial structure of the company. While the objective of amalgamation is to cut competition and to reap economies of large scale.

(ii) Number of companies In case of amalgamation, two or more companies are amalgamated to form one new company or where one or more companies are merged in another or taken over by an existing company. On the other hand, in case of external reconstruction only one company is involved in reorganisation of the company’s financial structure.

(iii) Vesting of rights and liabilities Amalgamation involves the amalgamation of the rights and liabilities and the transferee company becomes vested with all such rights and liabilities. While in case of external reconstruction the undertaking is carried on by the company is not in substance transferred to an outsider but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company.

In case of internal reconstruction, the capital of a company is reorganized to infuse new life in the company. It includes both alteration and reduction of share capital.

9.3 INTERNAL RECONSTRUCTION: ACCOUNTING TREATMENT

In this section, you will learn about the accounting treatment in various cases of internal reconstruction.

9.3.1 Alteration of Share Capital

The Companies Act has used the words, ‘‘Alteration Proper’’ for alteration of share capital. Such alteration can be done under provisions of Sections 61 and 62 of the Companies Act, 2013. The term alteration proper includes the following:

(*i*) Increase of share capital by issue of new shares.

(*ii*) Consolidation or subdivision of the existing shares into shares of larger or smaller denominations.

(*iii*) Conversion of fully paid shares into stocks and *vice versa.*

(*iv*) Cancellation of the unissued shares.

A company can make these alterations by passing an ordinary resolution, if it is authorised by its Articles of Association to do so. Such alteration must be notified and a copy of the resolution should be filed with the Registrar within 30 days of the date of the passing of such resolution.

Accounting entries

The accounting entries in respect of alteration of share capital are as follows:

(*i*) ***Increase of share capital.*** This is similar to making a fresh issue of share capital.

(*ii*) ***Consolidation of shares.*** In case of consolidation of shares, shares of smaller denominations are converted into shares of larger denominations. In such a case the paid up share capital remains the same but the number of shares get reduced.

Example. A company having equity share capital of ₹1 lakh divided into shares of ₹10 each decides to convert the share capital into equity shares of ₹100 each.

The following journal entry will be passed for such conversion:

Equity Share Capital (₹10) A/c	Dr.	1,00,000	
To Equity Share Capital (₹100) A/c			1,00,000
(Being conversion of 10,000 equity shares of ₹10 each into 1,000 shares of 100 each)			

(*iii*) ***Subdivision of shares.*** In this case, shares of larger denominations are converted into shares of smaller denominations. The journal entry in respect of such conversion would be on the same pattern as explained in case of consolidation of shares, except the number of shares would increase.

Example. A company having equity share capital of ₹1 lakh divided into shares of ₹100 each decides to convert it into shares of ₹10 each.

In such a case the journal entry will be as follows:

Equity Share Capital (₹100) A/c	Dr.	1,00,000	
To Equity Share Capital (₹10) A/c			1,00,000
(Being conversion of 1,000 shares of ₹100 each into 10,000 equity shares of ₹10 each)			

(*iv*) ***Conversion of shares into stock.*** A company can convert its fully paid up shares into stock or *vice-versa*. In case shares are converted into stock, the following journal entry will be passed:

Share Capital A/c	Dr.
To Capital Stock A/c	

(*v*) ***Cancellation of unissued shares.*** In case a company cancels its unissued shares, it does not require any accounting entry to be passed. The authorised share capital of the company will stand reduced by the amount of unissued shares now cancelled.

9.3.2 Capital Reduction Account

A company can reduce its share capital as per the provisions of Sections 66 of the Companies Act, 2013. The term reduction of share capital includes the following:

(*i*) Writing off lost capital.

(*ii*) Refunding surplus paid-up capital.

(*iii*) Reducing liability of the members for uncalled capital.

A company can reduce its share capital only when each of the following conditions is satisfied:

(*i*) The Articles of Association of the company permits such reduction.

(*ii*) The company passes a special resolution for reducing its share capital.

(*iii*) The company obtains the confirmation of the National Company Law Tribunal (NCLT) in respect of such reduction.

In order to get the confirmation of the National Tribunal, the company has to file a scheme of reconstruction with the National Tribunal. The National Tribunal, before sanctioning such a scheme of reduction would look to the protection of the interests of the creditors and minority groups of the shareholders. In case these parties object to the scheme, the National Tribunal will see that their claims against the company are satisfied to the satisfaction of the National Tribunal.

Reduction of capital will not be effective until a copy of the resolution and sanction of the National Tribunal is filed and registered with the Registrar of joint stock companies. *NCLT* may, at its discretion, order the words "and reduced" to be added to the name of the company for the period it prescribes. *NCLT* may also require the company to publish the reasons for reduction of capital for the information of the public.

Accounting entries

Accounting entries to be passed in respect of reduction of share capital are as follows:

(*i*) ***Writing off lost capital.*** This means writing off or cancelling that part of the paid up capital which is not represented by tangible assets.

Example. Following is the Balance Sheet of *A* Ltd. as on 31 March, 2012:

***A* Ltd.**
Balance Sheet as at 31 March, 2012

	Particulars	₹
A	**Equity and Liabilities**	
1	Shareholders' Fund	
	(*a*) Share Capital	
	Authorised:	
	.... Shares of ₹10 each	....
	Issued, Subscribed & Paid-up:	
	10,000 Equity Shares of ₹10 each fully paid	1,00,000
	(*b*) Reserves and Surplus:	
	Profit and Loss Account	(50,000)
		–
		50,000
2	Current Liabilities:	
	Trade Payables	50,000
		50,000
	TOTAL (1) + (2)	1,00,000
B	**Assets**	
1	Non-current Assets	
	(*a*) Fixed Assets	
	(*i*) Tangible Assets	50,000
	(*ii*) Intangible Assets: Goodwill	20,000
		70,000
2	Current Assets	30,000
		30,000
	TOTAL (1) + (2)	1,00,000
		–

The above balance sheet shows that company has lost ₹70,000 (*i.e. P & L* account ₹50,000 plus Goodwill ₹20,000) of its paid up share capital. This may be written off by means of the following journal entry:

Share Capital A/c	Dr.	70,000	
To Capital Reduction A/c			70,000

The share capital now stands reduced to ₹30,000. However, this reduction of share capital can be effected in two ways. One alternative could be only to reduce the paid-up value of the existing shares from ₹10 to ₹3 each without reducing the nominal value of the shares. This means, the shareholders can be asked in future to pay ₹7 more if the company requires additional funds. The journal entry in such a case will be the same as explained above.

The shareholders will not generally be willing for the above alternative since it puts additional burden on them. Other alternative can, therefore, be to reduce both the nominal as well as the paid up value of share to ₹3 each. In such a case the following journal entry will be passed:

Share Capital (₹10) A/c	Dr.	1,00,000	
To Share Capital (₹3) A/c			30,000
To Capital Reduction A/c			70,000

(*ii*) ***Refunding surplus paid-up capital.*** In case a company finds that it has more capital than that it can profitably use, it may decide to refund surplus capital to its shareholders.

Example. A company has share capital of ₹1 lakh divided into shares of ₹10 each. The company decides to repay to its members ₹2 per share and make shares as of ₹8 each fully paid-up.

The following journal entries will be passed in such a case:

(*i*)	Share Capital (₹10) A/c	Dr.	1,00,000	
	To Share Capital (₹8) A/c			80,000
	To Sundry Members A/c			20,000
	(For conversion of share capital and money due to members)			
(*ii*)	Sundry Members A/c	Dr.	20,000	
	To Bank A/c			20,000
	(For payment of money to members)			

(*iii*) ***Reducing liability of members for uncalled capital.*** In case the liability of members in respect of the uncalled share capital is reduced, the paid-up value of the share capital will remain unchanged. However, the members will stand to gain since they will not have to pay money to the company to the extent of uncalled capital cancelled.

Example. A company has share capital of ₹1 lakh divided into shares of ₹10 each, called and paid-up ₹6 each. The company decides to cancel the liability of members to the extent of the ₹2 per share, thus making the shares of ₹8 each, ₹6 paid-up.

The following journal entry will be passed in such a case:

Share Capital (₹10) A/c	Dr.	60,000	
To Share Capital (₹8) A/c			60,000
(Being conversion of shares of ₹10 each into shares of ₹8 each)			

(*iv*) ***Reduction in claims of creditors, debenture-holders, etc.*** Sometimes, the creditors and the debenture-holders of the company are required to reduce their claims against the company on account of heavy losses suffered by the company which cannot be met in full by the company's shareholders.

Example. Following are the extracts from a company's balance sheet as on 31 December, 2011:

Liabilities	₹	*Assets*	₹
13% Debentures of ₹100 each	1,00,000		
Creditors	50,000		

Under the scheme of internal reconstruction, the debenture-holders agree to accept new 15 per cent debentures of ₹80,000 in full satisfaction of the claims while the creditors agree to reduce their claims by ₹10,000.

The following journal entry will be passed for the sacrifice made by the debenture-holders and the creditors:

13% Debentures A/c	Dr.	1,00,000	
Unsecured Creditors A/c	Dr.	10,000	
To 15% Debentures A/c			80,000
To Capital Reduction A/c			30,000

Tutorial Note

Some accountants are of the opinion that in case the creditors and debenture-holders are required to make sacrifice under a reconstruction scheme, the company should open in its books "Reorganisation" or "Reconstruction Account", in place of "Capital Reduction Account". In support of their argument, they say that the word capital stands only for the claims of the shareholders. However, this is not wholly true. The term capital, in a wider sense includes not only the funds provided by the shareholders but also funds provided by others including debenture-holders and creditors. The students, may, therefore, use any of the terms *viz.* Capital Reduction Account or Reorganisation Account or Reconstruction Account.

(*v*) ***Disposal of capital reduction account.*** As explained in the preceding pages, the capital reduction account represents the sacrifice made by the different parties *i.e.* shareholders, debenture-holders, creditors, etc. This sacrifice is used for writing off accumulated losses, intangible assets, over valuation of asset, etc. Similarly, any appreciation in the value of the assets, capital profits, etc. are also credited to this account. The balance of this account is transferred to capital reserve.

The following journal entry will be passed for disposal of capital reduction account:

Capital Reduction A/c	Dr.
To Profit and Loss A/c (Debit balance)	
To Goodwill A/c	
To Preliminary Expenses A/c	
To Assets	
To Capital Reserve	
(Each asset should be credited individually with the amount of over-valuation)	

(***vi***) ***Treatment of arrears of preference dividends.*** The preference shareholders are entitled to get dividend at a fixed rate in priority to other shareholders. However, the company is not bound to pay them dividends. Moreover, the liability to pay dividends arises only when the dividends have been declared by the company. Of course, no dividend can be paid to the equity shareholders unless all arrears of dividends in respect of cumulative preference shares have been cleared. Preference shares are always taken as cumulative unless otherwise stated.

In case dividends in respect of preference shares have been declared but have not yet been paid, the unpaid dividends will appear as a liability in the company's balance-sheet. The claimants of the unpaid dividends are just like any other creditors of the company. In case they agree to sacrifice under a scheme of reconstruction of the company, their sacrifice will be credited to the capital reduction account.

However, if the preference dividends have not yet been declared by the company, the arrears of preference dividends will appear either in the inner column of the company's balance-sheet or by way of footnote outside the company's balance-sheet. In case claimants of such arrears of preference dividends, agree, under a reconstruction scheme, to sacrifice either in whole or in part, their arrears of dividends, no accounting entry is necessary since the company had not so far admitted any liability in respect of them. However, if the company is required to pay in full or in part the arrears of preference dividends under the reconstruction scheme, this will be an additional loss to the company. The following journal entries will be passed in such a case:

(*i*) Capital Reduction A/c Dr.
To Preference Dividends A/c
(With the amount payable as dividends)

(*ii*) Preference Dividends A/c Dr.
To Bank A/c
(With the amount paid)

The accounting entries in respect of internal reconstruction can be well understood with the help of comprehensive illustrations given in the following pages.

Illustration 9.1: 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 directors 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:
- (*a*) Fully paid equity shares equal to 2/5th of their holding.
- (*b*) 5% preference shares fully paid-up to the extent of 20% of the above new equity shares.
- (*c*) 3,000 6% second debentures of ₹10 each.

(*ii*) An issue of 2,500 5% first debentures of ₹10 each was made and fully subscribed in cash.

(*iii*) 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 Shares Capital A/c (₹2,50,000 × 2/5)		1,00,000
	To 5% Pref. Shares Capital A/c (₹1,00,000 × 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 9.2: The following is the Balance Sheet of Downhill Ltd. as at 31st March, 2012:

Downhill Ltd.
Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Fund	
		(*a*) Share Capital	
		Authorised:	
		Equity shares of ₹100 each	....
		Issued, Subscribed & Paid-up:	
		20,000 Equity shares of ₹100 each fully paid	20,00,000
		(*b*) Reserves and Surplus	
		Profit and Loss Account	(19,80,000)
		Preliminary Expenses	(20,000)
			–
	2	Non-current Liabilities	
		(*b*) Long-term Borrowings	
		12% Debentures	5,00,000
			5,00,000
	3	Current Liabilities	
		(*a*) Trade Payables	3,00,000
		(*b*) Other Current Liabilities:	
		Outstanding Debenture Interest	1,20,000
			4,20,000
		TOTAL (1) + (2) + (3)	9,20,000

B	**Assets**	
1	Non-current Assets	
	Fixed Assets	
	(*i*) Tangible Assets	
	Land and Building	1,50,000
	Plant and Machinery	3,00,000
	Furniture	80,000
	(*ii*) Intangible Assets: Goodwill	25,000
		5,55,000
2	Current Assets	
	(*a*) Inventories	2,70,000
	(*b*) Trade Receivables	60,000
	(*c*) Cash and Cash Equivalents	35,000
		3,85,000
	TOTAL (1) + (2)	9,20,000
		–

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 claims 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 and 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 (₹100) A/c Dr. To Capital Reduction A/c (Being reduction in the value of equity shares by ₹95 each)	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 10,000 equity shares of ₹10 each (fully paid-up)]	1,00,000	 1,00,000
	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	 5,00,000

Bank A/c Dr.	5,00,000	
To Equity Share Capital A/c		5,00,000
(Being 50,000 Equity Shares of ₹10 each issued for cash and subscribed in full)		
Creditors A/c Dr.	3,00,000	
To Equity Share Capital (₹10) A/c		2,00,000
To Bank A/c		50,000
To Capital Reduction A/c		50,000
(Being creditors of ₹1,00,000 paid in cash equivalent to 50% of their claims and the rest issued equity shares of ₹10 each in full settlement)		
Land & Buildings A/c Dr.	50,000	
To Capital Reduction A/c		50,000
(Being Land & Buildings revalued at ₹2,00,000)		
Capital Reduction A/c Dr.	21,20,000	
To Plant & Machinery A/c		90,000
To Provision for Doubtful Debts A/c		5,000
To Goodwill A/c		25,000
To Preliminary Expenses A/c		20,000
To *P* & *L* A/c		19,80,000
(Being balance of Capital reduction account utilised for writing off the fictitious assets and accumulated losses)		

Note: Capital Reduction Account balance has been completely utilised.

Downhill Ltd. (And reduced)
Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Fund	
		Share Capital	
		Authorised:	
		Equity Shares of ₹10 each	....
		Issued, Subscribed & Paid-up:	
		80,000 Equity Shares of ₹10 each fully paid	8,00,000
			8,00,000
	2	Non-current Liabilities	
		Long-term Borrowings 12% Debentures	5,00,000
			5,00,000
		TOTAL (1) + (2)	13,00,000
B		**Assets**	
	1	Non-current Assets	
		(*a*) Fixed Assets	
		Tangible Assets:	
		Land and Building	2,00,000
		Plant and Machinery	2,10,000
		Furniture	80,000
			4,90,000

NOTES

	Particulars		
2	Current Assets		
	(*a*) Inventories		2,70,000
	(*b*) Trade Receivables	60,000	
	Less: Provision for Doubtful Debts	(5,000)	55,000
	(*c*) Cash and Cash Equivalents		4,85,000
			8,10,000
	TOTAL (1) + (2)		13,00,000
			–

Illustration 9.3: The following was the Balance Sheet of Continental Construction Ltd., as on 31 March, 2012:

Continental Construction Ltd.
Balance Sheet as at 31 March, 2012

	Particulars		₹
A	**Equity and Liabilities**		
1	Shareholders' Funds:		
	(*a*) Share Capital		
	Authorised:		
	20,000 Equity Shares of ₹10 each		2,00,000
	Issued, Subscribed & Paid-up: 12,000 Equity Shares of ₹10 each		1,20,000
	Less: Calls in Arrear		9,000
			1,11,000
	(*b*) Reserves and Surplus		
	Profit and Loss Account as per Last Balance Sheet	(22,900)	
	Less: Profit for the year	2,100	(20,800)
	(*c*) Preliminary Expenses		(1,500)
			88,700
2	Current Liabilities		–
	(*a*) Trade Payables		15,425
	(*b*) Short-term Provisions:		
	Provision for Taxation		4,000
			19,425
	TOTAL (1) + (2)		1,08,125
B	**Assets**		
1	Non-current Assets		
	(*a*) Fixed Assets		
	(*i*)Tangible Assets		
	Land and Building	20,500	
	Plant and Machinery	50,850	71,350
	(*ii*) Intangible Assets: Goodwill		10,000
			81,350
2	Current Assets		
	(*a*) Inventories		10,275
	(*b*) Trade Receivables		15,000
	(*c*) Cash and Cash Equivalents		1,500
			26,775
	TOTAL (1) + (2)		1,08,125

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 use:

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 shares as per Reconstruction Scheme dated.....)			
	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-up, at ₹5 per share)			
	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. (And Reduced)
Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Funds:	
		Share Capital:	
		Authorised:	
		20,000 Equity Shares of ₹10 each	2,00,000
		Issued, Subscribed & Paid-up: 12,000 Equity Shares of ₹10 each, ₹7 Paid-up	84,000

NOTES

				84,000
2	Current Liabilities			
	(*a*) Trade Payables			15,425
	(*b*) Short-term Provisions:			
	Provision for Taxation			3,700
				19,125
	TOTAL (1) + (2)			1,03,125
B	**Assets**			
1	Non-current Assets			
	(*a*) Fixed Assets			
	(*i*) Tangible Assets:			
	Land and Building		20,500	
	Plant and Machinery	50,850		
	Less: Amount written off under			
	reconstruction scheme	(10,000)	40,850	61,350
2	Current Assets		–	
	(*a*) Inventories			10,275
	(*b*) Trade Receivables			15,000
	(*c*) Cash and Cash Equivalents			16,500
				41,775
	TOTAL (1) + (2)			1,03,125
				–

Illustration 9.4: The Balance Sheet of *XY* Limited is as follows:

***XY* Ltd.**

Balance Sheet as at 31 March, 2012

	Particulars		₹
A	**Equity and Liabilities**		
1	Shareholders' Funds:		
	(*a*) Share Capital		
	Authorised:		
	4,00,000 Equity Shares of ₹5 each		20,00,000
	10,000, 8% Preference Shares of ₹100 each		10,00,000
			30,00,000
	Issued, Subscribed & Paid-up:		
	2,00,000 Equity Shares of ₹5 each		10,00,000
	6,000, 8% Preference Shares of ₹100 each		6,00,000
	(*b*) Reserves and Surplus		
	Profit and Loss Account		(4,08,000)
			11,92,000
2	Non-current Liabilities		–
	Long-term Borrowings:		
	9% Debentures		6,00,000
			6,00,000
3	Current Liabilities		
	(*a*) Short-term Borrowings		
	Bank of India–Overdraft		1,50,000
	(*b*) Trade Payables		69,000
	(*c*) Other Current Liabilities		
	Interest Accrued on Debentures	1,08,000	
	Interest Accrued on Bank Overdraft	15,000	1,23,000
			3,42,000
	TOTAL (1) + (2) + (3)		21,34,000

B		**Assets**	
	1	Non-current Assets	
		(*a*) Fixed Assets	
		(*i*) Tangible Assets	11,40,000
		(*ii*) Intangible Assets: Patents and Copyrights	80,000
		(*b*) Non-current Investments	65,000
		(Market value ₹55,000)	
			12,85,000
	2	Current Assets	
		(*a*) Inventories	4,00,000
		(*b*) Trade Receivables	
			4,39,000
		(*c*) Cash and Cash Equivalents	10,000
			8,49,000
		TOTAL (1) + (2)	21,34,000

Preference dividend is in arrear for one year.

(*i*) Preference shareholders to give up their claims, inclusive of dividends, to the extent of 30% and desire to be paid off.

(*ii*) Debenture-holders agree to give up their claims to interest in consideration of their interest rate being enhanced to 12%.

(*iii*) Bank agrees to give up 50% of its interest outstanding in consideration of its being paid off at once.

(*iv*) Creditors would like to grant a discount of 5% if they paid immediately.

(*v*) Balance of Profit & Loss Account, Patents and Copyrights and Debtors of ₹30,000 to be written off.

(*vi*) Fixed Assets to be written down by ₹34,000.

(*vii*) Investments are to reflect their market value.

(*viii*) To the extent not specifically stated, equity shareholders suffer on reduction of their rights. Cost of reconstruction is ₹3,350.

Draft journal entries in the books of the company assuming that the scheme has been put though fully with the equity shareholders bringing in necessary cash to pay off the parties and to take working capital of ₹30,000 and prepare the Balance Sheet after reconstruction.

Solution:

In the Books of *XY* Ltd.

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
	8% Preference Share Capital A/c	Dr.	6,00,000	
	To Preference Shareholders A/c			4,20,000
	To Capital Reduction A/c			1,80,000
	(Being 30% of claim given up by preference shareholders as per reconstruction scheme dated...)			
	Capital Reduction A/c	Dr.	33,600	
	To Preference Shareholders A/c			33,600
	(Being 70% of arrear preference dividend payable to preference shareholders as per reconstruction scheme)			
	9% Debentures A/c	Dr.	6,00,000	
	Interest accrued on Debentures A/c	Dr.	1,08,000	
	To 12% Debentures A/c			6,00,000
	To Capital Reduction A/c			1,08,000
	(Being 9% debentures converted into equivalent number of 12% debentures and accrued debentures interest sacrificed as per Reconstruction scheme)			

Equity Share Capital A/c	Dr.	3,00,000	
To Capital Reduction A/c			3,00,000
[Being equity shareholders rights reduced to a share of ₹3.50 each, the amount of sacrifice credited to capital reduction A/c (*WN* 1)]			
Bank A/c	Dr.	7,00,000	
To Equity Share Capital A/c			7,00,000
[Being amount received on 2,00,000 equity shares @ ₹3.50 per share as per reconstruction scheme (*WN* 2)]			
Bank of India A/c	Dr.	1,50,000	
Interest accrued on Bank Overdraft A/c	Dr.	15,000	
To Bank A/c			1,57,500
To Capital Reduction A/c			7,500
(Being bank overdraft paid off including 50% of accrued interest as per reconstruction scheme, the interest sacrificed credited Capital to Reduction A/c)			
Creditors A/c	Dr.	69,000	
To Bank A/c			65,550
To Capital Reduction A/c			3,450
(Being creditors claim discharge to the extent of 95% as per reconstruction scheme, the balance of the claim sacrificed)			
Capital Reduction A/c	Dr.	3,350	
To Bank A/c			3,350
(Being reconstruction expenses paid)			
Preference Shareholders A/c	Dr.	4,53,600	
To Bank A/c			4,53,600
(Being amount due to preference shareholders discharged)			
Capital Reduction A/c	Dr.	5,62,000	
To Profit and Loss A/c			4,08,000
To Patents & Copyright A/c			80,000
To Debtors A/c			30,000
To Investment A/c			10,000
To Fixed Assets A/c			34,000
(Being writing off debit balance of profit and loss account, patents, copyrights and writing down the value of debtors, investments and fixed assets as per reconstruction scheme)			

_XY_ Ltd. (And Reduced)
Balance Sheet as at 31 March, 2012

		Particulars	₹
A		**Equity and Liabilities**	
	1	Shareholders' Funds:	
		(*a*) Share Capital	
		Authorised:	
		4,00,000 Equity Shares of ₹7 each	28,00,000
		Issued, Subscribed & Paid-up:	
		2,00,000 Equity Shares of ₹7 each	14,00,000

		(*b*) Reserves and Surplus	–
			14,00,000
	2	Non-current Liabilities	
		Long-term Borrowings:	
		12% Debentures	6,00,000
			6,00,000
		TOTAL (1) + (2)	20,00,000
B		**Assets**	
	1	Non-current Assets	
		(*a*) Fixed Assets	
		Tangible Assets	11,06,000
		(*b*) Non-current Investments	55,000
		(Market value ₹55,000)	11,61,000
	2	Current Assets	
		(*a*) Inventories	4,00,000
		(*b*) Trade Receivables	4,09,000
		(*c*) Cash and Cash Equivalents	30,000
			8,39,000
		TOTAL (1) + (2)	20,00,000
			–

Working Notes:

1. Computation of sacrifices received and their application:

Sl. No.	*Sacrifices received*	₹	*Sl. No.*	*Amounts to be written off or provided for*	₹
(*i*)	Preference shareholders:		(*i*)	Reconstruction Expenses	3,350
	(30% of ₹6,00,000)	1,80,000	(*ii*)	Profit and Loss A/c	
(*ii*)	Debenture-holders:			(Dr. balance)	4,08,000
	Interest on Debentures	1,08,000	(*iii*)	Patents & Copyrights	80,000
(*iii*)	Bank of India:		(*iv*)	Arrear Pref. Dividend	
	Int. on Bank Overdraft (50%)	7,500		(70% of ₹48,000)	33,600
(*iv*)	Creditors:		(*v*)	Reduction in value of:	
	5% of ₹69,000	3,450		Fixed Assets	34,000
(*v*)	Equity Shareholders:			Debtors	30,000
	Sacrifice @ ₹1.50 per share			Investment	10,000
	(Balancing Figure)	3,00,000			
		5,98,950			5,98,950

2. Cash to be brought in by Equity Shareholders:

Payments to:	₹
Preference Shareholders (including arrear of preference dividend) (70% of ₹6,48,000)	4,53,600
Bank of India (including interest on bank overdraft) (₹1,50,000 + ₹7,500)	1,57,500
Creditors 95% of ₹69,000	65,550
Others:	
Reconstruction Expenses	3,350
Additional Cash for Working Capital	20,000
	7,00,000

Hence, contribution per equity share comes to = ₹7,00,000 ÷ 2,00,000 = ₹3.50.

3. The total number of issued equity shares remain at 2,00,000 of ₹7 (₹3.50 + ₹3.50) each fully Paid-up.

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 memorandum 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

NOTES

the memorandum 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 Notsowell Limited as on 31st March, 2012:

Equity Share Capital A/c (₹10 shares)	₹1,00,000
Preference Share Capital A/c (₹100 each)	1,00,000
15% 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, 2012.

Memorandum Balance Sheet

Liabilities	₹	*Assets*	₹
Share Capital:		Fixed Assets	1,50,000
Equity (₹10 shares)	1,00,000	Current Assets	1,50,000
Preference (₹100 shares)	1,00,000	*P & L* A/c	
15% Debentures	1,00,000	(accumulated loss-bal. fig.)	50,000
Sundry Creditors	50,000		
	3,50,000		3,50,000

Check Your Progress

1. When can a company make alterations in its share capital?
2. What does the term reduction of share capital include?
3. Mention some other terms used for the Capital Reduction account.

9.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A company can make alterations in its share capital by passing an ordinary resolution, if its authorised by its Articles of Association to do so. Such alteration must be notified and a copy of the resolution should be filed with the Registrar within 30 days of the date of passing of such resolution.
2. The term reduction of share capital includes the following:
   - Writing off lost capital
   - Refunding surplus paid-up capital
   - Reducing lability of the members for uncalled capital
3. Some of the other terms used for Capital Reduction Account are Reorganisation Account or Reconstruction Account.

9.5 SUMMARY

NOTES

- Reconstruction means the reorganizing the capital structure of a company including the reduction of claims of both the shareholders and the creditors against the company.
- Such reconstruction generally becomes necessary on account of bad financial position of the company.
- In external reconstruction, a new company is formed to take over the business of an existing company which is in a bad financial position.
- In internal reconstruction, the capital of a company is reorganized to infuse new life in the company.
- Internal reconstruction includes both alteration and reduction of share capital.
- Alteration of share capital can be done under the provisions of Sections 61 and 62 of the Companies Act, 2013.
- The accounting entries for alteration of share capital includes categories of increase of share capital, consolidation of shares, subdivision of shares, conversion of shares into stock and cancellation of unissued shares.
- Section 66 of the Companies Act 2013 deals with the provisions of reduction of capital.
- Reduction of share capital includes writing off lost capital, refunding surplus paid-capital and reducing liability of the members for uncalled capital.
- Accounting entries in case of reduction of capital includes the categories of writing off lost capital, refunding surplus paid-up capital, reducing liability of members for uncalled capital, reduction in claims of creditors, etc; disposal of capital reduction account, and treatment of arrears of preference dividends, etc.

9.6 KEY WORDS

- **Reconstruction:** It means reorganizing the capital structure of a company including the reduction of claims of both the shareholders and the creditors against the company.
- **External reconstruction:** In this type of reconstruction, a new company is formed to take over the business of an existing company which is in a bad financial position.
- **Internal reconstruction:** In this type of reconstruction, the capital of a company is reorganized to infuse new life in the company.

9.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What is the meaning of reconstruction? Mention its types.
2. List the conditions to be satisfied for a company to be able to reduce its share capital.

Long Answer Questions

1. What does the term alteration proper include? Describe the accounting entries to be passed in case of alteration of capital.
2. Explain the concept of reduction of share capital and preparation of capital reduction account.

9.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

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Goyal, V. K. and R Goyal. 2012. *Corporate Accounting.* India: PHI Learning.

Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

UNIT 10 HOLDING COMPANY ACCOUNTS EXCLUDING INTER-COMPANY HOLDINGS

Structure

10.0 Introduction
10.1 Objectives
10.2 Meaning of Holding Companies
10.3 Some Items to Be Considered in the Consolidated Balance Sheet
10.3.1 Mutual Owings
10.3.2 Contingent Liability
10.3.3 Unrealized Profit
10.3.4 Revaluation of Assets
10.4 Answers to Check Your Progress Questions
10.5 Summary
10.6 Key Words
10.7 Self Assessment Questions and Exercises
10.8 Further Readings

10.0 INTRODUCTION

A holding company may be defined as a company which controls one or more other companies by means of holding shares in that company or companies or by having power to appoint directly or indirectly the whole or a majority of the board of directors of those companies. A company controlled by a holding company is termed as a subsidiary company and company controlled by the subsidiary company is termed as a sub-subsidiary of the principal holding company.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept of holding company
- Explain the treatment of mutual owings and contingent liabilities in case of consolidated balance sheet
- Describe the treatment of unrealized profits and revaluation of assets in the consolidated balance sheet.

10.2 MEANING OF HOLDING COMPANIES

According to section 2(46) of the Companies Act 2013, a holding company is one, which has one or more as its subsidiaries. This implies that there can be no holding company without there being one or more subsidiaries.

According to section 2(87) of the Companies Act 2013, subsidiary company means a company in which the holding company:

(i) controls the Composition of the Board of Directors i.e. it has the power to appoint or remove all or majority of the directors; or

(ii) exercises or controls more than one half of the total share capital either at its own or together with one or more of its subsidiary companies.

Total share capital for clause (*ii*) means aggregate of the paid up (*a*) equity share capital, and (*b*) convertible preference share capital.

Accounting Standard 21, "Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India, defines a subsidiary company as "an enterprise that is controlled by another enterprise (known as parent)".

A parent has been defined as "an enterprise that has one or more subsidiaries".

Wholly Owned And Partly Owned Subsidiaries

The wholly owned subsidiary company is one in which all the shares are owned by the holding company (or the group). In such a case, in order to fulfil the legal requirement of minimum number of members (2 in case of a private company and 7 in case of a public company), the holding company appoints the requisite number of nominees holding (say) one share each on behalf of the holding company.

A partly owned subsidiary is one in which the holding company (or the group) does not hold all the shares. The interest of such shareholders outside the group is termed as "Minority Interest".

A subsidiary company cannot hold shares in the holding company after it becomes its subsidiary. However, it can continue to own such shares in the holding company which it acquired before it became its subsidiary. But it will have no voting rights in respect of such shares.

Final Accounts

Financial Year of Holding and Subsidiary Companies

The Companies Act, 2013 has introduced the concept of uniform financial year for all companies. According to section 2(41) of the Act, "Financial year means a period ending on 31st day of March every year." Hence, now a holding company and a subsidiary company, each shall have its financial year ending on 31st March only.

In case of holding or subsidiary company incorporated outside India, it has been provided that if such a company is required to follow a different financial year for consolidation of its accounts, outside India, the National Company Law Tribunal (*NCLT*) may, if it is satisfied, allow any period as its financial year whether or not that period is a year.

This can happen in case of foreign companies having subsidiaries in India. Even in such case, the Indian company has to prepare its accounts for the year ending 31st March, for income tax purposes.

Consolidation of Final Accounts

In India, it is now compulsory for a holding company to prepare consolidated financial statements. According to section 129(3) of the Companies Act, 2013, where a company has one more subsidiaries, it shall in addition to its own financial statements, prepare a consolidated financial statement of the company and of all subsidiaries in the same form and manner as that of its own. Such financial statements shall also be laid before the annual general meeting of the company along with laying of its own financial statements. Provided further that:

(i) The company shall attach along with its financial statement a separate statement containing the salient features of the financial statements of its subsidiary or subsidiaries in the form as may be prescribed.

(ii) The Central Government may provide for consolidation of accounts of companies in such manner as may be prescribed.

AS 21: Consolidated Financial Statements

The following are the specific features of Accounting Standard (AS) 21: Consolidated Financial Statements, issued by the Council of the Institute of Chartered Accountants of India. It comes into effect in respect of accounting periods commencing on or after 1-4-2011. An enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this Standard. The following is the text of the Accounting Standard:

1. Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

2. Scope

(1) This standard is mandatory if an enterprise presents consolidated financial statements.

(2) This Statement should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

(3) This Statement should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

3. Definitions

For the purpose of this Statement, the following terms are used with the meanings specified:

Control: (a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

A *subsidiary* is an enterprise that is controlled by another enterprise (known as the parent).

A *parent* is an enterprise that has one or more subsidiaries.

A *group* is a parent and all its subsidiaries.

Consolidated financial statements are the financial statements of group presented as those of a single enterprise.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

It may be noted that all the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statement.

4. Presentation of Consolidated Financial Statements

A parent which presents consolidated financial statements should present these statements in addition to its separate financial statements.

Users of the financial statements of a parent are usually concerned with, and need to be informed about, the financial position and results of operations of not only the enterprise itself but also of the group as a whole. This need is served by providing the users:

(a) Separate financial statements of the parent; and

(b) Consolidated financial statements, which present financial information about the group as that of a single enterprise without regard to the legal boundaries of the separate legal entities.

NOTES

5. Scope of Consolidated Financial Statements

(1) A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign, other than those referred to in paragraph (2).

(2) A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, such subsidiaries should be accounted for investments in accordance with Accounting Standard (AS) 13: Accounting for Investments. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

6. Consolidation Procedures

(1) In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line-by-line basis by adding together like items of assets, liabilities, income and expenses. So that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

(a) the cost to the parent of its investment in each subsidiary and the parent’s portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;

(b) any excess of the cost to the parent of its investment in a subsidiary over the parent’s portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements;

(c) when the cost to the parent of its investment in a subsidiary is less than the parent’s portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;

(d) minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and

(e) minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parents shareholders. Minority interests in the net assets consist of:

(i) the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and

(ii) the minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.

Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

(2) Intragroup balances and intragroup transactions and resulting unrealised profits *should be eliminated, in full*. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

(3) The financial statements used in the consolidation should be drawn upto the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn upto different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.

(4) Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

(5) An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13: Accounting for Investments, from the date that the enterprise ceases to be a subsidiary and does not become an associate.

(6) Minority interest should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

7. Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

In a parent's separate financial statements, investments in subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13: Accounting for Investments.

8. Disclosure

In addition to disclosures required by paragraphs 6 and 7, following disclosures should be made:

(a) in consolidated financial statements, a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

NOTES

(b) in consolidated financial statements, where applicable :

(i) the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

(ii) the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period, and

(iii) the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

9. Transitional Provisions

On the first occasion that consolidated financial statements are presented, comparatives figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

Check Your Progress

1. Which Section of the Companies Act mandates a consolidated financial statement?
2. What is minority interest as per AS 21?

10.3 SOME ITEMS TO BE CONSIDERED IN THE CONSOLIDATED BALANCE SHEET

In this section, you will learn about the important items of consolidated in the consolidated balance sheet of holding companies.

10.3.1 Mutual Owings

Mutual owings refers to the amount the holding company owes to it subsidiary firm or any amount due to the holding firm from its subsidiary. Since in the consolidated balance sheet, the entities are treated as one, such amounts like mutual owings do not gave a real effect on the combined assets and liabilities. In fact, such amounts only tend to inflate the actual value of debtors and creditors. This is why it is advised that while preparing consolidated balance sheet, such amounts be deducted and only such owings be shared which are due from outsiders of the company.

10.3.2 Contingent Liability

Contingent liability is a liability which may or may not happen. It is customary to show contingent liabilities as a footnote to the balance sheet. Contingent liability may be of two types:

(a) External contingent liability, and (b) Internal contingent liability. External contingent liability is on account of a transaction between the company and the third party while internal contingent liability is on account of a transaction between the companies of the same group. While preparing the consolidated balance sheet the external contingent liabilities are shown as a footnote to the balance sheet while the internal contingent liabilities are eliminated from the footnote since they appear as actual liabilities in the consolidated balance sheet.

Illustration 10.1: Following are the extracts from the balance sheets of *H* Ltd. and its subsidiary *S* Ltd.

H Ltd. Balance Sheet as on 31st December, 2017

Liabilities	₹	*Assets*	₹
Bills Payable	10,000	Bills Receivable (including ₹5,000 from S Ltd.)	10,000

Note: Contingent liabilities in respect of bills discounted ₹ 6,000 and in respect of a guarantee given for a loan to *S* Ltd. ₹ 5,000.

S Ltd. Balance Sheet as on 31st December, 2013

Liabilities	₹	Assets	₹
Bank loan (Guaranteed by H Ltd.)	5,000		
Bills payable (including ₹6,000 in favour of H Ltd.)	8,000		

Show how these items would appear in the consolidated balance sheet.

Solution

Bills receivable in the books of the *H* Ltd. appear at ₹ 10,000 including of ₹ 5,000 from *S* Ltd. In the books of *S* Ltd. bills payable appear at ₹ 8,000 including ₹ 6,000 issued in favour of *H* Ltd. This means that bills of ₹ 1,000 received by *H* Ltd. from *S* Ltd. have been got discounted by *H* Ltd. from its bankers. This amount of ₹ 1,000 has been included by *H* Ltd. in its contingent liability of ₹ 6,000.

In the consolidated balance sheet bills payable of *S* Ltd. will appear at ₹ 3,000 (*i.e.* 1,000 issued in favour of *H* Ltd. and got discounted by it + ₹ 2,000 in favour of outsiders). The contingent liability in respect of bills discounted will be shown only at ₹ 5,000 since bills payable of ₹ 1,000 discounted by *H* Ltd. appears as a full fledged liability. Similarly, the bank loan taken by *S* Ltd. and guaranteed by *H* Ltd. appears as a full fledged liability in the consolidated balance sheet and hence there is no need of it being shown as a contingent liability. The consolidated balance sheet will, therefore, appear as under:

Consolidated Balance Sheet

Liabilities		₹	*Assets*	₹
Bills payable: H Ltd.	10,000		Bills receivable (H Ltd.)	15,000
S Ltd.	3,000	13,000		
Loan from bank: S Ltd.		5,000		

Note: Contingent liability in respect of bills discounted ₹ 5,000.

10.3.3 Unrealized Profit

The problem of unrealised profits arises in those cases where companies of the same group have sold goods to each other at a profit and the goods still remain unsold with the company to whom the goods were sold.

While preparing the consolidated balance sheet, the following procedure may be adopted for adjustment in respect of unrealised profits:

(a) Ascertain the total amount of unrealised profit included in the stock lying with the purchasing company. For example, if goods costing ₹ 5,000 were sold by *H* Ltd. to *S* Ltd. for a sum of ₹ 6,000 and 50 per cent of the goods are still in stock with *S* Ltd., the amount of unrealised profit is ₹ 500.

(b) The amount of unrealised profit to the extent of the interest of the holding company need not be reduced now. For example, if in the above case, *H* Ltd. holds 4/5 of the share capital of *S* Ltd., it was the practice earlier to reduce the unrealised profits to 4/5 of ₹ 500, *i.e.*, ₹ 400.

However, according to AS 21, it is now necessary to consider the total profit on stock as unrealised without taking note of minority interest. For example, in the above case, the unrealised profit should be taken as ₹ 500.

(c) Deduct the unrealised profit from the profit of the company selling the goods and from the stock of the company purchasing the goods on the basis of following journal entry:

Profit and Loss A/c (Selling company) *Dr.*
To Stock Reserve (Purchasing company)

Illustration 10.2: The following are the extracts from the Balance Sheet of *H* Ltd. and *S* Ltd. as on 31st March, 2014.

Liabilities	*H Ltd.* ₹	*S Ltd.* ₹	Assets	*H Ltd.* ₹	*S Ltd.* ₹
Share Capital:			Stock	95,000	42,000
(Equity Shares of			Investment		
₹ 10 each fully paid)	4,00,000	1,00,000	(8,000 shares in *S* Ltd.		
P & L A/c as on 1.4.2011	1,00,000	30,000	acquired on 1.7.2011)	2,00,000	
Profit for the year	50,000	20,000			

Stock of *H* Ltd. includes ₹ 6,000 relating to stock purchased from *S* Ltd. which follows the practice of charging 25% extra on the cost for determining the selling price.

You are required to show how the above items will appear in the Consolidated Balance Sheet.

Solution

1. *Unrealised Profit on stock*

Unrealised Profit:	₹
Cost of Stock for *H* Ltd.	6,000
Rate of Profit charge by *S* Ltd.	25%

The stock reserve has to be be created for full amount of ₹ 1,200 as required by AS 21.

2. *Analysis of Profits of S Ltd.*	Capital *profit* ₹	Revenue *profit* ₹
P & L as on 1.4.2011	30,000	
Profit earned during the year	5,000	15,000
	35,000	15,000
Less: Minority Interest 1/5	7,000	3,000
	28,000	12,000
3. *Consolidated Profit & Loss A/c:*		
Profit and loss Balance of *H* Ltd. as on 1.4.2011		1,00,000
Profit for the year		50,000
Share of Revenue Profit from *S* Ltd.	12,000	
Less: Stock Reserve*	1,200	10,800
		1,60,800
4. *Minority Interest:*		
Paid up Value of shares		20,000
Add: Share of Capital Profits		7,000
Add: Share of Revenue Profits		3,000
		30,000
5. Cost of Control:		
Cost of Shares:		2,00,000
Less: Paid up value of shares	80,000	
Share of Capital Profits	28,000	1,08,000
Goodwill		92,000

*Assumed that the sales took place after acquisition of shares by the holding company.

The various items will appear in the Consolidated Balance Sheet as follows:

Consolidated Balance Sheet (Extracts)

	Particulars	₹
I.	**Equity and Liabilities**	
1.	**Shareholders' Funds:**	
	Share Capital	4,00,000
	Reserves & Surplus:	
	P & L Statement Consolidated	1,60,800
2.	**Minority Interest**	30,000
II.	**Assets**	
1.	**Non-current Assets:**	

	Fixed Assets			
	Intangible:			
	Goodwill			92,000
2.	**Current Assets:**			
	Inventories:	*H* Ltd.	95,000	
		S Ltd.	42,000	
			1,37,000	
	Less: Stock Reserve		1,200	1,35,800

Illustration 10.3: On 31st March, 2012, the balance sheets of Major Ltd. and its subsidiary Minor Ltd. stood as follows:

Liabilities:	*Major Ltd. (₹)*	*Minor Ltd. (₹)*
Equity share capital	8,00,000	2,00,000
General reserves	1,50,000	70,000
Profit and loss account	90,000	55,000
Creditors	1,20,000	80,000
	11,60,000	4,05,000
Assets:		
Fixed assets	5,50,000	1,00,000
75% Shares in Minor Ltd. (at cost)	2,80,000	–
Stock	1,05,000	1,77,000
Other current assets	2,25,000	1,28,000
	11,60,000	4,05,000

Draw a consolidated balance sheet as at 31st March, 2012 after taking to consideration the following information:

(i) Major Ltd. acquired the shares on 31st July, 2011.

(ii) Minor Ltd. earned a profit of ₹45,000 for the year ended 31st March, 2012.

(iii) In January, 2012, Minor Ltd. sold to Major Ltd. goods costing ₹ 15,000 for ₹ 20,000. On 31st March, 2012, half of these goods were lying as unsold in the godowns on Major Ltd.

Solution

Major Ltd. and its Subsidiary Minor Ltd.
Consolidated Balance Sheet
as on 31st December, 2012

	Particulars		₹
I.	**Equity and Liabilities**		
1.	**Shareholders' Funds:**		
	Share Capital		8,00,000
	Reserves & Surplus		
	General Reserve		1,50,000
	Statement of P&L (Surplus)		
	Major Ltd.	90,000	
	Add: Share in Minor Ltd. profit	22,500	
		1,12,500	
	Less: Unrealized profit	2,500	1,10,000

	Particulars			₹
2.	**Minority Interest (*WN 5*)**			81,250
3.	**Current Liabilities:**			
	Accounts Payables:			
	Trade Creditors	Major Ltd.	1,20,000	
		Minor Ltd.	80,000	2,00,000
		Total (1) + (2) + (3)		**13,41,250**
II.	**Assets**			
1.	**Non-current Assets:**			
	Fixed Assets			
	Tangible:	Major Ltd.	5,50,000	
		Minor Ltd.	1,00,000	6,50,000
	Intangible:			
	Goodwill (*WN 4*)			58,750
2.	**Current Assets:**			
	Inventories:	Major Ltd.	1,05,000	
		Minor Ltd.	1,77,000	
			2,82,000	
	Less: Unrealized Profit		2,500	2,79,500
	Other:	Major Ltd.	2,25,000	
		Minor Ltd.	1,28,000	3,53,000
		Total (1) + (2)		**13,41,250**

Working Notes:

(1) *Computation of Capital Profits:*

	₹
General Reserve	70,000
Profit and Loss account balance as on 31st March, 2011 (₹ 55,000 – ₹ 45,000)	10,000
Current year's profit upto 31st July, 2011 (₹ 45,000 × 4/12)	15,000
	95,000

Share of Major Ltd. = ₹ 95,000 × $\frac{75}{100}$ = ₹ 71,250

Minority shareholders' share = ₹ 95,000 × $\frac{25}{100}$ = ₹ 23,750

(2) *Computation of Revenue Profits:*

Profits from 1st August, 2011 to 31st March, 2012 *i.e.* for 8 months

= ₹ 45,000 × $\frac{8}{12}$ = ₹ 30,000

Major Ltd.'s share = ₹ 30,000 × $\frac{75}{100}$ = ₹ 22,500

Minority shareholders' share = ₹ 30,000 × $\frac{25}{100}$ = ₹ 7,500

(3) *Unrealised profit in respect of stock with Major Ltd.*

Total profit charged by Minor Ltd. = ₹ 20,000 – ₹ 15,000 = ₹ 5,000

Since only half of the goods remained unsold as on 31st March, 2012, the unrealised profit = ₹ 5,000 × $\frac{1}{2}$ = ₹ 2,500.

It is desirable to treat, the entire profit of ₹ 2,500 as unrealised profit in view of the latest Accountant Standard (AS-21) "Consolidated Financial Statements".

(4) *Cost of control (or Goodwill)*

	₹	₹
Amount paid for acquiring 75% share of Minor Ltd.		2,80,000
Less: Paid up value of 75% share of Minor Ltd.	1,50,000	
H Ltd.'s share of capital profits		2,21,250
Cost of control (or Goodwill)		58,750

(5) *Minority Interest:*

	₹
Paid up value of 25% shares of Minor Ltd.	50,000
Add: Share in capital profits	23,750
Share in revenue profits	7,500
	81,250

Illustration 10.4: Following are the extracts for the balance sheets of *H* Ltd., *S* Ltd. and *SS* Ltd. as on 31st December, 2017:

Liabilities	*H Ltd.*	*S Ltd.*	*SS Ltd.*	*Assets*	*H Ltd.*	*S Ltd*	*SS Ltd.*
Share Capital	4,00,000	3,00,000	1,60,000	Shares in *S* Ltd.	4,00,000		
Revenue Profits	90,000	20,000	14,000	Shares in *SS* Ltd.	1,40,000		
				Stock-in-trade	1,20,000	95,000	30,000
				Plant and Mach.	2,80,000	2,60,000	2,20,000

H Ltd. holds 80 per cent of the share capital of the *S* Ltd. and 70 per cent of the share capital of *SS* Ltd. Included in the above stock-in-trade were goods acquired from associated companies on which profits have been made by the respective companies as under:

H Ltd.—	Goods from	*S* Ltd. at	₹ 6,000 above cost.
S Ltd.—	Goods from	*SS* Ltd. at	₹ 4,000 above cost.
SS Ltd.—	Goods from	*H* Ltd. at	₹ 2,000 above cost.

S Ltd. purchased an item of plant from *H* Ltd. on 1st April 2017 for ₹ 24,000 on which the later company had made a profit of ₹ 2,400. Depreciation has been charged in the accounts of *S* Ltd. at 10 per cent per annum.

You are required to show how the items in respect of unrealised profit will appear in the consolidated balance sheet.

Solution

As per AS 21, stock reserve should be created in respect of total unrealised profit, both in respect of stock and plant. If this is done, the reserves for unrealised profits will be as under:

Stock Reserve for unrealised profit

(a) Sales by *S* to *H* = ₹ 6,000
(b) Sales by *SS* to *S* = ₹ 4,000
(c) Sales by *H* to *SS* = ₹ 2,000
₹ 12,000

Unrealised profits in respect of plant
Sale of plant by *H* to *S* = ₹ 2,400
= ₹ 180
= ₹ 2,220

In case, it is desired to create reserve for unrealised profit after considering the minority interest, the reserve for unrealised profit would be as under:

Unrealised profit in respect of stocks:

		₹
Sales by *S* to *H* = $\frac{6,000 \times 80}{100}$	=	4,800
Sales by *SS* to *S* = $\frac{4,000 \times 70}{100} \times \frac{80}{100}$	=	2,240
Sales by *H* to *SS* = $\frac{2,000 \times 70}{100}$	=	1,400
		8,440

Unrealised profit in respect of plant:

Sale of plant by *H* to *S* = $\frac{80}{100} \times 2,400 = 1,920 - 180 = 1,170$

Since AS 21 requires creation of reserve for unrealised profits in total, it will be better to create stock reserve for the total amount without considering minority interest. The Balance Sheet will appear as under:

Consolidated Balance Sheet (Extracts)

	Particulars				₹
I.	**Equity and Liabilities**				
1.	**Shareholders' Funds:**				
	Reserves & Surplus				
	Revenue:	*H* Ltd.		90,000	
		S Ltd.	20,000 × 80/100	16,000	
		SS Ltd.	14,000 × 70/100	9,800	
				1,15,800	
	Less: Unrealized profits (12,000 + 2,220)			14,220	1,01,580
II.	**Assets**				
1.	**Non-current Assets:**				
	Fixed Assets				
	Tangible:				

	Particulars				₹
	Plant:	*H* Ltd.	2,80,000		
		S Ltd.	2,60,000		
		SS Ltd.	2,20,000	7,60,000	
	Less: Unrealized profit			1,740	7,58,260
2.	**Current Assets:**				
	Inventories:	*H* Ltd.		1,20,000	
		S Ltd.		95,000	
		SS Ltd.		30,000	
				2,45,000	
	Less: Unrealized Profits			12,000	2,33,000

10.3.4 Revaluation of Assets

The holding company may decide to revalue the assets and liabilities of the subsidiary company on the date of acquisition of shares by it in the subsidiary company. Any profit or loss on such revaluation is a capital profit or loss. Sometimes revaluation of assets and liabilities in not given effect immediately.

The revaluation may be done on a later date but with effect from the date of holding company acquiring shares in the subsidiary company. In such an event the past profits of the subsidiary company may have to be corrected on account of change in the amount of depreciation. It should be noted that any profit or loss due to change in the amount of depreciation on account of revaluation of the assets after the date of acquisition is a revenue profit or loss.

Illustration 10.5: The summarised balance sheet of *X* Ltd. and *Y* Ltd. as on 31st December, 2017 were as follows:

Liabilities	*X Ltd.* ₹	*Y Ltd.* ₹	*Assets*	*X Ltd.* ₹	*Y Ltd.* ₹
Authorised and Issued			Plant at cost less		
Capital:			depreciation	9,60,000	8,50,000
Ordinary shares of			Fixtures and fittings	2,60,000	80,000
₹10 each paid up	24,00,000	12,00,000	Stock at cost	2,00,000	1,50,000
Securities premium A/c	3,60,000	–	Debtors	8,20,000	4,10,000
Capital reserve on			Balance at bank	2,00,000	50,000
1 January, 2017	–	80,000	Trade Investments at cost	–	30,000
General reserve	1,50,000	1,00,000	96,000 shares of		
Profit and loss A/c	6,00,000	1,00,000	Y Ltd. at cost		–
Creditors	2,96,000	2,19,000	Goodwill at cost	5,00,000	1,50,000
Y Ltd. current A/c	34,000	–	Current A/c of X Ltd.	–	39,000
Profit for the year 2017	1,80,000	60,000			
	40,20,000	17,59,000			17,59,000

1. On 1st January 2017, *X* Ltd. acquired from the shareholders of *Y* Ltd. 96,000 shares in *Y* Ltd. and allotted in consideration thereof 72,000 of its own shares at a premium of ₹ 5 per share.
2. The consideration for the shares of *Y* Ltd. was arrived at *inter alia* by (i) valuing the plant at ₹ 10,44,444 (ii) valuing the fixtures at ₹ 83,211 and (iii) placing no value on trade investments and goodwill.
3. The depreciated figures for Plant and Fixtures at 31st December, 2017 are after providing depreciation for 2017, at the rates of 10 per cent and 5 per cent p.a. respectively, on the book values as at 1st January, 2017.
4. The stock of *Y* Ltd. included ₹ 50,000 in respect of goods received from *X* Ltd. invoiced at cost plus 25 per cent.

You are requested to prepare a consolidated Balance Sheet as on 31st December, 2017. (Figures may be rounded off to the nearest rupee.)

Solution

X Ltd. and its Subsidiary Y Ltd.
Consolidated Balance Sheet
as on 31st December, 2017

	Particulars			₹
I.	Equity and Liabilities			
1.	Shareholders' Funds:			
	Share Capital			
	2,40,000 shares of ₹ 10 each fully paid			24,00,000
	Reserves & Surplus			
	Security Premium Reserve		3,60,000	
	Capital reserve		39,200	
	General Reserve		1,50,000	
	Statement of P&L (Surplus)		8,10,040	13,59,240
2.	Minority Interest (WN 5)			2,89,810
3.	Current Liabilities:			
	Accounts Payables:			
	Trade Creditors			5,15,000
	Total (1) + (2) + (3)			45,64,050
II.	Assets			
1.	Non-current Assets:			
	Fixed Assets			
	Tangible:			
	Plant:		9,60,000	
		X Ltd.		
		Y Ltd.	9,40,000	19,00,000
	Fixtures:	X Ltd.	2,60,000	
		Y Ltd.	79,050	3,39,050
	Intangible:			
	Goodwill			5,00,000

2.	Current Assets:			
	Inventories:	X Ltd.	2,00,000	
		Y Ltd.	1,50,000	
			3,50,000	
	Less: Provision		10,000	3,40,000
	Accounts Receivable:			
	Debtors:		8,20,000	
		X Ltd.		
		Y Ltd.	4,10,000	12,30,000
	Cash and cash equivalents:			
	Balance at Bank:		2,00,000	
		X Ltd.		
		Y Ltd.	50,000	2,50,000
	Cash in transit			5,000
	Total (1) + (2)			45,64,050

Working Notes:

1.	Profit/Loss on revaluation in Y Ltd.	₹
	(i) Plant-Book value on 1st January, 2017: 8,50,000 ×	9,44,444
	100/90	10,44,444
	Revaluation	1,00,000
	Profit	84,211
	(ii) Fixtures—Book value on 1st January, 2017: 80,000	83,211
	× 100/95	1,000
	Revaluation	
	Loss	

2.	Analysis of Profit (Loss) of Y Ltd.	Capital (₹)	Revenue (₹)
	Capital reserve	80,000	
	General reserve	1,00,000	
	Profit and loss A/c balance as on 1st January, 2017	1,00,000	
	Profit for 2017		60,000
	Revaluation/write offs:		
	Plant	1,00,000	(10,000)*
	Fixtures	(1,000)	50*
	Goodwill	(1,50,000)	
	Trade investments	(30,000)	
		1,99,000	50,050
	Minority interest, 20 per cent	39,800	10,010
		1,59,200	40,040

*Adjustment for depreciation for changes in values of the two assets.

3.	Cost of control.		₹
	Cost of 96,000 shares		10,80,000
	Paid up value of the shares	9,60,000	
	Capital profit as per (2) above	1,59,200	11,19,200
	Capital reserve		39,200

		₹
4.	Consolidated Profit and Loss A/c	
	X Ltd.: Profit and loss A/c, balance on 1st January, 2017	6,00,000
	Profit for 2017	1,80,000
	Revenue profit from Y Ltd.	40,040
		8,20,040
	Less: Stock reserve, 25/125 of 50,000	10,000
		8,10,040

		₹
5.	Minority interest.	
	Paid up value of shares	2,40,000
	Add: Share of capital profit	39,800
	Add: Share of revenue profit	10,010
		2,89,810

Illustration 10.6: Following are the balance sheets of *H* Ltd. and its subsidiary *S* Ltd. as on31st March, 2017:

Liabilities	*H Ltd* ₹	*S Ltd.* ₹	*Assets*	*H Ltd.* ₹	*S Ltd.* ₹
Equity share capital:			Plant and machinery	3,90,000	1,35,000
Share of ₹10 each			Furniture	80,000	40,000
fully paid	6,00,000	2,00,000	80% Shares in S Ltd. (at cost)	3,40,000	—
General reserve	3,40,000	80,000	Stock	1,80,000	1,20,000
Profit and loss account	1,00,000	60,000	Debtors	50,000	30,000
Creditors	70,000	35,000	Cash at bank	70,000	50,000
	11,10,000	3,75,000		11,10,000	3,75,000

Additional information:

(i) Profit and loss account of *S* Ltd. stood at ₹ 30,000 on 1st April, 2016 whereas general reserve stood at ₹ 80,000 even on this date.

(ii) *H* Ltd. acquired 80% shares in *S* Ltd. on 1st October, 2016.

(iii) *S* Ltd.'s plant and machinery which stood at ₹ 1,50,000 on 1st April, 2016 was considered worth ₹ 1,80,000 as on 1st October, 2016, this figure is to be considered while consolidating the balance sheets.

You are required to prepare consolidated balance sheet as on 31st March, 2017.

(*CS Inter, June 2008, adapted*)

Solution

H Ltd. and its Subsidiary S Ltd.
Consolidated Balance Sheet
as on 31st December, 2017

	Particulars		₹
I.	Equity and Liabilities		
1.	Shareholders' Funds:		
	Share Capital:		
	Equity shares of ₹ 10 each fully paid		6,00,000
	Reserves & Surplus		
	General Reserve		3,40,000
	Statement of P&L (Surplus)	1,00,000	
	Add: H Ltd., Shares in S Ltd. Revenue Profit	10,500	1,10,500

	Particulars			₹
2.	Minority Interest (WN 5)			75,125
3.	Current Liabilities:			
	Trade Payables:			
	Sundry Creditors	H Ltd.	70,000	
		S Ltd.	35,000	1,05,000
	Total (1) + (2) + (3)			12,30,625
II.	Assets			
1.	Non-current Assets:			
	Fixed Assets			
	Tangible:			
	Plant & Machinery:			
		H Ltd.	3,90,000	
		S Ltd.	1,70,625	5,60,625
	Furniture:			
		H Ltd.	80,000	
		S Ltd.	40,000	1,20,000
	Intangible:			
	Goodwill (WN 3)			50,000
2.	Current Assets:			
	Inventories:			
		H Ltd.	1,80,000	
		S Ltd.	1,20,000	3,00,000
	Trade Receivable:			
	Debtors:	H Ltd.	50,000	
		S Ltd.	30,000	80,000
	Cash and cash equivalents:			
	Bank:	H Ltd.	70,000	
		S Ltd.	50,000	1,20,000
	Total (1) + (2)			12,30,625

Working Notes:

		₹
(1)	Revised value of Plan and Machinery	
	Book value of S Ltd.'s plant and machinery as on 01.04.2016	1,50,000
	Less: Book value of plant and machinery as on 31.3.2017	1,35,000
	Depreciation for full year	15,000

Rate of depreciation = $\frac{\text{₹}\,15{,}000 \times 100}{\text{₹}\,1{,}50{,}000} = 10\%$

Depreciation for six months	
(i.e. up to 30.9.2016) = 15,000 × 6/12 = ₹ 7,500	₹
Book value as on 1.10.2016 = (₹ 1,50,000 – ₹ 7,500) =	1,42,500
Appreciation made = ₹ 1,80,000	
₹ 1,42,500	
₹ 37,500	
Book value as on 31.3.2017	1,35,000
Appreciation	37,500
	1,72,500
Less: Depreciation for six months @ 10% p.a.	1,875
Revised value as on 31.3.2017	1,70,625

(2)	Capital Profits		₹
	General Reserve		80,000
	Profit and Loss Account as on 1.4.2016		30,000
	Current year's profit up to 1.10.2016 (₹ 60,000 – ₹ 30,000) 6/12		15,000
	Appreciation in value of plant and machinery		37,500
			1,62,500
	H Ltd.'s share = ₹ 1,62,500 × 80%		1,30,000
	Minority shareholders share (₹ 1,62,500 – ₹ 1,30,000)		32,500
(3)	Cost of Control/Goodwill	₹	₹
	Amount paid for 80% shares in S Ltd.		3,40,000
	Less: Paid-up value of 80% shares in S Ltd.	1,60,000	
	H Ltd.'s share of capital profit	1,30,000	2,90,000
	Cost of Control/Goodwill		50,000
(4)	Revenue Profits		₹
	Profit after 1×10×2016 = ₹6/12 (₹ 60,000 – ₹ 30,000)		15,000
	Less: Depreciation in respect of increase in the value of plant and machinery for six months		1,875
			13,125
	H Ltd.'s share = ₹ 13,125 × 80% = ₹ 10,500		
	Minority shareholder's share = ₹ 13,125 – ₹ 10,500 = ₹ 2,625		
(5)	Minority Interest		₹
	Paid-up value of 20% Shares		40,000
	Add: Capital Profits		32,500
	Revenue Profits		2,625
			75,125

Check Your Progress

3. Where are contingent liabilities shown in the consolidated balance sheet?
4. When does the problem of unrealised profits arise?

10.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 129(3) of the Companies Act says that where a company has one or more subsidiaries, it shall in addition to its own financial statements, prepare a consolidated financial statement of the company and of all subsidiaries in the same form and manner as that of its own.
2. As per AS 21, minority interest is that part of the net results of the operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiaries by the parent.

3. While preparing the consolidated balance sheet the external contingent liabilities are shown as a footnote to the balance sheet while the internal contingent liabilities are eliminated from the footnote since they appear as actual liabilities.
4. The problem of unrealised profits arises in those cases where companies of the same group gave sold goods to each other at a profit and the goods still remain unsold with the company to whom the goods are sold.

10.5 SUMMARY

- According to Section 2(46) of the Companies Act 2013, a holding company is one, which has one or more as its subsidiaries. This implies that there can be holding company without there being one or more subsidiaries.
- According to AS 21 defines subsidiary company as an enterprise that is controlled by another enterprise.
- The wholly owned subsidiary company is one in which all the shares are owned by the holding company.
- A partly owned subsidiary is one in which the holding company does not hold all the shares.
- According to Section 129(3) of the Companies Act 2013 where a company has one more subsidiaries, it shall in addition to its own financial statements, prepare a consolidated financial statement of the company and of all subsidiaries in the same form and manner as that of its own.
- Accounting Standard 21 mentions the provisions related to the preparation of Consolidated Financial Statements.
- Some items requires special consideration in terms of mutual owings, contingent liabilities, unrealized profits and revaluation of assets and liabilities.

10.6 KEY WORDS

- **Holding company:** It is defined as a company which controls one or more other companies by means of holding shares in that company or companies or by having the power to directly or indirectly appoint the whole majority of the board of directors of those companies.
- **Subsidiary company:** It refers to a company controlled by a holding company.
- **Contingent liability:** It is a liability which may or may not happen.

10.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. How are holding companies and subsidiary companies defined in the Companies Act?
2. Write a short note on wholly owned and partly owned subsidiaries.
3. When should a subsidiary be excluded from consolidation?
4. Mention the disclosures to be made in consolidated financial statements as per AS 21.

Long Answer Questions

1. Discuss the consolidation procedures as per Accounting Standard 21.
2. Explain the treatment of the following in the case of:
   a) Mutual ownings
   b) Contingent liabilities
   c) Unrealized profits
   d) Revaluation of assets

10.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e.* New Delhi: Vikas Publishing House.

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *An Introduction to Accountancy, 12/e.* New Delhi: Vikas Publishing House.

Goyal, V. K. and R Goyal. 2012. *Corporate Accounting.* India: PHI Learning.

Radhika, P and Anita Raman. 2018. *Corporate Accounting.* New Delhi: McGraw-Hill Education.

UNIT 11 LIQUIDATION OF COMPANIES II

NOTES

Structure

11.0 Introduction
11.1 Objectives
11.2 Meaning and Reasons for Winding Up
    11.2.1 Liquidator
    11.2.2 Preferential Creditor
11.3 Calculation of Liquidator's Remununeration
11.4 Liquidator's Final Statement of Accounts
11.5 Answers to Check Your Progress Questions
11.6 Summary
11.7 Key Words
11.8 Self Assessment Questions and Exercises
11.9 Further Readings

11.0 INTRODUCTION

As mentioned in Unit 6, liquidation or winding up of a company is a process by which dissolution of a company is brought about and its property administered for the benefit of its creditors and members. An administrator called liquidator is appointed and he takes over the control of the company, collects its assets, pays its debts and finally distributes the surplus among its members in accordance with their rights. In this unit, you will study briefly about the meaning an reasons for winding up. You will also learn about the appointment, removal, powers and duties of the liquidator as per the Companies Act. Further you will learn about the concept of Liquidator's final statement of accounts.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning and reasons of winding up
- Explain the role of liquidators and importance of preferential creditors
- Describe the calculation of liquidator's remuneration
- Explain the preparation of liquidator's final statement of accounts

11.2 MEANING AND REASONS FOR WINDING UP

You were introduced to the concept of winding up and liquidation in Unit 6.

There can be many different reasons for winding up:

- Companies are acting out of their legal scope of activities
- There is a management dispute
- The company has stopped its operations
- There is shareholders' dispute
- There is financial or corporate restructuring of the company
- The company has committed offences

11.2.1 Liquidator

Section 275 of the Companies Act 2013 details provisions related to company liquidators and their appointments. The following are the important provisions:

- For the purposes of winding up of a company by the Tribunal, the Tribunal at the time of the passing of the order of winding up, shall appoint an Official Liquidator or a liquidator from the panel maintained under sub-section (2) as the Company Liquidator.
- The provisional liquidator or the Company Liquidator, as the case may, shall be appointed by the Tribunal from amongst the insolvency professionals registered under the Insolvency and Bankruptcy Code, 2016;
- Where a provisional liquidator is appointed by the Tribunal, the Tribunal may limit and restrict his powers by the order appointing him or it or by a subsequent order, but otherwise he shall have the same powers as a liquidator.
- The terms and conditions of appointment of a provisional liquidator or Company Liquidator and the fee payable to him or it shall be specified by the Tribunal on the basis of task required to be performed, experience, qualification of such liquidator and size of the company.
- On appointment as provisional liquidator or Company Liquidator, as the case may be, such liquidator shall file a declaration within seven days from the date of appointment in the prescribed form disclosing conflict of interest or lack of independence in respect of his appointment, if any, with the Tribunal and such obligation shall continue throughout the term of his appointment.
- While passing a winding up order, the Tribunal may appoint a provisional liquidator, if any, appointed under clause (c)of sub-section (1)of section 273, as the Company Liquidator for the conduct of the proceedings for the winding up of the company.

Removal and Replacement of Liquidator

The following are the important provisions mentioned under Section 276 in this regard:

- The Tribunal may, on a reasonable cause being shown and for reasons to be recorded in writing, remove the provisional liquidator or the Company Liquidator, as the case may be, as liquidator of the company on any of the following grounds, namely:—
  - (a) misconduct;
  - (b) fraud or misfeasance;
  - (c) professional incompetence or failure to exercise due care and diligence in performance of the powers and functions;
  - (d) inability to act as provisional liquidator or as the case may be, Company Liquidator;
  - (e) conflict of interest or lack of independence during the term of his appointment that would justify removal.
- In the event of death, resignation or removal of the provisional liquidator or as the case may be, Company Liquidator, the Tribunal may transfer the work assigned to him or it to another Company Liquidator for reasons to be recorded in writing.
- Where the Tribunal is of the opinion that any liquidator is responsible for causing any loss or damage to the company due to fraud or misfeasance or failure to exercise due care and diligence in the performance of his or its powers and functions, the Tribunal may recover or cause to be recovered such loss or damage from the liquidator and pass such other orders as it may think fit.
- The Tribunal shall, before passing any order under this section, provide a reasonable opportunity of being heard to the provisional liquidator or, as the case may be, Company Liquidator.

Powers and Duties of Company Liquidator

Section 290 of the Companies Act 2013, mentions the following provisions in this regard:

1) Subject to directions by the Tribunal, if any, in this regard, the Company Liquidator, in a winding up of a company by the Tribunal, shall have the power—
   - (a) to carry on the business of the company so far as may be necessary for the beneficial winding up of the company;
   - (b) to do all acts and to execute, in the name and on behalf of the company, all deeds, receipts and other documents, and for that purpose, to use, when necessary, the company's seal;

(c) to sell the immovable and movable property and actionable claims of the company by public auction or private contract, with power to transfer such property to any person or body corporate, or to sell the same in parcels;

(d) to sell the whole of the undertaking of the company as a going concern;

(e) to raise any money required on the security of the assets of the company;

(f) to institute or defend any suit, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the company;

(g) to invite and settle claim of creditors, employees or any other claimant and distribute sale proceeds in accordance with priorities established under this Act;

(h) to inspect the records and returns of the company on the files of the Registrar or any other authority;

(i) to prove rank and claim in the insolvency of any contributory for any balance against his estate, and to receive dividends in the insolvency, in respect of that balance, as a separate debt due from the insolvent, and rateably with the other separate creditors;

(j) to draw, accept, make and endorse any negotiable instruments including cheque, bill of exchange, hundi or promissory note in the name and on behalf of the company, with the same effect with respect to the liability of the company as if such instruments had been drawn, accepted, made or endorsed by or on behalf of the company in the course of its business;

(k) to take out, in his official name, letters of administration to any deceased contributory, and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate which cannot be conveniently done in the name of the company, and in all such cases, the money due shall, for the purpose of enabling the Company Liquidator to take out the letters of administration or recover the money, be deemed to be due to the Company Liquidator himself;

(l) to obtain any professional assistance from any person or appoint any professional, in discharge of his duties, obligations and responsibilities and for protection of the assets of the company, appoint an agent to do any business which the Company Liquidator is unable to do himself;

(m) to take all such actions, steps, or to sign, execute and verify any paper, deed, document, application, petition, affidavit, bond or instrument as may be necessary,—

(i) for winding up of the company;
(ii) for distribution of assets;
(iii) in discharge of his duties and obligations and functions as Company Liquidator; and

(n) to apply to the Tribunal for such orders or directions as may be necessary for the winding up of the company.

2) The exercise of powers by the Company Liquidator under sub-section (1)shall be subject to the overall control of the Tribunal.

3) Notwithstanding the provisions of sub-section (1), the Company Liquidator shall perform such other duties as the Tribunal may specify in this behalf.

NOTES

11.2.2 Secured Creditors and Preferential Creditors

Preferential creditors is a term used to refer to creditors who have the right to paid first their due over all other creditors in the situation of liquidation. They may or may not be paid before secured creditors depending on the laws.

Secured Creditors

A secured creditor may adopt any of the following options:

(i) He may rely on the security and ignore the company's liquidation.
(ii) He may value the security and prove for the balance of his debt in the company's liquidation.
(iii) He may give up his security and prove for the whole amount in company's liquidation.

Interest on Debt

The date upto which interest will be payable by the company on loans, debentures, etc., depends on the fact whether the company is solvent or insolvent. In case the company is solvent (i.e., when the available assets are sufficient to pay liabilities up to the commencement of winding up), interest will be paid upto the date of actual payment. In case the company is insolvent, the interest will be payable only upto the date of commencement of company's winding up.

Overriding Preferential Payment (Section 326)

(1) In the winding up of a company under this Act, the following debts shall be paid in priority to all other debts:-

(a) Workmen's dues; and

(b) Where a secured creditor has realized a secured asset, so much of the debts due to such secured creditors as could not be realized by him or the amount of the workmen's portion in his security (if payable under the law), whichever is less, pari passu with the workmen's dues:

Provided that in case of the winding up of a company, the sums referred to in sub-clauses (i) and (ii) of clause (b) of the Explanation, which are payable for a period of two years preceding the winding up order or such other period as may be prescribed, shall be paid in priority to all other debts (including debts due to secured creditors), within a period of thirty days of sale of assets and shall be subject to such charge over the security of secured creditors as may be prescribed.

(2) The debts payable under the proviso to sub-section (1) shall be paid in full before any payment is made to secured creditors and thereafter debts payable under that sub-section shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

Explanation—For the purposes of this section, and section 327 which deals with Preferential Payments:

(a) "Workmen", in relation to a company, means the employees of the company, being workmen within the meaning of the Industrial Disputes Act, 19471;

(b) "Workmen's Dues", in relation to a company, means the aggregate of the following sums due from the company to its workmen, namely:-

(i) All wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any workman in respect of services rendered to the company and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947;

(ii) All accrued holiday remuneration becoming payable to any workman or, in the case of his death, to any other person in his right on the termination of his employment before or by the effect of the winding up order or resolution;

(iii) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company or unless the company has, at the commencement of the winding up, has a contract with the Insurance whereby the insurer would be liable to the workmen for compensation as much the company would have been liable workmen under the Employees' Compensation Act, 1923, all amount due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any workman of the company;

(iv) All sums due to any workman from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the workmen, maintained by the company;

(c) “workmen’s portion’, in relation to the security of any secured creditor of a company, means the amount which bears to the value of the security the same proportion as the amount of the workmen’s dues bears to the aggregate of the amount of workmen’s dues and the amount of the debts due to the secured creditors.

Example 1: The value of the security of a secured creditor of a company is ₹ 1,00,000. The total amount of the workmen’s dues is ₹ 1,00,000. The amount of the debts due from the company to its secured creditors is ₹ 3,00,000. The aggregate of the amount of workmen’s dues and the amount of debts due to secured creditors is ₹ 4,00,000. The workmen’s portion of the security is, therefore, one-fourth of the value of the security that is ₹ 25,000.”

In brief, as a result of the above provisions, out of total workmen’s dues, workmen’s wages or salaries and workmen’s accrued holiday remuneration for a period of 2 years preceding that date of winding up shall be paid before secured creditors. The other workmen’s dues for the remaining period and compensation due to workmen under the Employees Compensation Act, shall rank paripassu with the secured creditors. The amount not paid to secured creditors on account of the above provisions shall be an overriding preferential payment.

Example 2: The following details have been extracted form the books of a company at the time of the liquidation:

Secured creditors (with assets charged in their favour ₹ 2,00,000)	₹3,00,000
Workmen’s dues	1,00,000
Preferential creditors (excluding workmen’s dues)	50,000
Unsecured creditors	2,00,000
Other assets	2,50,000

The assets available will be used as follows:

1. Assets charged in favour of secured creditors worth ₹ 2,00,000 will be shared by Secured Creditors and workers in the ratio of 3:1

	₹
Share of secured creditors 2,00,000 ×3/4	1,50,000
Share of workers 2,00,000 × 1/4	50,000

2. Over-riding preferential payments amount to:

	₹
(i) Secured creditors to the extent of their security being used for workmen’s dues	50,000
(ii) Balance of workmen’s dues (1,00,000 – 50,000)	50,000
	1,00,000

3. Other Assets will be used as follows:

		₹
(i)	Over-riding preferential payments	1,00,000
(ii)	Preferential creditors	50,000
(iii)	Unsecured creditors	1,00,000
	(Total 1,00,000 + 2,00,000)	2,50,000

Preferential Payments (Section 327)

In a winding up, subject to the provisions of Section 326, there shall be paid in priority to all other debts

(h) All revenues, taxes, cesses and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date, and having become due and payable within the twelve months immediately before that date;

(i) All wages or salary2 including wages payable for time or piece work and salary earned wholly or in part by way of commission of any employee in respect of services rendered to the company and sue for a period not exceeding four months within the twelve months immediately before the relevant date, subject to the condition that the amount payable under this clause to any employee shall not exceed such amount as may be notified3:

(j) All accrued holiday remuneration becoming payable to any employee, or in the case of his death, to any other person claiming under him, on the termination of his employment before, or by the winding up order, or, as the case may be, the dissolution of the company;

(k) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company, all amount due in respect of contributions payable during the period of twelve months immediately before the relevant date by the company as the employer of persons under the Employees' State Insurance Act, 1948 (34 of 1948) or any other law for the time being in force;

(i) Unless the company has, at the commencement of winding up, under such a contract with any insurer as is mentioned in section 14 of the Workmen's Compensation Act, 1923 (8 of 1923), rights capable of being transferred to and vested in the workmen, all amount due in respect of any compensation or liability for compensation under the said Act in respect of the death or disablement of any employee of the company:

Provided that where any compensation under the said Act is a weekly payment, the amount payable under this clause shall be taken to be the amount of the lump sum for which such weekly payment could, if redeemable, be redeemed, if the employer has made an application under that Act;

(m) All sums due to any employee from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the employees, maintained by the company; and

(n) The expenses of any investigation held in pursuance of sections 2013 and 2016, in so far as they are payable by the company.

All the above preferential debts shall rank equally among themselves and in case of deficiency of assets, they shall abate in proportion to their total amounts. They shall enjoy priority or preference even over those creditors who are secured by a floating charge on the assets.

11.3 CALCULATION OF LIQUIDATOR'S REMUNUNERATION

Liquidator's remuneration: Liquidator is usually paid remuneration as a certain percentage of the assets realised as well as a certain percentage of the payments made to unsecured creditors or shareholders. While calculating such remuneration, the following points should be kept in mind.

(*a*) In case liquidator is entitled to remuneration as a certain percentage of the assets realised, such realisation does not include cash in hand, unless otherwise specified.

In case of an asset specifically pledged, it is generally presumed that such asset has been realised by the concerned creditor himself. Hence, the liquidator will be allowed commission only on the amount of surplus realised from such creditor and not on the total value realised on account of sale of the asset. However, in case of hypothecation of an asset, it may be presumed that the liquidator has himself realised the assets and, therefore, he may be allowed remuneration on the full value realised on account of sale of such an asset.

(*b*) In case liquidator is entitled to remuneration as a certain percentage of the amount distributed among the unsecured creditors, the term unsecured creditors also includes preferential creditors for this purpose unless otherwise specified in the question.

(*c*) In case the liquidator is entitled to get commission on payments made to persons who are the last in order of payment either because the amount is insufficient or because the residual money has to go to them, liquidator's remuneration should be calculated on this basis that every payment of say ₹100 to the liquidator will involve funds of "₹100 + liquidator's commission". This will be clear with the following examples:

NOTES

Example 1 Cash available for distribution among unsecured creditors ₹10,000

Unsecured creditors ₹8,000

Liquidator's remuneration 5 per cent of the amount distributed among the unsecured creditors.

Since the cash available is sufficient to pay both liquidator's remuneration and unsecured creditors, the liquidator's remuneration will be calculated as follows:

8,000 × (5/100) = ₹400.

Example 2 Unsecured creditors ₹10,000

Cash available for distribution among unsecured creditors: ₹8,000

Liquidator's remuneration: 5 per cent of amount distributed among unsecured creditors.

Since the case available is insufficient to pay the unsecured creditors, it means they will be the last persons to get the payment. Hence, the liquidator's remuneration will be calculated as follows:

8,000 × (5/105) = ₹381.

Example 3 Cash available before payment to unsecured creditors: ₹30,000

Unsecured creditors: ₹10,000

Share capital: ₹15,000

Liquidator's remuneration: 5 per cent of the amount distributed among shareholders.

Since the liquidator's remuneration is to be calculated on payment persons who will be the last to get payment, it will be calculated as follows:

Cash available for shareholders: ₹20,000

Liquidators' remuneration: 5 per cent of the amount distributed among the shareholders

Every payment of ₹100 to shareholders will involve funds of ₹105

Liquidator's remuneration will, therefore, be ₹20,000 × (5/105) = ₹952.

Check Your Progress

1. Mention the Section of the Companies Act which contains provisions related to appointment of company liquidators.
2. List the grounds on which the provisional liquidator or company liquidator may be removed.

11.4 LIQUIDATOR'S FINAL STATEMENT OF ACCOUNTS

As stated earlier, the liquidator is required to realise the assets of the company and distribute the proceeds among the parties having claims against the company. In order to record all daily cash payments, the liquidator maintains a proper cash book. He has to submit from time to time as required by law, a statement of total receipts and payments made by him during a particular period. In the event of the affairs of the company being finally wound up, he has to submit a final statement of account to the court, members/creditors as the case may be. Such statement is termed as "Liquidator's Final Statement of Account." It is to be prepared in the prescribed form as given as:

Liquidator's Statement of Account of the Winding up

1. Name of the company...........Ltd.
2. Nature of Proceeding*
3. Date of commencement of the winding up
4. Name and address of the Liquidator.

Statement showing how the winding-up has been conducted and the property of the company has been disposed off from.........19..... (commencement of winding-up) to ....19..... (close of winding up).

Receipts	*Estimated value* ₹ *P*	*Value realised* ₹ *P*	*Payments* ₹	*Payments* *P*
Assets:			Legal charges	
Cash at Bank ...			Liquidator's remuneration	
Cash in hand ...			where applicable	
Marketable securities ...			% on ₹..... realised	
Bills receivable ...			% on ₹... distributed	
Trade debtors ...			Total ...	
Loans and advances ...			(By whom fixed.....)	
Stock-in-trade ...			Auctioneers' and valuers'	
Work-in-progress ...			charges	
Freehold property ...			Costs of possession and	
Leasehold property ...			maintenance of estate	
Plant and machinery ...			Gazette and newspapers	
Furniture fittings,			Incidental outlay (establish-	
Utensils, etc. ...			ment charges and other	
Patents, trade			expenses of liquidation)	
marks etc. ...			Total costs and charges	
Investments other			(*i*) *Debentureholders:*	
than marketable			Payment of ₹... per ₹..	
securities ...			debenture	
Surplus from securities ...			Payment of ₹..... per ₹...	
Unpaid calls at			debenture	
commencement			(*ii*) *Creditors:*	
of winding up			..... *Preferential	
Amount received from			..... *Unsecured:	
calls on contributories			Dividend(s),....P. in the	
made in the winding up			rupees on ₹...(The estimate	
Receipts per Trading A/c ...			of the amount expected	
Other property, *viz*,			to rank for dividend was	
....			₹.....)	
....			(*iii*) *Returns to contributories:*	
Total ...			.....P. per rupee... **share...	
Less:			.....P. per rupee... **share...	
Payment to redeem ...			P. Per rupee... **share...	
securities ...				
Cost of execution ...				
Payments per				
trading A/c ...				
Net realisations ...	...	...	...	...
...	...			

*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 ₹.....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:

(*a*) Unclaimed dividends payable to creditors in the winding up ₹........

(*b*) Other unclaimed distributions in the winding up ₹........

(*c*) Moneys 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..........19

(Sd.)
Liquidator.

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 19

(Sd.)
Liquidator.

NOTES

The order to be followed by the liquidator in making various payments, has already been explained in the Unit 6. It is also clear from the prescribed form of the liquidators' statement of account as given above. However, it should be remembered that though debentureholders have been shown before preferential creditors in the prescribed form of the liquidator's statement of account, preferential creditors as explained before, are paid in priority to debentureholders having a floating charge over the assets of the company.

Following further points should be kept in mind while preparing liquidator's statement of account:

Realisation of an asset specifically pledged: In case an asset, specifically pledged in favour of a creditor, is realised, only surplus, if any, has to be shown in the statement of affairs on the "receipts side." For example, if stock of ₹10,000 pledged with the bank for a loan of ₹6,000, realises ₹8,000, only surplus of ₹2,000 (*i.e.* ₹8,000 – 6,000) has to be shown in the "receipts side" in the statement of affairs.

Calls in advance: Any money received by the company on account of calls in advance will be paid in priority to any payment to the shareholders of that class.

Example 4 Share capital 1,000 equity shares of ₹10 each, ₹8 called and paid-up: ₹8,000

Calls in advance on 100 shares @ Re 1 per share ₹100

In case the company has a sum of ₹300 available for distribution among the shareholders of the company, ₹100 must be returned in priority to those shareholders who have paid calls in advance. The balance of ₹200 will be distributed among all the shareholders proportionately.

***Adjustment of the right of contributories*:** While making payment to contributories, it should be seen that the sacrifice made by all contributories is just and equitable.

In other words, in case a contributory has contributed more than the other contributory of the same class, he should be first returned that extra money.

Similarly, when contributories have paid different amounts on the same class of shares (equity or preference) and a call has to be made, it should be seen that:

(*a*) no contributory gets benefit at the expense of another contributory, and

(*b*) only so much amount is called which is necessary to adjust the rights of different contributories.

Illustration 11.1: *A* Ltd. went into voluntary liquidation. The following are the details:

Assets realised	₹40,000
Liquidator's remuneration	5,000
Unsecured creditors	20,000

Preference share capital is ₹20,000 (2,000 shares of ₹10 each). Equity share capital consists of:

1,000 shares of ₹10 each, ₹9 called and paid up ₹9,000

2,000 shares of ₹10 each, ₹5 called and paid up ₹10,000

You are required to prepare the "Liquidator's Statement of Account."

Solution:

LIQUIDATOR'S STATEMENT OF ACCOUNT

Receipts	₹	*Payments*	₹
Assets realised	40,000	Liquidator's remuneration	5,000
Calls made	6,000	Unsecured creditors	20,000
(2,000 shares @ ₹3 per share)		Preference shareholders	20,000
		Equity shareholders	1,000
		(1,000 shares @ Re 1 per share)	
	46,000		46,000

Working Note:

The amount of call made has been ascertained as follows:	₹
Amount available for distribution among the preference shareholders before making call from equity shareholders	15,000
Deficiency	
	5,000
If call is made on 2,000 shares @ ₹4 each, the amount realised will be	8,000
Surplus after paying preference shareholders in full	3,000
Each equity shareholder will get (3,000 ÷ 3,000)	1 per share
Amount to be called from holders of 2,000 equity shares @ ₹3 per share (*i.e.* ₹4 – Re 1)	6,000
Amount to be paid to holders of 1,000 shares (₹9 paid up) @ Re 1 per share	1,000

Illustration 11.2:

Asco Limited

BALANCE SHEET

as on 31st March, 2008

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, 2008. 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

The 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 amount due on 200 shares were found to be irrecoverable.

Prepare Liquidator's Statement of Account.

Solution:

Books of Asco Ltd. (In liquidation)

LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

Receipts		₹	*Payments*	₹
Cash at bank		50,000	Liquidation expenses	4,000
Realisation of assets:			Liquidator's commission (2% on 3,50,000)	7,000
Machinery		1,66,000	Preferential creditors:	
Furniture		8,000	Income-tax payable	10,000
Stock	1,10,000		Unsecured creditors	3,50,000
Less: Secured bank loan	1,00,000	10,000	Preference shareholders:	
Debtors		2,30,000	(1,000, 6% preference shares of	
Call on 1,800 equity shares @ ₹15			₹100 fully paid)	1,00,000
per share (*W.N.* 2)		27,000	Final payment to equity share holders:	
			(2,000 equity shares of ₹100 each	
			fully paid up @ ₹ 10 per share: (*W.N.* 2)	20,000
		4,91,000		4,91,000

Working Notes:

1. Computation call per equity share

	₹
(*i*) 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 @ ₹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 × 10) = ₹20,000.

Illustration 11.3: M/s Blue Ltd. passed a special resolution to wind up their company voluntarily. The declaration of solvency filed on 31 December, 2010 showed the following position:

Estimated to

realise

Assets	*Book Value*	₹
(*a*) Plant and machinery	(50,000)	49,000
(*b*) Stock	(22,000)	20,000
(*c*) Sundry debtors	(74,000)	62,000
(*d*) Cash at bank		600
		1,31,600

	Liabilities		*Estimated to Rank for Dividend* ₹
(*a*)	Bank overdraft secured by floating charge 28,000		
(*b*)	Unsecured Loan		15,000
	Interest due for 9 months upto 31.12.2010 15,900		900
(*c*)	Sundry creditors (Trade) 47,000		
(*d*)	Other creditors:		
	Preferential	₹7,150	
	Rent	₹3,000	
	Others	4,000	14,150
(*e*)	Audit fee		1,050
(*f*)	Provision for Income tax (pre-year ending 31.12.2010)		12,500
(*g*)	Expenses of liquidation (estimated)		7,500
			1,26,100
	Estimated surplus		5,500

The other information necessary for you to prepare the Liquidator's Cash Account is as under:

(*i*) January, 2011—Liquidator collected ₹50,000 from Sundry Debtors. He paid the Preferential Creditors in full and ₹25,000 on account of secured overdraft.

(*ii*) February, 2011—Liquidator collected the remaining good debts amounting to ₹13,450. He paid the balance of secured overdraft with interest amount upto date amounting to ₹950.

(*iii*) March, 2011—The sale of Plant and Machinery and stock was completed for a consideration of ₹47,500 and ₹19,000 respectively. The vendees had taken possession of the premises of M/s Blue Ltd. from 1 January, 2005 together with the assets. A sum of ₹1,250 was recovered by the liquidator for 3 months compensating due from the vendees, and paid ₹3,000 as rent to landlord.

(*iv*) April 2011—The Liquidator made the payment to creditors as under:

(*a*) 1st Dividend at 75 paise in a rupee to unsecured creditors;

(*b*) The unsecured loan creditor waived his interest from 1 October, 2005;

(*c*) Trade creditors were finalised at ₹47,550.

(*v*) May, 2011—Income-tax liability discharged by paying ₹11,500 as per assessment order.

(*vi*) June, 2011—Liquidator made calls on shareholders holding "B Equity shares" in order to obtain necessary funds and on 29 June, 2011 these were paid. The liquidator made all outstanding payment including final liquidation expenses ₹9,600.

(*vii*) The company's share capital was as under:

(*a*) 3,000 9 per cent Preference Shares of ₹10 each fully paid up (*b*) 10,000 '*A*' Equity Shares of ₹10 each ₹5 per share paid up

(*c*) 8,000 '*B*' Equity Shares of ₹10 each ₹5 per share paid up

(*viii*) As per the company's articles of association, the preference shareholders are entitled to recover their capital with 15 per cent premium in priority to equity shareholders and shall have no other rights.

(*ix*) The two classes of Equity Shares rank *pari passu*.

Solution:

M/s Blue Ltd.

LIQUIDATOR'S ACCOUNT

Date	*Receipts*	₹	*Date*	*Payments*	₹
2011					
2 Jan.	To Balance b/d	600	Jan.	By Preferential creditors	7,150
	To Sundry debtors	50,000		By Bank, part repayment of overdraft	25,000
				By Balance c/d	18,450
		50,600			50,600
1 Feb.	To Balance b/d	18,450	Feb.	By Bank (repayment of interest and overdraft)	3,950
	To Sundry debtors	13,450		By Balance c/d	27,950
		31,900			31,900
1 Mar.	To Balance b/d	27,950	Mar.	By Rent (to Landlord)	3,000
	To Plant and machinery	47,500		By Balance c/d	92,700
	To Stock	19,000			
	To Rent	1,250			
		95,700			95,700
1 Apr.	To Balance b/d	92,700	Apr.	By Loan creditors (75 per cent of ₹15,600)	11,700
				By Sundry creditors trade (75 per cent of 47,550)	35,662
				By Audit fee (75 per cent of ₹1,050)	788
				By Other creditors (75 per cent of ₹, 4,000)	3,000
				By Balance c/d	41,550
		92,700			92,700
1 May	To Balance b/d	41,550	May	By Income-tax	11,500
				By Balance c/d	30,050
		41,550			41,550
1 Jun.	To Balance b/d	30,050	Jun.	By Loan creditors (25%)	3,900
	To Equity shareholders [on 8,000 shares @ ₹4.505 (app.) per share]	36,045		By Sundry creditors trade (25 per cent)	11,888
				By Audit fee (25 per cent)	262
				By Other creditors (25 per cent)	1,000
				By Cost of liquidation	9,600
				By 9 per cent Preference shareholders (at a premium of 15 per cent)	34,500
				By '*A*' Equity shareholders (@ ₹0.495 (app.) per share)	4,945
		66,095			66,095

Blue Ltd.
LIQUIDATOR'S STATEMENT OF ACCOUNT

Receipts	₹	*Payments*	₹
Assets realised:		Liquidation expenses	9,600
Cash at bank	600	Bank overdraft, secured by floating charge	28,950
Trade debtors	63,450	Creditors (paid fully)	89,850
Stock-in-trade	19,000	By Payment to contributories:	
Plant and Machinery	47,500	Preference shareholders 3,000, 9 per cent	
Amount received as rent	1,250	preference shares @ ₹11.50 per share	34,500
Amount received from calls on		Equity shareholders 10,000	
contributories in the winding up	36,045	*'A'* Equity shares @ 49.45 paise per share	4,945
	1,67,845		1,67,845

Receiver for Debentureholders

A Receiver is an independent person appointed by the court or an individual or group of individuals to take possession of certain property for protective purposes or receive income and profits therefrom and apply them as required.

The terms of issue of debentures may give express power to the debentureholders to appoint a Receiver on happening of a specified event, *e.g.,* on failure of the company to pay them their interest or the instalment on the due date. In such a case, the debentureholders may appoint the Receiver to takeover the company's property for protection of their interests. However, if no such power has been given by the terms of the issue of debentures, the debentureholders will have to apply to the court for appointment of the Receiver. Such a Receiver (whether appointed by the debentureholders or the court) realises the assets specifically or generally charged in favour of the debentureholders. After meeting his expenses, remuneration and making payment to persons entitled to get payment in priority to the debentureholders, he will make payment to the debentureholders. Surplus if any will be handed over by him to the liquidator of the company. Thus, in case a Receiver is appointed by the debentureholders, two statements of account will have to be prepared: (*i*) Receivers's Statement of Account and (*ii*) Liquidator's Statement of Account.

Illustration 11.4: Weak Ltd. went into the hands of Receiver appointed by the Debentureholders as on 31 March 2010. The interest on debentures is payable on 31 March each year.

BALANCE SHEET
as on 31 March, 2010

Liabilities	₹	*Assets*	₹
6 per cent Cumulative preference		Fixed assets	90,000
shares (₹10)	25,000	Stock	79,000
Equity share capital (₹10)		Debtors	35,000
₹7.50 called up	75,000	Profit and loss A/c	45,000
Capital reserve	10,000	Calls-in-arrear	1,000
5 per cent Debentures			
(secured by floating charge)	30,000		
Debenture interest (Net)	1,200		

7 per cent Bank loan (including interest)	20,000		
Creditors	88,800		
	2,50,000		2,50,000

Creditors include ₹6,100 preferential creditors for rates and wages etc. and ₹300 tax on accrued debenture interest.

The Receiver collected ₹20,000 from Debtors against ₹21,000 claim. Stock (book value₹49,000) was sold out for ₹42,000. Debentures were paid forthwith. Receiver's expenses and remuneration amounted to ₹3,000. By 30 June, 2010, he paid out the preferential creditors and secured loans, and handed over the balance on 30 June 2010 to the Liquidator the date on which winding up resolution was passed.

The Liquidator sold out fixed assets for ₹45,000. The remaining stock was sold at a discount of 20% and the remaining book debts were collected in full.

He called up the uncalled amount. The call was paid by all the contributories except one member holding 500 shares and from whom the original call in arrear was due. That amount also could not be recovered.

The Liquidator made the payment on 31 August, 2010. Liquidator's expenses amounted to ₹700 and his remuneration was 2% on realisations (except that received from Receiver) and 2% on distributions.

Arrears of preference dividend upto the date of winding are to be paid in priority to Equity Shareholders by virtue of the terms of issue. Preference Dividend has been paid upto 30 June, 2008.

You are required to prepare:

(*i*) Receipts and Payments Account of Receiver. (*ii*) Liquidator's Final Statement of Account. (*iii*) Statement of Deficiency as regards Members.

Solution:

RECEIVER'S RECEIPTS AND PAYMENTS ACCOUNT

Receipts	₹	*Payments*		₹
Realisation:		Receiver's expenses and remuneration		3,000
Debtors	20,000	Preferential creditors		6,100
Stock	42,000	Debentures (floating charge)	30,000	
		Debenture interest (gross)	1,500	31,500
		7% Bank loan	20,000	
		Interest (3 months to June)	350	20,350
		Balance handed over to liquidator		1,050
	62,000			62,000

LIQUIDATOR'S RECEIPTS AND PAYMENTS ACCOUNT

Receipts		₹	*Payments*		₹
To Cash from receiver		1,050	Liquidator's expenses		700
To Realisation:			Liquidator's remuneration: (Note 2)		
Fixed assets	45,000		2% on 1,06,750	2,135	
Stock (79,000 – 49,000 at 20 per cent less)	24,000		2% on 1,02,907	2,058	4,193
			Unsecured creditors:		

Debtors (35,000 – 21,000)	14,000		88,800 – (6,100+300)	82,400
Calls (25,000 – 1,250)	23,750	1,06,750	Preference shareholders (Note 1)	
			(@ 73.2 paise in a rupee)	20,507
		1,07,800		1,07,800

STATEMENT OF DEFICIENCY AS REGARDS MEMBERS

Particulars	₹	₹
Excess of liabilities and capital over assets		35,000
Debit balance in profit and loss A/c on 31 March, 2010		
(*Less:* Capital reserve)		
Losses on realisation and expenses:		
Fixed assets (90,000 – 45,000)	45,000	
Stock (79,000 – 66,000)	13,000	
Debtors (35,000 – 34,000)	1,000	
Interest on bank loans	350	
Receiver's expenses and remuneration	3,000	
Liquidator's expenses	700	
Liquidator's remuneration	4,193	
Arrears of preference dividend	3,000	70,243
Total deficiency		1,05,243
Deficiency as regards equity shareholders:		
Equity capital	1,00,000	
Less: Calls-in-arrear: (1,000 + 1,250)	2,250	97,750
Deficiency as regards preference shareholders: (28,000 – 20, 507)		7,493

Working Notes:

1. Preference Shareholders:

	₹
Preference capital	25,000
Dividend for 24 months from 1 July 2008 to 30 June 2010)	3,000
	28,000

₹20,507 available cash distributed among claimants of ₹28,000 *i.e.* @ 73.2 paise in a rupee

2. Remuneration of Liquidator on distribution:

Total cash		1,07,800
Less: Expenses	700	
Remuneration on collection	2,135	2,835
Cash for distribution (to creditors and contributories) and for 2% commission on such distribution		1,04,965

Commission to the liquidator: 1,04,965 × 2/102 = ₹2,058

List '*B*' Contributories

In the event of company's winding up, the liquidators prepare two lists of contributories:

(*i*) List '*A*'. This list consists of those persons who are the members of the company on the date of the winding up. In other words, List '*A*' contributories is the list of the present members of the company.

(*ii*) List '*B*'. This list consists of those persons who were the members of the company during the 12 months preceding the date of winding up. In other words, List '*B*' contributories consists of the list of the past members of the company.

In case the assets of the company are not sufficient to pay the liabilities of the company, in the event of company's winding-up, the liquidator can ask

List '*B*' contributories to contribute towards the assets of the company, if each of the following conditions is satisfied:

(*i*) The winding up of the company has commenced within one year of his or having being ceased to be a member.

(*ii*) A debt or liability of the company which was incurred upto the date of his or her membership, is still outstanding.

(*iii*) The shares are partly paid up and the present member is not in a position to pay the calls made.

In any case a List '*B*' contributory cannot be required to pay more than the amount unpaid on the shares held by him or her.

Illustration 11.5: Ban Luck Limited went into voluntary liquidation and the proceedings commenced on 2 July, 2010. Certain creditors could not receive payment out of the realisation of assets and out of the contributions from the contributories of the '*A*' List.

The following details of share transfers are made available to you:

Name of the transferor shareholders member	*No. of shares transferred*	*Date of the transferor ceasing to be a member*	*Creditors remaining unpaid and outstanding at the time of the transferor ceasing to be a*
(*i*) *A*	1,000	1 March, 2009	6,000
(*ii*) *B*	1,250	15 August, 2009	8,000
(*iii*) *C*	500	1 October, 2009	10,750
(*iv*) *D*	2,000	1 December, 2009	13,000
(*v*) *E*	250	1 April, 2010	15,000

All the shares were of ₹10 each, on which ₹5 per share had been paid-up. Ignoring other details like liquidator's expenses etc., you are required to work out the liability of the individual contributories listed above.

Solution:

STATEMENT OF LIABILITY OF '*B*' LIST CONTRIBUTORIES

Date		*Creditors*	*Incremental*	*No. of shares held*			
				B	*C*	*D*	*E*
				1,250	*500*	*2,000*	*250*
		₹	₹	₹	₹	₹	₹
15 August,	2009	8,000	8,000	2,500	1,000	4,000	500
1 October,	2009	10,750	2,750	–	500	2,000	250
1 December,	2009	13,000	2,250	–	–	2,000	250
1 April,	2010	15,000	2,000	–	–	–	2,000
Maximum amount payable to creditors (*i*)				2,500	1,500	8,000	3,000
Amount of calls-in-arrear @ ₹5 per share (*ii*)				6,250	2,500	10,000	1,250
Actually liability lower of (*i*) or (*ii*)				2,500	1,500	8,000	1,250

Total amount paid to Creditors ₹13,250.

Notes:

(*i*) Incremental creditors of ₹2,000 on 1 April, 2010 will get only ₹250 from *E*. This is because the maximum amount recoverable from *E* is ₹1,250 of which ₹1,000 will be absorbed by creditors outstanding on 1 December.

(*ii*) The Liabilities outstanding on the date of transfer of shares have been apportioned on the basis of the number of shares held by "*B*" list contributories.

Illustration 11.6: In a winding up of a company, certain creditors remained unpaid. The following persons had transferred their holding sometime before winding up:

Name	*Date of Transfer* *2011*	*No. of Shares transferred*	*Amount due to creditors on the date of transfer* ₹
P	January 1	1,000	7,500
Q	February 15	400	12,500
S	March 15	700	18,000
T	March 31	900	21,000
U	April 5	1,000	30,000

The shares were of ₹100 each, ₹80 being called up and paid up on the date of transfers.

A member, *R*, who held 200 shares died on 28th February; 2011 when the amount due to creditors was ₹15,000. His shares were transmitted to his son *X*.

Z was the transferee of shares held by *T*, *Z* paid ₹20 per share as calls in advance immediately on becoming a member.

The liquidation of the company commenced on 1st February, 2012 when the liquidator made a call on the present and the past contributories to pay the amount.

You are asked to quantify the maximum liability of the transferors of shares mentioned in the above table, when the transferees:

(*i*) pay the amount due as "present" member contributories;

(*ii*) do not pay the amount due as "present" member contributories.

Also quantify the liability of *X* to whom shares were transmitted on the demise of his father *R*.

Solution:

STATEMENT OF LIABILITY AS CONTRIBUTORIES OF FORMER MEMBERS

on the date of transfer *(ceasing to be member)* *No. of Shares*		*Creditors outstanding*	*Q* *400*	*R/X* *200*	*S* *700*	*U* *to be paid to creditor* *1,000*	*Amount*
2011		₹	₹	₹	₹	₹	₹
Feb. 15		12,500	2,174	1087	3,804	5,435	12,500
Feb. 28	15,000						
	–12,500	2,500	–	263	921	1,316	2,500
March15	18,000						
	–15,000	3,000	–	316	1,105	1,579	3,000
April 5	30,000						
	–18,000	12,000	–	2,000	–	10,000	12,000
Total (*a*)		30,000	2,174	3,666	5,830	18,330	30,000
Maximum liability at ₹20 per share on shares held (*b*)			8,000	4,000	14,000	20,000	
Lower of (a) and (*b*)			2,174	3,666	5,830	18,330	

Working Note:

The transferors are *P*, *Q*, *S*, *T* and *U*. When the transferees pay the amount due as "present" member contributories, there will not be any liability on the transferors. It is only when the transferees do not pay as "present" member contributories that the liability would arise in the case of "past" members as contributories.

X to whom shares were transmitted on demise of his father *R* would be liable as an existing member contributory. He steps into the shoes of his deceased father under Section 430. His maximum liability would be at ₹20 per share on 200 shares received on transmission *i.e.* for ₹4,000.

P will not be liable to pay any amount as the winding up proceedings commenced one year from the date of the transfer. *T* also will not be liable as the transferee. *Z* has paid the balance ₹20 per share as call in advance. *Q*, *R/X*, *S* and *U* will be liable, as former members, to the maximum extent as indicated, provided the transferees do not pay the calls.

Check Your Progress

3. What should be kept in mind in case where contributories have paid different amounts on the same class of shares and a call has to be made?
4. Name the contributories list in which the name of past members of the company is mentioned.

11.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Section 275 of the Companies Act 2013 details provisions related to company liquidators and their appointments.
2. Removal of the provisional liquidator or the Company Liquidator, as the case may be, as liquidator of the company may be on any of the following grounds, namely:—
   (a) misconduct;
   (b) fraud or misfeasance;
   (c) professional incompetence or failure to exercise due care and diligence in performance of the powers and functions;
   (d) inability to act as provisional liquidator or as the case may be, Company Liquidator;
   (e) conflict of interest or lack of independence during the term of his appointment that would justify removal.
3. The following points should be kept in mind in case where contributories have paid different amounts on the same class of shares and a call has to be made:
   a. No contributory gets benefit at the expense of another contributory, and
   b. Only so much amount is called which is necessary to adjust the rights of different contributories
4. List B is the contributories list in which the name of past members of the company is mentioned.

11.6 SUMMARY

NOTES

- Liquidator is usually paid remuneration as a certain percentage of the assets realised as well as a certain percentage of the payments made to unsecured creditors or shareholders.
- The liquidator is required to realise the assets of the company and distribute the proceeds among the parties having claims against the company.
- In the event of the affairs of the company being finally wound up, the liquidator has to submit a final statement of account to the court, members/creditors as the case may be. Such statement is termed as 'Liquidator's Final Statement of Account'.
- While preparing liquidator's statement of account, the following points should be considered: realisation of as asset specifically pledged, adjustment of the right of contributaries, etc.
- In case a Receiver is appointment by the debenture holders, two statements of account will have to prepared: (i) Receivers' Statement of Account and (ii) Liquidator's Statement of Account.

11.7 KEY WORDS

- **Liquidator:** It refers to the person or officer who is appointed by legal laws to wind up the affairs of a company when the company is dissolving.
- **Preferential creditors:** It refers to the persons or organizations who have the priority of being paid money due to them in case of liquidation of the company.
- **Liquidator's final statement of account:** It refers to the final statement of account to the court, members/creditors prepared by the liquidator in case of winding up of companies.

11.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Briefly explain the provisions in case of appointment of liquidators under the Companies Act 2013.
2. List the provisions related to the removal of liquidators under the Companies Act 2013.
3. What are the options available to the secured creditors in case of winding up?
4. Write a short note on the role of liquidators.
5. Mention the points to be kept in mind for calculation of liquidator's remuneration.

6. Briefly explain the concept of receivers for debenture holders and its impact on the preparation of liquidator's final statement of account.
7. What is the contributories list prepared by liquidators in the final winding up of a company?

Long Answer Questions

1. Describe the power and duties of company liquidators under the Companies Act 2013.
2. Explain preferential payments in case of winding up and the provisions for overriding preferential payments.
3. Describe the format and points to be kept in mind for the preparation of liquidator's final statement of account.

Practical Problems

1. The Balance Sheet of Bubble Ltd. as on 31st December 2011 was as follows:

Liabilities	₹	*Assets*	₹
Share capital:		Land and building	25,000
8,000 Preference shares of ₹10 each	80,000	Other fixed assets	2,00,000
12,000 Equity shares of ₹10 each	1,20,000	Stock	5,25,000
Bank loan	4,00,000	Debtors	1,00,000
8 per cent Debentures	1,00,000	Profit and loss A/c	58,000
Interest outstanding on debentures	8,000		
Creditors	2,00,000		
	9,08,000		9,08,000

The company went into liquidation on that date. Prepare Liquidator's Statement of Account after taking into account the following:

(1) Liquidation expenses and liquidator's remuneration amounted to ₹3,000 and ₹10,000, respectively.

(2) Bank loan was secured by pledge of stock.

(3) Debentures and interest thereon are secured by a floating charge on all assets.

(4) Fixed assets were realised at book values and current assets at 80 per cent of book values.

[**Ans.** Preference shareholders get only ₹4,000]

2. The following is the balance sheet of M/s. Unfortunate Ltd. as on 31st December, 2012:

Liabilities	₹	*Assets*	₹
4,000, 6% Preference shares of ₹100 each fully paid-up	4,00,000	Land and buildings	2,00,000
2,000 Equity shares of ₹100 each, ₹75 per share paid-up	1,50,000	Plant and machinery	5,00,000
6,000 Equity shares of ₹100 each, ₹60 per share paid-up	3,60,000	Patents	80,000
	9,10,000	Stock at cost	1,10,000
5% Debentures (having a floating charge on all assets)	2,00,000	Sundry debtors	2,20,000
Interest outstanding on debentures (also secured as above)	10,000	Cash at bank	60,000
Creditors	2,90,000	P & L A/c	2,40,000
	14,10,000		14,10,000

On the date, the company went into voluntary liquidation. The dividends on preference shares were in arrear for the two years. Creditors include a loan of ₹1,00,000 on mortgage of land and buildings. The assets realised were as under:

	₹
Land and buildings	2,40,000
Plant and machinery	4,00,000
Patents	60,000
Stock	1,20,000
Sundry debtors	1,60,000

The expenses of liquidation amounted to ₹21,800. The liquidator is entitled to a commission of 3% on all assets realised (except cash at bank) and commission of 2% on amounts distributed among unsecured creditors. Preferential creditors amount to ₹30,000. All payments were made on 30th June, 2013.

Prepare the Liquidator's Final Statement of Account.

[**Ans.** Payment to Pref. Shareholders ₹4,48,000 (including dividend);
Equity shareholders (*a*) ₹75 paid up @ ₹15.25 per share
(*b*) ₹60 paid up @ Re 0.25 per share]

3. *T* Ltd. was placed in voluntary liquidation on 31 December, 2007, when its Balance Sheet was as follows:

Liabilities	₹	*Assets*	₹
Issued share capital		Freehold factory	5,80,000
50,000 Eq. shares of ₹10		Plant and Machinery	2,89,000
each fully paid *less* calls-in		Motor vehicles	57,500
arrears amounting to		Stock	1,86,000
₹25,000	4,75,000	Debtors	74,000
6,000 5 per cent Cumulative		Profit and loss A/c	2,14,000
Pref. shares of ₹100			
each fully paid	6,00,000		
Share premium A/c	50,000		
5 per cent Debenture A/c	1,00,000		
Interest on debentures	2,500		
Bank overdraft	58,000		
Creditors	1,15,000		
	14,00,500		14,00,500

The preference dividends in arrears from 2004 onwards.

The Company's article provide that on liquidation, out of the surplus assets remaining after payment of liquidation costs and outside liabilities, there shall be paid firstly all arrears of preference dividend, secondly the amount paid-up on the preference shares together with a premium thereon of ₹10 per share, and thirdly any balance then remaining shall be paid to the equity shareholders.

The Bank Overdraft was guaranteed by the directors who were called upon by the Bank to discharge their liability under the guarantee. The directors paid the amount to the Bank.

The liquidator realised the assets as follows:

	₹
Freehold factory	7,00,000
Plant and Machinery	2,40,000
Motor vehicles	59,000
Stock	1,50,000
Debtors	60,000
Calls-in-Arrears	25,000

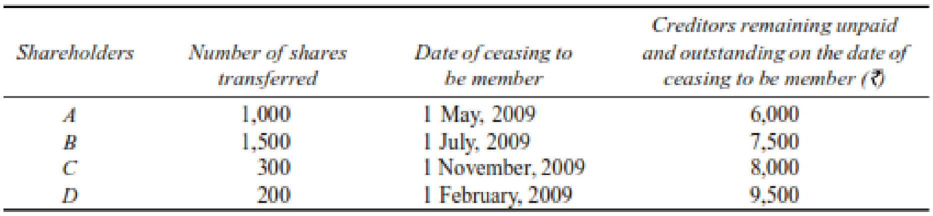
Creditors were paid less discount of 5 per cent. The debentures and accrued interest were repaid on 31st March, 2008.

Liquidation costs were ₹3,820 and the liquidator's remuneration was 2 per cent on the amount realised.

Prepare Liquidator's Statement of Account.

[**Ans.** Liquidator's Remuneration ₹24,680; Preference shareholders
get ₹7,80,000 and Equity shareholders ₹1,54,500]

4. In liquidation of Unfortunate Ltd., which commenced on 1 April, 2010 certain creditors could not receive payment out of the realisation of the assets and out of contribution from ‘*A*’ 1 ist contributories. The following are the details of certain transfers which took place after 1 April, 2009.

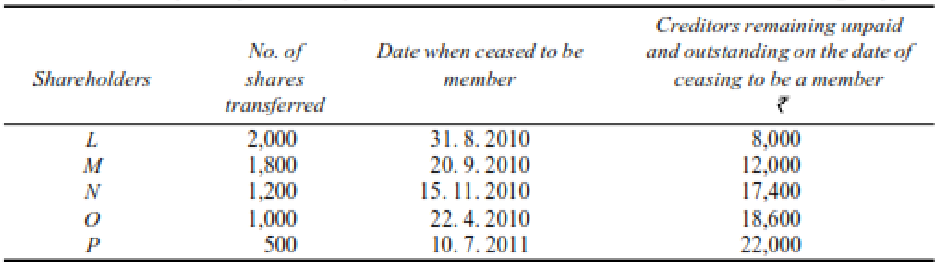


Shareholders	*Number of shares transferred*	*Date of ceasing to be member*	*Creditors remaining unpaid and outstanding on the date of ceasing to be member (₹)*
A	1,000	1 May, 2009	6,000
B	1,500	1 July, 2009	7,500
C	300	1 November, 2009	8,000
D	200	1 February, 2009	9,500

All the shares were of ₹10 each, ₹6 paid-up Ignoring expenses remuneration to liquidator, etc., show the amount to be realised from the various persons listed above.

[**Ans.** Liability to pay: *A* ₹2,000; *B* ₹4,125; *C* 1,125 and *D* ₹800]

5. In a winding up which commenced on 15th September, 2011 certain creditors could not receive payments out of the realisation of assets and out of contribution from ‘*A*’ list of contributories. Following are the details of certain share transfers that took place prior to liquidation and the amount of creditors remaining unpaid:



Shareholders	*No. of shares transferred*	*Date when ceased to be member*	*Creditors remaining unpaid and outstanding on the date of ceasing to be a member* ₹
L	2,000	31. 8. 2010	8,000
M	1,800	20. 9. 2010	12,000
N	1,200	15. 11. 2010	17,400
O	1,000	22. 4. 2010	18,600
P	500	10. 7. 2011	22,000

All the shares were of ₹10 each, on which ₹5 per share had been called and paid up. Ignoring expenses of liquidation, remuneration to liquidator etc., work out the amount to be realised from the above contributories.

[**Ans.** Amount contributed by the Contributories: *M* ₹4,800; *N* ₹5,600; *O* ₹5,000; *P* ₹2,500]

11.9 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e*. New Delhi: Vikas Publishing House.

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NOTES

BLOCK - IV
BANKING COMPANY ACCOUNTS AND HR ACCOUNTING

UNIT 12 ACCOUNTS FOR BANKING COMPANIES AND INSURANCE COMPANIES

Structure

12.0 Introduction
12.1 Objectives
12.2 Accounts for Banking Companies
12.3 Preparation of Profit and Loss Account and Balance Sheet of Banking Companies
12.3.1 RBI Disclosure and Comments on Balance Sheet Items
12.4 Accounting Policies for Banking Sector
12.4.1 Accounting Treatment of Transactions of Special Types
12.5 Accounts for Insurance Companies
12.6 Preparation of Profit and Loss Account and Balance Sheet of Insurance Companies
12.6.1 Special Terms
12.6.2 Life Insurance Companies Annual Accounts
12.7 Answers to Check Your Progress Questions
12.8 Summary
12.9 Key Words
12.10 Self Assessment Questions and Exercises
12.11 Further Readings

12.0 INTRODUCTION

Banking business in India is largely governed by the Banking Regulation Act, 1949. According to Section 5(*b*) of this Act, banking means “the acceptance for the purpose of lending or investment of deposits of money from the public repayable on demand, order or otherwise and withdrawable by cheque, draft, order or otherwise.” Thus, according to this definition accepting of deposits from the public for lending or investment is the main function of a banking company. However, under Section 6 of the Banking Regulation Act, a banking company can also carry on some other businesses, such as acting as agents for any government or local authority or any other person, carrying on every kind of guarantee and indemnity business, undertaking and executing of trust etc.

The Act has been amended from time to time. The major amendments have been in 1994, 2007, 2012 and most in recently in 2017 by The Banking Regulation (Amendment) Act, 2017. The basic provisions of the Amendment Act, 2017 are as under:

1. **Power of Central Government to authorize Bank for issuing directions to banking companies to initiate insolvency resolution process (Sec. 35AA):** The Central government may by order authorize the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a *Default*, under the insolvency and Bankruptcy Code, 2016.

   According to the Insolvency and Bankruptcy Code 2016, the term *Default* means "non-payment of debt when whole or any part of instalment of the amount of debt has become due and is not repaid by the debtor or the corporate debtor, as the case may be".

2. **Power of Reserve Bank to issue directions in respect of stressed assets (Sec. 35AB):** Without prejudice to the provisions of section 35A, the Reserve Bank may, from time to time, issue directions to the banking companies for resolution of stressed assets.

   The Reserved bank may specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise banking companies on resolution of stressed assets.

Stressed Assets: Stressed assets are a powerful indicator of the health of the banking system. Stressed assets comprise of :

NPAs + Restructured Assets + Written off Assets.

Nonperforming Assets (NPAs) include advances whose interest or principal remain overdue for a period of 90 days. While *Restructured Assets* include those advances where the defaulting borrowers have been given another opportunity to repay the advances. This opportunity may in the form of charging interest at a reduced rate, extended time period for repayment *written off assets* are those advances which the bank does not count its assets though the borrower owes it. It does not mean that the borrower is pardoned or got exempted from payment.

The sections given in this unit are of The Banking Regulation Act, 1949 unless stated otherwise.

In this unit, we are concerned mainly with the technique of preparing the final accounts of banking companies. You will also learn about accounting for insurance companies.

The insurance business in India can be divided into two broad categories:

(*i*) Life Insurance:

(*ii*) General Insurance: It includes

(*a*) Fire Insurance (*b*) Marine Insurance (*c*) Miscellaneous Insurance

Life insurers can do life insurance business while general insurers can transact the rest of the business. It may be noted that no composites are permitted under the law. In other words, a firm cannot combine life insurance business with general insurance business.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the accounts for banking companies
- Explain the preparation of Profit and Loss Account and Balance Sheet of banking companies
- Examine the disclosures and policies on banking sector
- Describe the accounts for insurance companies
- Assess the preparation of Profit and Loss Account and Balance Sheet of insurance companies

12.2 ACCOUNTS FOR BANKING COMPANIES

The important provisions relating to final accounts of a banking company are as follows:*

Prescribed form: The final accounts of a banking company include the Profit & Loss Account and the Balance Sheet. It may be noted that no Profit & Loss Appropriation Account is prepared in case of a banking company. All appropriations are done in the Profit & Loss Account itself. The Third Schedule to the Banking Regulation Act, gives the formats of the Profit & Loss Account and the Balance Sheet.

Accounting year: On account of the amended provisions of the Income Tax Act 1961 requiring every company to close its accounts on 31st March each year, *w.e.f.* financial year ending 31st March 1989, now a banking company also closes its accounts on 31st March each year.

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 realisation of security given to or held by it (Section 8).

Non-banking assets: A banking company may have to take possession of certain assets charged in its favour on account of the failure of a debtor to repay the loan in time. Such an asset is termed a non-banking asset. It must be disposed off by the banking company within 7 years of its acquisition (Section 9). Income from either profit or loss on the sale of such an asset has to be shown separately in the profit and loss account of the banking company.

* The sections given in the unit are of the Banking Regulation Act, 1949, unless stated otherwise. The Act had been further amended by the Banking Regulation (Amendment) Act, 2007 making changes regarding maintenance of liquid assets etc.

Share capital: In order to ensure that no banking company commences or carries on business with a weak and vulnerable capital structure, section 11 lays down the following minimum limits of paid-up capital and reserves to be complied with by a banking company which wishes to commence or carry on business in India.

Types of Banking Company	*Aggregate value of paid-up capital and reserves*
1. Banking companies incorporated outside India	₹
(*i*) If it has a place of business in Bombay or Calcutta or both	20,00,000
(*ii*) If it has places of business elsewhere	15,00,000
2. Banking companies incorporated in India	
(*i*) If it has places of business in more than one state and none of them is situated in the city of Bombay or Calcutta	5,00,000
(*ii*) If it has places of business in more than one State and any such place or places of business are in Bombay or Calcutta or both	10,00,000
(*iii*) If it has all its places of business in one state none of which is situated in the city of Bombay or Calcutta–for the principal place of business	10,00,000
plus	
(*a*) in respect of each of its other places of business situated in the same district	10,000
plus	
(*b*) in respect of each place of business situated elsewhere in the state otherwise than in the same district	25,000
Subject to an overall limit of	5,00,000
(*iv*) If it has one place of business and that also not in Bombay or Calcutta	50,000
(*v*) If it has all its places of business in one state, one or more of which is or are situated in the city of Bombay or Calcutta	5,00,000
plus	
in respect of each places of business situated outside the city of Bombay or	25,000
Calcutta, as the case may be Subject to an overall limit of	10,00,000

According to an amendment in 1962, a banking company commencing business, after the coming into force of the Banking Companies (Amendment) Act, 1962, shall have a paid-up capital of not less than ₹ 5 lakhs irrespective of the number of places of its business.

According to Section 12 of the Act a banking company shall not be entitled to commence its business in India unless it satisfies the following conditions:

(*i*) Its subscribed capital is not less than one half of the authorised capital and paid-up capital is not less than one half of the subscribed capital. When the capital is increased, it should comply with the conditions prescribed above within a period not exceeding 2 years as the Reserve Bank may allow.

(*ii*) The capital of the banking consists of equity shares only or equity shares and such preference shares as may have been issued prior to 1st July, 1945 in accordance with the guidelines framed by the Reserve Bank of India. Moreover, such preference shares shall not be entitled to exercise voting rights with equity shareholder even in cases dividend remain unpaid on such shares.

The above provisions do not apply to any banking company incorporated before 15 Jan., 1937 (Section 12).

The limits as to share capital given above were fixed a long time back. These limits have been found to be quite inadequate. In order to strengthen the capital base of the banks, the Reserve Bank, on the recommendations of the Narasimhan Committee, introduced in April, 1992 the risk weighted asset ratio system, in line with capital measurement system introduced by Basel Committee in 1988. According to the system (popularly known as Basel Norms), paid-up capital and reserves of a bank (after writing off bad debts) should form an adequate percentage of the assets of the bank, their investments, loans and advances. All these items have been assigned weights according to the prescribed risk. Ratio so computed is known as Capital Adequacy Ratio (CAR).

The Basel Committee Norms were revised by a new accord popularly known as Basel II Norms, released on June 26, 2004 which were expected to be implemented by the end of 2006. Under Basel II Norms banks have to maintain a capital adequacy ratio (CAR) of 9% which includes Tier I Capital i.e. core capital like Equity and Reserves and Tier II Capital. Now Basel III norms accord has come into being. As per Basel III banks have to maintain a CAR of 8% with a minimum of 7% of Tier I Capital. However at present RBI has asked banks to maintain a CAR of a 9%.

The Reserve Bank of India (RBI) has been allowing since 1989 private banks to be set up. It comes after almost two decades of nationalization of 14 larger banks in 1969. Such a private bank has to be registered as a company under the Companies act. As per the recent guidelines issued on August 1, 2016 by Reserve Bank of India regarding licensing of new banks in the private sector, the initial minimum paid up voting equity capital for such a bank shall be ₹ 500 corers. The Promoters shall hold initially 40% of the paid up voting equity capital of the bank. It will maintain a minimum capital adequacy ratio of 13% on its risk weighted assets for a minimum period of three years after commencement of its operations. Subject to any higher percentage as may be prescribed by RBI.

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% of the price at which the said shares are issued such price shall include the premium charged on as amended by The Banking Regulation (Amendment Act, 2012).

Charge on uncalled capital: A banking company cannot create any charge upon its uncalled capital and any such charge shall be void (Section 14).

Payment of dividend: A banking company cannot pay dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation 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 capitalised 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).

RBI Guidelines Regarding Dividends*

Reserve Bank of India has issued the following guidelines to banks regarding payment of dividend:

1. **Eligibility criteria for declaration of dividend:** Only those banks, which comply with the following minimum prudential requirements, would be eligible to *declare* dividends:

   (i) The bank should have:

   - Capital to Risk Weighted Asset Ratio (CRAR) of at least 9% for preceding two completed years and the accounting year for which it proposes to declare dividend.
   - Net Not Performing Assets (NPA) less than 7%.

   In case any bank does not meet the above CRAR norm, but is having a CRAR of at least 9% for the accounting year for which it proposes to declare dividend, it would be eligible to declare dividend provided its Net NPA ratio is less than 5%.

   (ii) The bank should comply with the provisions of Section 15 and Section 17 (discussed below) of the Banking Regulation Act, 1949 as discussed above.

* RBI circular 2004-2005/451 dated May 4, 2005.

NOTES

(iii) The bank should comply with the prevailing regulations/guidelines issued by RBI, including creating adequate provisions for impairment of assets and staff retirement benefits, transfer of profits to Statutory Reserves etc.

(iv) The proposed dividend should be payable out of the current year's profit.

(v) The reserve Bank should not have placed any explicit restrictions on the bank for declaration of dividends.

In case any bank does not meet the above eligibility criteria no special dispensation shall be available from the Reserve Bank.

2. **Quantum of dividend payable:** Banks, which fulfill the eligibility criteria set out at paragraph1 above, may declare and pay dividends, subject to the following:

   (i) The dividend payout ratio shall not exceed 40%.

   (ii) In case the profit for the relevant period includes any extra-ordinary profits/income, the payout ratio shall be computed after excluding such extra-ordinary items for reckoning compliance with the prudential payout ratio.

   (iii) The financial statements pertaining to the financial year for which the bank is declaring a dividend should be free of any qualifications by the statutory auditors, which have an adverse bearing on the profit during that year. In case of any qualification to that effect, the net profit should be suitably adjusted while computing the dividend payout ratio.

Capital Adequacy Ratio

The banking companies must maintain adequate capital to ensure their financial stability and soundness. This was realized as early as 1974 when Central Bank Governors of Group of Ten (G-10) Countries established BaselCommittee on Banking Supervision (BCBS). The Committee's Secretariat is located at Bank for International Settlement (BIS) in Basel, Switzerland. It provides a forum for regular co-operation on banking supervisory matters to improve the quality of banking services worldwide. The Committee also frames and revises capital adequacy norms popularly known as Basel Committee Norms on Capital Adequacy. Till date of these norms have been issued in three stages: Basel I Norms in 1988, Basel II Norms in 2004 and, Basel III Norms in 2010. Basel III Norms are now desired to be implemented by the banks. The norms call for minimum ratio of capital to risk weighted assets.

In India, the Reserve Bank of India has also be instructing the banks to follow these capital adequacy norms in a phased manner. It has also introduced the "Risk Adjusted (Weighted) Asset Ratio System" which seeks to measure capital adequacy as the ratio of capital funds to risk weighted assets. The ratio is calculated as under:

Capital Adequacy Ratio

$$= \frac{\text{Capital Funds}}{\text{Risk adjusted (weighted) assets and off Balance Sheet Items}} \times 100$$

Or

Risk Weighted Assets Ratio

Each of the above terms are being explained in the following pages.

Capital Funds according to Basel Committee capital funds have two components: (a) Tier I Capital and (b) Tier II Capital.

(a) **Tier I Capital**: It is also known as the core capital since it is the most permanent and readily available support to a bank against unexpected losses is capital of Tier I.

Elements of Tier I Capital for Indian Banks: They include the following:

(i) Aggregate of Paid up Capital

(ii) Statutory Reserve

(iii) Other disclosed Free Reserves including Securities Premium and Capital Reserve arising out of surplus on sale of fixed assets.

The aggregate amount of the above items is to be reduced by: (i) equity investment in subsidiaries; (ii) intangible assets; and (iii) current and brought forward losses.

(b) **Tier II Capital:** It is the capital which is less permanent and less readily available to a bank compared to Tier I Capital in case of unexpected losses.

Elements of Tier II Capital for Indian Banks: They include the following:

(i) Undisclosed Reserves if they represent accumulations of post-tax profits

(ii) Revaluation Reserves at a discount of 55%

(iii) General Provisions and Loss Reserves if not attributable to the actual diminution in value identifiable potential loss in any specific asset and thus available for meeting unexpected losses. Moreover they can be taken up only to the extent of 1.25% of total risk weighted assets.

(iv) Hybrid debt instruments as stated below:

(a) Debt capital instruments

(b) Perpetual Cumulative Preference Shares.

(c) Redeemable Cumulative/Non-cumulative Preference Shares.

(v) Sub-ordinated Debt if fully paid, free of restrictive clauses and not redeemable at the initiative of the holders.

Elements of Tier I Capital for foreign Banks: They include the following

(i) Interest free funds from Head Office kept in a separate account in Indian books specially for the purpose of meeting the capital adequacy norms.

(ii) Statutory reserves kept in Indian books.

(iii) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

(iv) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.

(v) Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.

(vi) The net credit balance, if any, in the inter-office account with Head Office/overseas branches will not be reckoned as capital funds. However, any debit balance in Held Office Account will have to be set off against the capital.

Elements of Tier II Capital for foreign Banks: The elements of Tier II capital of foreign banks are similar to those of Indian banks.

Ratio of Tier II capital to Tier I capital: The quantum of Tier II capital is limited to a maximum of 100% of Tier I Capital. The objective is to ensure that the capital funds of a bank predominantly comprise of core capital rather than items of a less permanent nature. It may further be noted that the Tier II capital of a bank may exceed its Tier I capital. If it happens the excess will be ignored for the purpose of computing the capital adequacy ratio.

Risk Adjusted Assets: They refer to weighted aggregate of funded assets and not funded or off balance sheet items as detailed later. It may be noted that various assets of a bank are exposed to different degrees of risks. For example cash balance has no risk while advances are subject to credit risk. Similarly different off Balance Sheet Items i.e. items which are not shown in the balance sheet, are also subject to varying degrees of risks. For example risk involved in counter guarantee against guarantee given by other bank is much less as compared to the direct guarantee.

The Reserve Bank of India, realizing the above facts, has given different weights to different assets as given below. The value of each asset or item is multiplied by the relevant weight or credit conversion factor to ascertain adjusted value of assets or off balance sheet items. The aggregate is taken into consideration for computing the Risk Weighted Asset Ratio. Thus the Risk Weighted Ratio can be computed as follows

$$\frac{\text{Capital Funds}}{\text{Risk Adjusted assets/off Balance Sheet Items}} \times 100$$

This ratio can also be termed as the Actual Capital Adequacy Ratio. It should be compared with the desired Capital Adequacy Ratio to ascertain whether it is adequate or inadequate.

The risk factor weights for computation of capital change for credit risks are specified by the Reserve Bank of India through a circular regarding “Prudential Norms for Capital Adequacy” issued from time to time.

Reserve Bank of India & Basel Committee Norms

As stated earlier, the Basel Committee has already issued minimum capital adequacy norms for bank as a percentage of Risk Weighted Assets in phases Basel I in 1988, Basel II in 2004 and Basel III in 2010. The requirements of Tier I Capital have been constantly increased to strengthen and increase the loss absorbing capacity of the banks Basel III norms have provided Capital Conservation Buffer (CCB) which functions as an additional layer of common equity (equity capital) to ensure there that bank makes up at least for the minimum common equity requirement even in difficult times.

The Reserve Bank of India has been issuing instructions from time to time to scheduled commercial banks to ensure that they also maintain capital adequacy norms as per the International Standards said down by Basel Committee. In term of Basel III Capital Regulation the Reserve Bank vide is Maser Circular dated March 27, 2014 has provided as follows for Minimum Capital Ratios as a percentage of Risk Weighted Assets (RWAs).

Minimum Capital Ratios	**As a percentage of RW/As**		
	March 31, 2017	March 31, 2018	March 31, 2019
1. Minimum Tier I Capital	7	7	7
2. Minimum Total Capital	9*	9*	9*
3. Capital Conservation Buffer (CCB)	1.25	1.875	2.05
4. Minimum Total Capital + CCB	10.25	10.875	11.05

****Note:*** The difference between the minimum total capital requirement of 9% and the Tier I requirement can be met with Tier II or higher forms of capital. It will be noticed from the above that RBI requiring Banks to consistently strengthens and increase their capital adequacy ratio.

Statutory reserve: According to Section 17 of the Banking Regulation Act, 1949 it is obligatory for every banking company incorporated in India to create a reserve fund and transfer to it at least 20% of its annual profits as disclosed by its Profit and Loss Account before any dividend is declared.

Subsidiary companies: In order to prevent the banking company from carrying on trading activities indirectly by acquiring controlling interest, it has been provided that a banking company can form a subsidiary company only for one or more of the following purposes:

(*i*) The undertaking and executing of trust.

(*ii*) The undertaking of the administration of estates as executor, trustee or otherwise.

(*iii*) The carrying on business of banking exclusively outside India, with the prior permission of the Reserve Bank.

(*iv*) Such other purposes as are incidental to banking business (Section 19).

Limits as to investments in shares and debentures: Except in the circumstances given above no banking company shall hold shares in any other company, whether as pledgee, mortgagee or absolute owner of an amount exceeding 30% of the paid up share capital of that company or 30% of its own paid up share capital and reserves. The RBI has removed the above limit on investments made by the banks in the equity and debentures issues of certain financial institutions. These include IDBI, IFCI, ICICI, Export Import Bank of India, IRBI, NABARD, NHB, UTI, LIC, GIC, RCTFC, TDICI, Tourism Finance Corporation of India, etc.

However, a banks exposure to capital market in all forms has been restricted to 5 per cent of total outstanding advances (including commercial paper) as on March 31 of the previous year by Reserve Bank of India. The ceiling of 5 per cent would cover (*i*) direct investments in equity shares and convertible bonds and debentures; (*ii*) advances against shares to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds; and (*iii*) secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers. A uniform margin of 40 per cent was prescribed on all advances/financing of IPOs/guarantees. A minimum cash margin of 20 per cent (within the margin of 40 per cent) was prescribed in respect of guarantees issued by banks.

Cash reserve: According to Section 42 of the Reserve Bank of India, every scheduled bank has to maintain with the Reserve Bank, such percentage of its demand and time liabilities in India as the Reserve Bank may, from time to time, having regard to the needs of securing the monetary stability in the country, notify in the Gazette of India. This Cash Reserve Ratio (CRR) is being constantly reduced to make greater funds available with the banks to lend money to trade and industry. It now stands at 4% w.e.f. for 16, 2016. Section 18 of the Banking Regulation Act, also makes such provision for non-scheduled banks. However, such cash reserved can be maintained with the bank itself or Reserve Bank or both.

Statutory liquidity ratio: Over and above the Cash reserve, every scheduled bank is required to maintain in India, assets the value of which shall not be less than such percentage not exceeding 40% of the total of its demand and time liabilities in India, in such form and manner which the Reserve Bank by notification in the official gazette may specify from time to time. At present it stands at 19.5% w.e.f. October 4, 2017.

Such assets shall be maintained in such form and manner as mmay be specified in that notification. This is known as Statutory Liquidity Ratio.

Loans and advances: A banking company cannot grant any loans or advances on the security of its own shares. Moreover, it cannot enter into any commitment for granting any loan or advance to or on behalf of the following persons:

(*i*) Any of its directors.

NOTES

(*ii*) Any firm in which any of its director is interested as partner, manager, employer or guarantor.

(*iii*) Any company (not being a subsidiary of a banking company or a company registered under Section 8 of the Companies Act, 2013 i.e., a charitable or a government company) of which any of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest.

(*iv*) Any individual in respect of whom any of its directors is a partner or guarantor (Section 20).

The above restrictions on granting of loans and advances were introduced by an amendment in 1968 in the Banking Regulation Act.

12.3 PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET OF BANKING COMPANIES

The Profit and Loss Account of a banking company has to be prepared in Form *B* of Schedule *III*, attached to the Banking Regulation Act. As stated earlier the form has been revised *w.e.f.* 1st April 1991 and the Profit and Loss Account of a banking company for the year ending March 31, 1992, and onwards has to be prepared in the prescribed new form as given follows:

Form 'B'

THIRD SCHEDULE

FORM OF PROFIT AND LOSS ACCOUNT

Profit and Loss Account for the year ended 31st March, 19...

		Schedule Number	*Year ended (₹)*
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		
	TOTAL		......
IV	APPROPRIATIONS:		
	Transfer to statutory reserves		......
	Transfer to other reserves		......
	Transfer to Govt./proposed dividend		......
	Balance carried over to balance sheet		......
	TOTAL		......

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 funds	......
IV	Other	......
	TOTAL	......

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, Bldg. 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	Misc. Income	
	TOTAL	......

Note:

Under Items *II* to *V* loss figures may be shown in brackets.

SHEDULE 15: INTEREST EXPENDED

		₹
I	Interest on deposits	.....
II	Interest on RBI/Inter-Bank borrowings	.....
III	Others	.....
	TOTAL	.....

SCHEDULE 16: OPERATING EXPENSES

		₹
I	Payments to and provisions for employees	.....
II	Rent, taxes and lighting	.....
III	Printing and stationery	.....
IV	Advertisement and publicity	.....
V	Depreciation on Bank's property	.....
VI	Directors' fees, allowances and expenses	.....
VII	Auditors' fees and expenses (including branch auditors)	.....
VIII	Law charges	.....
IX	Postages, telegrams, telephones etc.	.....
X	Insurance	.....
XI	Other expenditure	.....
	TOTAL	.....

Note:

Corresponding figures for the immediately preceding financial year should be shown in separate columns.

Comments on Profits and Loss Account Items

Interest Earned (Schedule 13)

(1) *Interest/Discount on Advances/Bills*: Includes interest and discount on all types of loans and advances like cash credit, demand, loans, overdrafts, 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.

(2) *Income on Investments*: Includes all income derived from the investment portfolio by way of interest and dividend.

(3) *Interest on Balances with Reserve Bank of India and other Inter-bank Funds*: Includes interest on balance with Reserve Bank and other banks, call loans, money market placements, etc.

(4) *Others*: Includes any other interest/discount income not included in the above heads.

Other Income (Schedule 14)

(1) *Commission, Exchange and Brokerage*: Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on letters of credit, letting out of lockers and guarantees, commission on government business, commission on other permitted agency business including consultancy and other services, brokerage, etc. on securities. It does not include foreign exchange income.

(2) *Profit on Sale of Investments*; *Less*: —Loss on Sale of Investments;

(3) *Profit on Revaluation of Investments*; *Less*: —Loss on Revaluation of Investments;

(4) *Profit on Sale of Land, Buildings and Other Assets*; *Less*: —Loss on sale of land, buildings and other assets.

Includes profit/loss on sale of securities, furniture, land and buildings, motor vehicle, gold, silver, etc. Only the net position should be shown. If the net position is a loss, the amount should be shown as a deduction. The Net Profit/Loss on revaluation of assets may also be shown under this item.

(5) *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.

(6) *Income earned by way of dividends etc.* from subsidiaries, companies, joint ventures abroad/in India.

(7) *Miscellaneous Income*: Includes recoveries from constituents for 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.

NOTES

Interest Expended (Schedule 15)

(1) *Interest on Deposits*: Includes interest paid on all types of deposits including deposits from banks and other institutions.

(2) *Interest on RBI/Inter-Bank Borrowings*: Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.

(3) *Others*: 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 (Schedule 16)

(1) *Payments to and Provisions for Employees*: 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.

(2) *Rent, Taxes and Lighting*: Including rent paid by the bank 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."

(3) *Printing and Stationery*: Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.

(4) *Advertisement and Publicity*: Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.

(5) *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.

(6) *Directors' Fees, Allowances and Expenses*: Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowance, 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.

(7) *Auditors' Fees and Expenses (including branch auditors' fee and expenses)*: Includes the 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 inspection 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'.

(8) *Law Charges*: All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.

(9) *Postage, Telegrams, Telephones, etc*.: Includes all postal charges like stamps, telegram, telephones, teleprinter, etc.

(10) *Repairs and Maintenance*: Includes insurance charges on bank's property, maintenance charges, etc.

(11) *Insurance*: Includes insurance charges on bank's property, insurance premia paid to DICGC etc. to the extent they are not recovered from the concerned parties.

(12) *VRS Expenditure*: In case a banking company has not expensed Voluntary Retirement Expenditure in full in the same year, the entire ex-gratia amount shall be treated as an extra-ordinary item and a deferred revenue expenditure. The period of deferment would be restricted to maximum of 5 years including the year of acceptance of VRS. While allocating the deferred revenue expenditure, it should be recognised that the tax benefits for the whole expenditure will arise in the first year itself. Hence the basis of allocation should be:

(*i*) for the first year the charge should be equal to the firm of tax benefit obtained + 1/5 of the balance, and

(*ii*) in each of the others 4 years, the charge should be equal to 1/5 of the net amount i.e. the gross amount less the tax benefit obtained for the first year.

(13) *Other Expenditure*: All expenses other than those included in any of the other heads, like licence 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: Includes provisions made for bad and doubtful debts, provisions for taxation, provisions for dimunition in the value of investments, transfers to contingencies and other similar items.

Preparation of Balance Sheet

The Balance Sheet of a banking company has to be prepared in Form A of Schedule *III*, attached to the Banking Regulation Act. The form of balance sheet, as stated earlier, has been revised *w.e.f.* April 1, 1991. The Balance Sheet of a banking company has to be prepared in the prescribed new form for the year ending 31st March 1992, and onwards as given below:

The Third Schedule: Form 'A'

FORM OF BALANCE SHEET

Balance Sheet as on 31st March...

	Schedule	₹
CAPITAL AND LIABILITIES:		
Capital	1	.....
Reserves and surplus	2	.....
Deposits	3	.....
Borrowings	4	.....
Other liabilities and provisions	5	.....
	Total:	.....
ASSETS:		
Cash and balance with RBI	6	.....
Balance with banks and money at call and short notice	7	.....
Investments	8	.....
Advances	9	.....
Fixed assets	10	.....
Other assets	11	.....
	Total:	.....
Contingent liabilities:		
Bills for collection	12	.....

The following schedules are required to be furnished with the Balance Sheet:

SCHEDULE 1: CAPITAL

		₹
I	FOR NATIONALISED BANKS:	
	Capital (Fully owned by Central Government)	.....
II	FOR BANKS INCORPORATED OUTSIDE INDIA	
	(*i*) Capital (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 *RBI* under Section 11(2) of the Banking Regulation Act, 1949	.....
	Total	.....
III	FOR OTHER BANKS:	
	Authorised capital (...shares of ₹ ...each)	.....
	Issued capital (...shares of ₹ ...each)	.....
	Subscribed capital (...shares of ₹ ...each)	.....
	Called up capital (...shares of ₹ ...each)	.....
	Less: calls unpaid	.....
	Add: Forfeited shares	.....

SCHEDULE 2: RESERVES AND 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 A/c:		.....
		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 borrowing in *I* and *II* above	₹	.....

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 RBI

			₹
I	Cash in hand (including foreign currency notes)	.....	
II	Balances with RBI in:		
	(*i*) Current A/c		.....
	(*ii*) Other A/c		.....
	Total (*I & II*)		.....

SCHEDULE 7: BALANCE WITH BANKS & MONEY AT CALL AND SHORT NOTICE

			₹
I	In India		
	(*i*) Balance with banks:		
	(*a*) in Current A/c	.....	
	(*b*) in Other deposit A/c	.....	.....
	(*ii*) Money at call and short notice		
	(*a*) With banks	.....	
	(*b*) With other institutions	.....	.....
	Total (*i*) *and* (*ii*)		.....

II	Outside India	
(*i*)	In Current A/c	.....
(*ii*)	In Other deposit A/c	
(*iii*)	Money at call and short notice	.....
	Total (*i*), (*ii*) *and* (*iii*)	.....
	GRAND TOTAL (*I and II*)	.....

NOTES

SCHEDULE 8: INVESTMENTS

			₹
I	Investments in India in		
(*i*)	Govt. 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*)	Govt. securities (incl. local authorities)		.....
(*ii*)	Subsidiaries and/or joint ventures abroad		.....
(*iii*)	Other investment (to be specified)		.....
		Total	.....
	Grand Total (*I and II*)		.....

SCHEDULE 9: ADVANCES

			₹
A (*i*)	Bills discounted and purchased		.....
(*ii*)	Cash credits, overdrafts and loans payable on demand		.....
(*iii*)	Term loans		.....
		Total	.....
B (*i*)	Secured by tangible assets		.....
(*ii*)	Covered by Bank/Govt. guarantees		.....
(*iii*)	Unsecured		.....
		Total	.....
C *I*	Advances in India:		
	(*i*) Priority sectors		.....
	(*ii*) Public sectors		.....
	(*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 (*CI and CII*)		.....

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 (Incl. furniture and fixture):		
	At cost as on 31st March of the preceding year	.....	
	Additions during the year	.....	
	Deductions during the year	.....	
	Depreciation to date	.....	.....
	Total (*I and II*)		.....

SCHEDULE 11: OTHER ASSETS

		₹
Inter-office adjustments (net)		.....
Interest accrued		.....
Tax paid in advance/tax deducted at source		.....
Stationery and stamps		.....
Non-banking assets acquired in satisfactions of claims		.....
Others*		.....
	Total	.....

*In case there is any unadjusted balance of loss (*i.e.* when the loss exceeds the aggregate of capital, reserves and surplus), the same may be shown under this item under appropriate footnote.

SCHEDULE 12: CONTINGENT LIABILITIES

			₹
I	Claims against the bank not acknowledged as debts		.....
II	Liability for party 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		.....
		Total	.....

12.3.1 RBI Disclosure and Comments on Balance Sheet Items

The Reserve Bank of India (RBI) has issued guidelines for improving transparency in the financial statements of banks by which from the accounting year ending March 2000, banks have been, advised to disclose the following additional information as a 'Note to Accounts':

(*a*) Maturity pattern of

(*i*) loans and advances (*ii*) investment in securities

(*iii*) deposits and (*iv*) borrowings

(*b*) Foreign Currency Assets and Liabilities

(*c*) Movement in NPAs, and

(*d*) Lending to sensitive sectors like real estate capital market and other factors as defined by RBI from time to time.

Comments on Balance Sheet Items

Capital (Schedule 1)

Nationalised banks: (*a*) *Capital (fully owned by Central Government)*: 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.

(*b*) *Banking Companies incorporated outside India*:

(*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 deposit kept with *RBI*, under sub-section 2 of Section 11 of the Banking Regulation Act, 1949 should also be shown.

Other banks (Indian): 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'.

Note: 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 (Schedule 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 & Loss Account. Surplus on revaluation should be treated as Capital Reserve. 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 will include all reserves, other than those separately classified. The expression 'reserve' shall not include any amount written off 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.

Note: Movement in various categories of reserves should be shown as indicated in the schedule.

Deposits (Schedule 3)

Demand deposits

(*i*) *From Banks* and

(*ii*) *From Others:* Includes all bank deposits repayable on demand. Includes all demand deposits of the non-bank sectors. Credit balance in overdrafts, cash credit account, 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.

Savings bank deposits

Includes all savings bank deposits (including inoperative savings bank accounts).

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.

(*I*) *Deposits of branches in India, and (II) Deposits of Branches outside India.* The total of the two items will agree with the total deposits.

Notes:

(*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 such deposits have matured for payment they should be shown 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 (Schedule 4)

Borrowings in India

(*i*) *Reserve Bank of India*: Includes borrowings/refinance obtained from the Reserve Bank of India.

(*ii*) *Other Banks*: Includes borrowings/refinance obtained from commercial banks (including co-operative banks).

(*iii*) *Other Institutions and Agencies*: Includes borrowing/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).

Borrowings outside India: Includes borrowings of Indian branches abroad as well as borrowing of foreign branches.

Secured borrowing included above: This item will be shown separately. Includes secured borrowings/refinance in India and outside India.

Notes:

(*i*) The total of the above mentioned 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 the 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 (Schedule 5)

Bills payable: The bank provides the facility of remitting funds from one place to another by means of bank drafts, telegraphic transfer, circular notes, pay orders etc. The person intending to remit the money has to deposit the money with the bank and get a pay order or bank draft in exchange for the money deposited. Alternatively, he may request the bank for making a telegraphic transfer from his account to the account of the person to whom he wants to remit the money. The paying bank is reimbursed by the bank who issues such draft or instructions. The banks also issues travellers and gift cheques for carrying or remitting money. If any such drafts, cheques etc. remain uncashed on the day of preparation of final accounts, they are shown under the hearing "Bills Payable" in the balance sheet.

Inter-office (or branch) adjustments (net): This item represents the difference on account of incomplete recording of transactions between one branch and another branch or between one branch and the head office.

It may have a debit or a credit balance. In case of a credit balance, it should be shown under this head. It may be noted that only the net portion is to be shown as inter-office accounts, inland as well as foreign.

Interest accrued: Includes interest accrued but not due on deposits and borrowings.

Others (including provisions): Includes 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 reserves 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 unclaimed dividend provisions and funds 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:

(*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).'

Cash and Balance with the Reserve Bank of India (Schedule 6)

(*i*) Cash in hand including foreign currency notes);

(*ii*) Balance with *RBI* (*a*) in current account; (*b*) in other accounts.

Includes cash in hand including foreign currency notes and also of foreign branches in the case of banks having such branches.

Balances with Banks and Money at Call and Short Notice (Schedule 7)

In India

(*i*) *Balance with banks*: (*a*) in Current Accounts; (*b*) in other Deposit Accounts: Including all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.

(*ii*) *Money at call and short notice*: (*a*) with Banks; (*b*) with Other Institutions. This items mainly represents the loans given by one bank to another for a short period. Call loans are repayable at any time the banker recalls them while short notice advances are repayable within a short notice of (say) 24 hours. The maximum notice period is usually of two weeks.

This includes deposits repayable within 15 days or less than 15 days notice lent in the inter-bank call money market.

Outside India

(*i*) *Current Accounts*

(*ii*) *Deposits Accounts*: Includes balances held by foreign branches and Indian branches of the banks outside India. Balance held with foreign branch 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.

(*iii*) *Money at Call and Short Notice*: Includes deposits usually classified in foreign countries as money at call and short notice.

Investment (Schedule 8)

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 shares of companies and corporations not included in item (*ii*) above should be included here.

(*iv*) *Debentures and Bonds*: Investments in debentures and bonds of companies and corporations not included in items (*ii*) should be included here.

(*v*) *Investment in Subsidiaries/Joint Ventures*: Investments in Subsidiaries/ Joint ventures (including RRBs) should be included here.

(*vi*) *Others*: Includes residual investment, if any, like gold, commercial paper and other instruments in the nature of shares/debentures/bonds.

Investments outside India

(*i*) *Government Securities (including local authorities)*: All foreign Government securities including securities issued by local authorities may be classified under this head.

(*ii*) *Subsidiaries 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.

Classification of Investments

(*i*) According to the revised guidelines issued by the Reserve Bank of India *w.e.f.* 30 September 2000, the banks are required to classify their entire investment portfolio under three categories:

(*a*) Held to Maturity;

(*b*) Available for Sale; and

(*c*) Held for Trading

(*ii*) Banks should decide the category of investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to Maturity

(*i*) The securities acquired by the banks with the intention to hold them up to maturity will be classified under **Held to Maturity**.

(*ii*) The investments included under 'Held to Maturity' should not exceed 25 per cent of the bank's total investments.

(*iii*) The following investments will be classified under 'Held to Maturity':

(*a*) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.

(*b*) Investment in subsidiaries and joint ventures.

(*c*) The investments in debentures/bonds, which are deemed to be in the nature of an advance.

(*iv*) Profit on sale of investments in this category should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account'. Loss on sale will be recognized in the Profit and Loss Account.

Available for Sale and Held for Trading

(*i*) The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under *Held for Trading.*

(*ii*) The securities which do not fall within the above two categories will be classified under *Available for Sale.*

(*iii*) The banks will have the freedom to decide on the extent of holdings under Available for Sale and "Held for Trading" categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills, capital position.

(*iv*) The investments classified under "Held for Trading" category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

(*v*) Profit or loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

Valuation

(*a*) *Held to Maturity*

(*i*) Investments classified under "Held to Maturity" category need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

(*ii*) Banks should recognize any diminution, other than temporary, in the value of their investments in subsidiaries/joint ventures which are included under "Held to Maturity" category and provide therefor. Such diminution should be determined and provided for each investment individually.

(*b*) *Available for Sale*

(*i*) The individual scrips in the "Available for Sale" category will be marked to market at the quarterly or at more frequent intervals. While the net depreciation under each classification should be ignored. The book value of the individual securities would not undergo any change after the revaluation.

(*ii*) The provisions required to be created on account of depreciation in the "Available for Sale" category in any year should be debited to the Profit and Loss Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve or the balance available in the Investment Fluctuation Reserve Account, whichever is less), shall be credited the Investment Fluctuation Reserve Account. It will be shown as a separate item under the head "Revenue and Other Reserves".

(*c*) *Held for Trading*

The individual scrips in the Held for Trading category will be marked to market at monthly or at more frequent intervals as in the case of those in the Available for Sale category. The book value of the individual securities in this category would not undergo any change after making to market.

Of course, in the Balance Sheet, the investments will continue to be disclosed as per the existing six classifications discussed above.

Investment Fluctuation Reserve

(*i*) With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks are advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years. IFR should be computed with reference to investments in two categories, *viz.*, "Held for Trading" and "Available for Sale". It will not be necessary to include investment under "Held to Maturity" category for the purpose of computation of IFR. However, banks are free to build up a higher percentage of IFR up to 10 per cent of the portfolio depending on the size and composition of their portfolio with the approval of their Board of Directors.

(*ii*) Banks should transfer maximum amount of the gains realised on sale of investments in securities to the IFR.

(*iii*) Transfer to IFR shall be as an appropriation of net profit “below the line” after appropriation to statutory reserve.

Advances (Schedule 9)

(*A*)

(*i*) *Bills discounted and purchased:* The banks also give advances to their customers by discounting their bills. Net amount after deducting the amount of discount is credited to the account of customer. The bank may discount the bills with or without any security from the debtor in addition to one or more persons already liable on the bill.

(*ii*) *Cash-Credits*: *Overdrafts and Loans repayable on demand*:

Cash credits. A cash credit is an arrangement by which a banker allows his customer to borrow money upon a certain limit. Cash credit arrangements are usually made against the security of commodities hypothecated or pledged with the bank.

In case of a cash credit facility the borrower need not borrow at once the whole of the amount he is likely to require, but draw such amounts as and when required. He can put back any surplus amount which he may find with him for the time being. Interest on cash credit account has to be paid on the amount actually drawn at any time and not on the full amount of the credit allowed.

Overdrafts: The customer may be allowed to overdraw his current account with or without security if he requires temporary accommodation. This arrangement like cash credit is advantageous from the customer’s point of view as he is required to pay interest on the actual amount used by him.

Loans: A loan is a kind of advance made with or without security. In case of loan the bank makes a lump sum payment to the borrower or credits his deposit account with the money advanced. Repayments may be made in instalments or at the expiry of a certain period. The customer has to pay interest on the total advance whether he withdraws the money from his account (credited with the loan) or not. A loan once repaid in full or in part cannot be drawn again by the borrower unless the banker sanctions a fresh loan.

(*iii*) *Term Loans*: A loan may be in the form of a demand loan. Demand loan is payable on demand. It is usually for a short period not exceeding a year, while the term loan is given for a fixed term usually exceeding a year.

In classification under Section '*A*', all outstanding-in India as well as outside-less provisions made, will be classified under three heads indicated above and both secured and unsecured advances will be included under these heads. Term loans should be mentioned including overdue instalments.

(*B*)

(*i*) *Secured by Tangible Assets*: All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India and outside India.

(*ii*) *Covered by Bank/Government Guarantee*: Advances in India and outside India to the extent that they are covered by guarantees of India and foreign governments and Indian and foreign banks and *DICGC* and *ECGC* are to be included.

(*iii*) *Unsecured*: All advances not classified under (*i*) and (*ii*) will be included here.

Total of '*A*' should tally with total of '*B*'.

(*C*)

(*i*) *Advances in India (Priority Sectors; Public Sectors; Banks and Others)*: Advances should be broadly classified into 'Advances in India' and 'Advances outside India'. Advances in India will be further classified on the sectorial 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 Sectors'. Such advances should be excluded from item

(*ii*) *i.e. Advances to Public Sector*: Advances to Central and State Governments and other Government undertakings including Government Companies and corporation which are, according to the statutes, to be treated as public sector companies are to be included in the category 'Public Sectors'. All advances to the banking sector including cooperative 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 cooperative sectors.

Notes:

(*i*) The gross amount of advances including refinance and rediscounts but excluding provision 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.

NOTES

Fixed Assets (Schedule 10)

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 including residential premises should be shown against 'Premises'. In the case of premises and other fixed assets, the previous balance, additions thereto and deductions therefrom during the year as also the total depreciation written off should be shown. Where sums have been written off on reduction of capital or revaluation of assets, every balance sheet 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 revision made.

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 all other fixed assets other than premises but including furniture and fixtures should be shown under this head.

Other Assets (Schedule 11)

They include the following:

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 balance of 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.

Interest accrued: Interest accrued but not due on investment and advances and interest due but not collected on investments will be the main components of this item. As banks normally debit the borrowers' account with interest due on the balance sheet date, usually there may not be any amount of interest due on advance. Only such interest as can be realised in the ordinary course should be shown under this head.

Tax paid in advance/deducted at source: 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.

Stationery and stamps: Only exceptional items of expenditure on stationery, like bulk purchase of security 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.

Non-banking assets acquired in satisfaction of claims: Immovable properties/tangible assets acquired in satisfaction of claims are to be shown under this head.

Others: This will include items like claims which have not been met, for instance, clearing items, debit items representing addition to assets or reduction in liabilities which have not been adjusted for technical reasons, want of particulars, etc. advances given to staff by a bank as employer and not as a banker, etc. Items which are in the nature of expenses which are pending adjustments should be provided for and the 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.

Contingents Liabilities (Schedule 12)

(*i*) Claims against the bank not acknowledged debts.

(*ii*) Liability for partly paid investments: Liabilities on partly paid shares, debentures, etc. will be included in this head.

(*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: This item will include letters of credit and bills accepted by the bank on behalf of customers. In such cases the bank takes upon itself the responsibility for payment.

In order to keep a proper record of such liability the bank maintains a customer acceptances, endorsements and guarantee register. All obligations undertaken by the bank as a result of guarantees, endorsements, acceptances etc. are recorded here. At the end of the accounting year, if some of these obligations remain undisbursed, they are to be shown as contingent liabilities under this head.

(*vi*) Other items for which the bank is contingently liable: Arrears of cumulative dividends, bills rediscounted under underwriting 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

A banking company receives a large number of bills of exchange for collection purposes. In order to keep a systematic record of such bills it maintains a book called “Bills for Collection Register” On receipt of a bill for collection the entry is made in this register. On collection of the bill of exchange, besides making a note of this fact in the bills for collection register, the following accounting entry is also passed by the banker:

Cash A/c	Dr.	.....	
(with the amount of bill collected)			
To Customer's A/c			.....
(with the amount of Bill collected less commission charges)			
To Commission A/c			.....

At the end of the accounting period, the amount of bills yet to be collected is ascertained from the bills for collection register. The total amount of such bills is shown here.

Acceptances Endorsement and other Obligations

In order to help its sound and good clients a bank may accept or endorse a bill of exchange and give guarantee for the payment of a debt. As per Schedule III this is an "Off Balance Sheet Item" and has to be shown outside the balance sheet.

The details of "Acceptances Endorsements and Other Obligations" undertaken by the bank may be recorded in a separate register. In case the bank has to meet an obligation on account of default of a customer, the following journal entry may be passed;

Customer A/c	Dr.
(with the total amount paid	
To Bank A/c	
(with the amount paid)	
To Interest/Commission Account	
(with the interest/commission paid, if any)	

Compulsory Deposits

About a decade back, certain persons were required to make compulsory deposits with a bank as per income tax, excise rules etc. These deposits were received by the concerned bank on behalf of the concerned authority. They are therefore included in the category of Demand Deposits and shown in the Balance Sheet accordingly.

Notes and Instruction for Compilation

General Instructions:

1. The formats of balance sheet and profit and loss account cover all items likely to appear in these statements. In case a bank does not have any particular item to report, it may be omitted from the formats.
2. Corresponding comparative figures for the previous year are to be disclosed as indicated in the formats. The words 'current year' and

'previous year' used in the formats are only to indicate the order of presentation and may not appear in the accounts.

3. Figures should be rounded off to the nearest thousand rupees. Thus, a sum of ₹ 19,75,921.20 will appear in the balance sheet as ₹ 19.76.
4. Unless otherwise indicated, the term 'banks' in these statements will include banking companies, nationalised banks, State Bank of India Associate Banks and all the institutions including co-operatives carrying on the business of banking whether or not incorporated or operating in India. The Hindi version of the Balance Sheet will be a part of the annual report.

12.4 ACCOUNTING POLICIES FOR BANKING SECTOR

On the recommendations of the Ghosh Committee, the Reserve Bank of India has issued a directive to all scheduled commercial banks to disclose the Accounting Policies adopted by them in the financial statements for the year ending 31st March, 1991, and later.

A specimen form based on the published accounts of IDBI Bank, for the year ending 31 March, 2017 in which accounting policies may be disclosed in the financial statements is given as:

Significant Accounting Policies

1. Basis of Preparation

The financial statements have been prepared in accordance with requirements prescribed under the Third Schedule of the Banking Regulation Act, 1949. The accounting policies used in the preparation of these financial statements, in all material aspects, conform to Generally Accepted Accounting Principles in India (Indian GAAP), the guidelines issued by Reserve Bank of India (RBI) from time to time, the Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) and prescribed under Section 133 of Companies Act, 2013 (â Actâ) read with Rule 7 of the Companies (Account) Rules, 2014, the provisions of the Act (to the extent notified) and practices generally prevalent in the banking industry in India. The Bank follows the accrual method of accounting, except where otherwise stated, and the historical cost convention.

2. Use of Estimates

The preparation of financial statements requires the management to make estimates and assumptions that affect the reported amount of assets, liabilities, expenses, income and disclosure of contingent liabilities as at the date of the financial statements. Management believes that these estimates and assumptions are reasonable and prudent. However, actual results could differ from estimates. Any revision to accounting estimates is recognized prospectively in current and future periods.

3. Revenue Recognition

Revenue is recognized to the extent it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured

(i) Interest income is recognized on accrual basis except in the case of nonperforming assets where it is recognized upon realization as per the prudential norms of the RBI.

(ii) Commissions on Letter of Credit (LC)/ Bank Guarantee (BG) are accrued over the period of LC/ BG.

(iii) Fee based income are accrued on certainty of receipt and is based on milestones achieved as per terms of agreement with the client.

(iv) Income on discounted instruments is recognized over the tenure of the instrument on a constant yield basis.

(v) Dividend is accounted on an accrual basis when the right to receive the same is established.

(vi) In case of Non-performing advances, recovery is appropriated as per the policy of the bank.

4. Advances and Provisions

(i) Advances are classified into Standard, Sub-standard, Doubtful and Loss assets and provisions are made in accordance with the prudential norms prescribed by RBI and additional provisions as decided by the management. Advances are stated net of provisions towards non-performing advances.

(ii) Advances are classified as Secured by Tangible Assets when security of at least 10% of the advance has been stipulated/created against tangible security including book debts. Security in the nature of escrow, guarantee, comfort letter, charge on brand, license, patent, copyright etc are not considered as Tangible Assets.

(iii) Amounts recovered against debts written-off in earlier years and provisions no longer considered necessary in the context of the current status of the borrower are recognized as income in the Profit and Loss account.

(iv) The Bank does not make any floating provision for bad and doubtful advances and investments.

(v) Provision on loans and advances restructured/rescheduled is made in accordance with the applicable RBI guidelines on restructuring of loans and advances by Banks.

(vi) The Bank had made countercyclical provisioning buffer as required by RBI guidelines, amended from time to time, with the approval of the Board, which can be utilized within the limits and in the circumstances permitted by Reserve Bank of India (RBI).

5. Investment

A. Classification

In terms of extant guidelines of the RBI on investment classification and valuation, the entire investment portfolio is categorized as

(i) Held To Maturity,

(ii) Available For Sale and

(iii) Held For Trading.

Investments under each category are further classified as

(i) Government Securities

(ii) Other Approved Securities

(iii) Shares

(iv) Debentures and Bonds

(v) Subsidiaries/Joint Ventures

(vi) Others (Commercial Paper, Mutual Fund Units, Security Receipts, Pass through Certificate).

B. Basis of Classification

(a) Investments that the Bank intends to hold till maturity are classified as Held to Maturity.

(b) Investments that are held principally for sale within 90 days from the date of purchase are classified as Held for Trading.

(c) Investments, which are not classified in the above two categories, are classified as Available for Sale.

(d) An investment is classified as Held To Maturity Available For Sale or Held For Trading at the time of its purchase and subsequent shifting amongst categories and its valuation is done in conformity with RBI guidelines.

(e) Investments in subsidiaries, joint venture are classified as Held To Maturity.

C. Valuation

(i) In determining the acquisition cost of an investment:

(a) Brokerage, commission, stamp duty, and other taxes paid are included in cost of acquisition in respect of acquisition of equity instruments from the secondary market whereas in respect of other investments, including treasury investments, such expenses are charged to Profit and Loss Account.

(b) Broken period interest paid/received is excluded from the cost of acquisition/ sale and treated as interest expense/income.

(c) Cost is determined on the weighted average cost method.

(ii) Investments Held To Maturity are carried at acquisition cost unless it is more than the face value, in which case the premium is amortized on straight line basis over the remaining period of maturity. Diminution, other than temporary, in the value of investments in subsidiaries/joint venture under this category is provided for each investment individually.

(iii) Investments Held For Trading and Available For Sale are marked to market scrip- wise and the resultant net depreciation, if any, in each category is recognized in the Profit and Loss Account, while the net appreciation, if any, are ignored.

(a) Treasury Bills, commercial papers and certificates of deposit being discounted instruments are valued at carrying cost.

(b) In respect of traded/quoted investments, the market price is taken from the trades/quotes available on the stock exchanges.

(c) The quoted Government Securities are valued at market prices and unquoted/nontraded government securities are valued at prices declared by Primary Dealers Association of India (PDAI) jointly with Fixed Income Money Market and Derivative Association of India (FIMMDA).

(d) The unquoted shares are valued at break-up value or at Net Asset Value if the latest balance sheet is available, else, at ₹ 1/- per company and units of mutual fund are valued at repurchase price as per relevant RBI guidelines.

(e) The unquoted fixed income securities (other than government securities) are valued on Yield to Maturity (YTM) basis with appropriate mark-up over the YTM rates for Central Government securities of equivalent maturity. Such mark-up and YTM rates applied are as per the relevant rates published by FIMMDA.

(f) Security receipts issued by the asset reconstruction companies are valued in accordance with the guidelines applicable to such instruments, prescribed by RBI from time to time. Accordingly, in cases where the cash flows from security receipts issued by the asset reconstruction companies are limited to the actual realisation of the financial assets assigned to the instruments in the concerned scheme, the Bank reckons the net asset value obtained from the asset reconstruction company from time to time, for valuation of such investments at each reporting period end.

(g) Quoted Preference shares are valued at market rates and unquoted/ non-traded preference shares are valued at appropriate yield to maturity basis, not exceeding redemption value as per RBI guidelines.

Profit or Loss on sale of investments is credited/debited to Profit and Loss Account. However, profits on sale of investments in Held to Maturity category is first credited to Profit and Loss Account and thereafter appropriated, net of applicable taxes to the Capital Reserve Account at the year/period end. Loss on sale is recognized in the Profit and Loss Account. Investments are shown net of provisions.

6. Fixed Assets (Property, Plant & Equipment) and depreciation

(i) Fixed assets other than Premises are stated at cost less accumulated depreciation. Premises are revalued in accordance with the Bank policy and RBI guidelines and the same are stated at revalued amount less accumulated depreciation.

(ii) Cost of asset includes purchase cost and all expenditure incurred on the asset before put to use. Subsequent expenditure incurred on assets put to use is capitalized only when it increases the future benefits from such assets or their functioning capability.

(iii) The appreciation on revaluation, if any, is credited to Revaluation Reserve.

(iv) Depreciation in respect of fixed assets is calculated on Straight Line Method with reference to cost or revalued amounts, in case of assets revalued and the same is charged to Profit and Loss account.

(v) In respect of revalued assets, the additional depreciation consequent to revaluation is transferred from revaluation reserve to general reserve in the balance sheet.

(vi) Fixed assets individually costing less than ₹5000 are fully depreciated in the year of addition.

(vii) Depreciation on tangible assets is allocated over useful life of the asset as prescribed under Part C of Schedule II of the Companies Act 2013. The useful lives and residual values are reviewed periodically. If the management estimate useful lives of an asset at the time of acquisition of the asset or of remaining useful life on subsequent review is shorter, depreciation is provided at a higher rate based on management estimate of useful life *I* remaining useful life.

(viii) Depreciation on additions/ sale of fixed assets during the year is provided for the period for which assets were actually held.

(ix) The useful lives of Fixed assets are as follows:

(x) Leasehold land is amortized over the period of lease.

(xi) Computer Software (non-integral) individually costing more than ₹ 2.50 Lacs is capitalised and depreciated in 6 years.

7. Foreign Currency Transactions

(i) Foreign currency transactions, on initial recognition are recorded at the exchange rate prevailing on the date of transaction. Monetary foreign currency assets and liabilities are translated at the closing rates prescribed by Foreign Exchange Dealers Association of India (FEDAI) and the resultant gain or loss is recognized in the Profit and Loss account. Exchange differences arising on the settlement of monetary items are recognized as income or expense in the period in which they arise.

(ii) Premium or discount arising at the inception of Forward Exchange Contracts which are not intended for trading is amortized as expense or income over the life of the contract. Premium or discount on other Forward Exchange Contracts is not recognized.

(iii) Outstanding Forward Exchange Contracts which are not intended for trading are revalued at closing FEDAI rates. Other outstanding Forward Exchange Contracts are valued at rates of exchange notified by FEDAI for specified maturities or at interpolated rates for in-between maturities. The resultant profit/ losses are recognized in the Profit and Loss Account.

(iv) Profit/ losses arising on premature termination of Forward Exchange Contracts, together with unamortized premium or discount, if any, is recognized on the date of termination.

(v) Contingent liability in respect of outstanding forward exchange contracts is calculated at the contracted rates of exchange and in respect of guarantees; acceptances, endorsements and other obligations are calculated at the closing FEDAI rates.

(vi) Operations of foreign branch are classified as Integral Foreign Operations. Assets and Liabilities are translated at the closing rates prescribed by Foreign Exchange Dealers Association of India (FEDAI) Income and Expenditure items are translated at quarterly average rates. The resultant gain or loss is recognized in the Profit and Loss Account.

8. Employee Benefits

(i) Payments to defined contribution schemes are charged to Profit and Loss Account of the year when contribution are due.

(ii) For defined benefit schemes, the cost of providing benefits is determined using the Projected Unit Credit Method, with actuarial valuations being carried out at each Balance Sheet date. Actuarial gains or losses are recognized in the profit and loss account for the period in which they occur.

(iii) The undiscounted amount of short-term employee benefits expected to be paid in exchange for the services rendered by employees is recognized during the period when the employee renders the service.

9. Segment Reporting

The Bank operates in three segments wholesale banking, retail banking and treasury services. These segments have been identified in line with AS-17 on segment reporting after considering the nature and risk profile of the products and services, the target customer profile, the organization structure and the internal reporting system of the Bank.

Segment revenue, results, assets, and liabilities include the amounts identifiable to each of the segments as also amounts allocated, as estimated by the management. Assets and liabilities that cannot be allocated to identifiable segments are grouped under unallocated assets and liabilities.

10. Income Tax

(i) Tax expense comprises of current and deferred tax.

Current tax is the amount of Income tax determined to be payable (recoverable) in respect of taxable income (tax loss) for a period calculated in accordance with the provisions of the Income Tax Act, 1961 and the Income Computation and Disclosure Standards (ICDS).

(ii) Deferred tax for timing differences between the book and tax profits for the year is accounted for, using the tax rates and laws that have been substantively enacted as of the balance sheet date. Deferred tax assets arising from timing differences are recognized to the extent there is reasonable certainty that these would be realized in future.

(iii) Deferred tax assets in case of unabsorbed depreciation/ losses are recognized only if there is virtual certainty that such deferred tax asset can be realized against future taxable profits.

(iv) Disputed taxes not provided for including departmental appeals are included under Contingent Liabilities.

11. Earnings Per Share

(i) The Bank reports basic and diluted Earnings Per Share in accordance with AS 20. Basic Earnings per Share is computed by dividing the net profit after tax by the weighted average number of equity shares outstanding at the year end.

(ii) Diluted Earnings per Share reflect the potential dilution that could occur if securities or other contracts to issue equity shares were exercised or converted during the period. Diluted Earnings per Share is computed by dividing the net profit after tax by the sum of the weighted average number of equity shares and dilutive potential equity shares outstanding at the year end.

12. Impairment of Assets

Fixed Assets are reviewed for impairment whenever events or changes in circumstances warrant that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated current realizable value and value in use. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds estimated current realizable value of the asset or value in use.

13. Provisions, Contingent Liabilities and Contingent Assets

(i) In conformity with AS 29, Provisions, Contingent Liabilities and Contingent Assets, the Bank recognizes provisions only when it has a present obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and when a reliable estimate of the amount of the obligation can be made.

(ii) Provisions are not discounted to its present value and are determined based on best estimate required to settle the obligation at the balance sheet date.

(iii) Reimbursement expected in respect of expenditure required to settle a provision is recognized only when it is virtually certain that the reimbursement will be received.

(iv) Contingent Assets are neither recognized nor disclosed.

Application of Indian Accounting Standards

In line with the global trends Indian Companies are also being required, in phases, by the Government to adopt International Financial Reporting Standards (IFRS). Indian Accounting Standards (Ind ASs) are largely based on International Financial Reporting Standards (IFRSs). The schedule for application of Ind ASs to banking and non-banking finance companies, as per Reserve Bank of India’s directives, is as under.

Banking Companies

All scheduled commercial banks have to comply with the Indian Accounting Standards (Ind ASs) for accounting period beginning on or after 1st April, 2018 with comparatives for periods ending on or after 31st March, 2018. Ind ASs would be applicable on or after the aforesaid date to both standalone financial statements and consolidated financial statements.

Non-banking Finance Companies (NBFCs)

Phase I: For accounting periods beginning on or after the 1st April, 2018, with comparatives for the periods ending on 31st March, 2018, or thereafter-

(A) NBFCs having net worth of rupees five hundred crore or more;

(B) Holding, subsidiary, joint venture or associate companies of companies covered under item (A), other than those already covered under clauses (i), (ii) and (iii) of sub-rule (1) of rule 4.

Phase II: For accounting periods beginning on or after the 1st April, 2019, with comparatives for the periods ending on 31st March, 2019, or thereafter-

(A) NBFCs whose equity or debt securities are listed or in the process of listing on any stock exchange in India or outside India and having net worth less than rupees five hundred crore;

(B) NBFCs, that are unlisted companies, having net worth of rupees two-hundred and fifty crore or more but less than rupees five hundred crore; and

(C) Holding, subsidiary, joint venture or associate companies of companies covered under item (A) or item (B) of sub-clause (b), other than those already covered in clauses (i), (ii) and (iii) of sub-rule (1) or item (B) of sub-clause (a) of clause (iv).

12.4.1 Accounting Treatment of Transactions of Special Types

Accounting treatment of some specific items in the Profit and Loss Account and Balance Sheet is explained in the following pages.

Income Recognition

Assets of the banks are classified as performing assets and non-performing assets for the purpose of income recognition. Assets which are not non-performing are performing assets. An asset become non-performing when it ceases to generate income for banks. A non-performing asset would be an advance where:

(*i*) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,

(*ii*) The account remains 'our of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC),

(*iii*) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

(*iv*) Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and

(*v*) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

The terms 'Out of Order' and 'Overdue' have been defined as under:

Out of Order: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

NOTES

Overdue: Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Banks have been advised by the Reserve Bank of India that they should identify the non-performing assets and ensure that interest on such non-performing assets is not recognised as income and taken to the profit and loss account. Banks are to recognise their income on Accrual Basis in respect of income on performing assets and on Cash Basis in respect of income on non-performing assets. Any interest accrued and credited to income account must be cancelled by a reserve entry once the credit facility comes under the category of non-performing assets.

A non-performing asset may become performing asset

An asset becomes non-performing when the interest and/or instalment of principal is delayed and not received before a stipulated time. In other words, an asset becomes non-performing when it ceased to generate income for banks. A term loan is treated as non-performing asset when interest and/or instalment of principal remains over due for a period of more than 90 days.

The identification of non-performing assets is to be done on the basis of the position as on the balance sheet data. If an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources (not by sanction of additional facilities or transfer of funds between accounts) the account need not be treated as non-performing assets. The bank should however ensure that the account remains in order subsequently.

Hence, non-performing assets, need not be permanently non-performing assets, it shall resume into performing assets, subject to the satisfaction of their norms at the discretion of banks.

Illustration 12.1: Given below are details of interest on advances of a Commercial Bank as on 31-3-2012.

	Interest Earned *₹ in lakhs*	*Interest Received* *₹ in lakhs*
Performing assets:		
Term loan	240	160
Cash credit and overdraft	1,500	1,240
Bills purchased and discounted	300	300
Non-performing assets:		
Term loan	150	10
Cash credit and overdraft	300	24
Bills purchased and discounted	200	40

Find out the income to be recognised for the year end 31-3-2012.

Solution:

Interest on performing assets should be recognised on accrual basis but interest on non-performing assets should be recognised on Cash basis as per directions given in various circulars issued by R.B.I.

	₹ *in lakhs*
Interest on Term loan (240 + 10)	250
Interest on cash credit and overdraft (1500 + 24)	1524
Income from bills purchased and discounted (300 + 40)	340
Income to be recognised:	2114

Bad Debts and Provisions for Doubtful Debts

The business of a banking company depends on public confidence. In order to ensure that this confidence is not impaired, the banks some years back were given a special privilege permitting them not to show in their published accounts bad debts and provisions for doubtful debts. They could show income after making deductions for such losses. In the Profit and Loss account the income from 'interest and discount' was usually shown after meeting such losses. In the Balance Sheet, the amount of advances was shown after deducting bad and doubtful debts.

However, with effect from April 1, 1991 this practice has undergone a change. The amount of bad debts and provision for bad debts has to be charged under the heading "Provisions and Contingencies" in the Profit and Loss Account. In the Balance Sheet, the advances are shown after deducting the both, bad debts and provision for bad debts. It may be noted that the banks collect from their branches information regarding bad and doubtful debts also. The Schedule of Advances to be filled in by the branches contains a separate column regarding doubtful debts in respect of bills purchased and discounted, cash-credits and overdrafts, and unsecured loans. However, while consolidating the Schedule of Advances at the Head Office level for Balance Sheet purposes the advances are shown net of any bad or doubtful debts.

Any surplus provision for doubtful debts has not to the deducted from advances but to be shown under the heading other liabilities and provisions in the Balance Sheet.

Assets Classification and Provisions for Doubtful Debts

As per the present guidelines of the Reserve Bank the assets classification and the requisite provision for doubtful debts is as under.

Assets Classification

Banks are required to classify the loan assets (advances) into four categories viz.:

(*i*) Standard Assets; (*ii*) Sub-standard Assets; (*iii*) Doubtful Assets; and (*iv*) Loss Assets.

(*i*) *Standard Assets*: Standard asset is one which does not disclose any problem and which does not carry more than normal risk attached to the business. Such asset is considered as performing asset.

(*ii*) *Sub-standard Assets*: With effect from 31st March, 2005 sub-standard asset is one which has been classified as a non-performing asset (NPA) for a period not exceeding 12 months. In such cases, the current net worth of the borrowers/ guarantors or the current market value of the security charged is not enough to ensure recovery of the dues to the banks in full. In other words, such assets will have well-defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

An asset where the terms of the loan agreement regarding interest and principal have been re-negotiated or rescheduled after commencement of production, should be classified as sub-standard and should remain in such category for at least 12 months of satisfactory performance under the re-negotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of this condition.

(*iii*) *Doubtful Assets*: A doubtful asset is one which has remained in sub-standard category for a peiod exceeding 12 months.

(*iv*) *Loss Assets*: A loss asset is one where loss has been identified by the bank or internal or external auditors or the co-operative Department or the RBI inspection but the amount has not been written off, wholly or partly. Such an asset is not realisable, although there may be some salvage or recovery value.

Provisions: The purpose of classifications of bank assets is to make adequate provisions on the basis of quality of assets, the realisation of the security and the erosion in the value of security. It has been directed that the banks should make provision against the various assets on the following basis:

(*i*) *Standard Assets:* The provision has to be made on the outstanding amount as under:

	% Rate of provision
(a) On direct advances to agricultural and SME	0.25
(b) On advances to commercial Real Estate (CRE) sector	1.00
(c) On all other loans and advances not covered by (a) and (b) above	0.40

(*ii*) *Sub-standard Assets:* Provision has to be made as under:

	% Rate of provision
(a) On secured exposures without making any allowance for ECGC Guarantee cover and securities available	15
(b) On unsecured exposures	25
(c) On unsecured exposures in respect of infrastructure loan accounts where certain safeguards such as escrow accounts are available	20

(*iii*) *Doubtful Assets*:

(*a*) To the extent the debt is not covered by realisable value of the security, 100% provision is to be made.

(*b*) In addition to the above (*a*), for the secured portion of the doubtful assets, provision is required to be made between 25% and 100% depending upon the period for which the asset has remained doubtful as given below:

Period for which the advances have been considered doubtful	*Percentage of provision*
Upto one year	25
More than one year but upto three years	40
Above three years	100

(*iv*) *Loss Assets*: The entire assets should be written off or if the assets are to be retained in the books for any reason 100% provision is required to be made.

Notes: (i) The provision standard assets should not be reckoned for arriving at net NPAS.
(ii) Provision towards standard assets should not be deducted from advanced but shown separately as contingent provisions against standard assets under "Other Liabilities and Provisions" — 'Others' in Schedule *V* of the Balance Sheet.

Illustration 12.2: Compute the amount of provision for doubtful debts from the following details of advances of National Bank Ltd.

		(₹ *in lakhs*)
1.	Total loans and advances	50
2.	Fully secured advances without any default by the borrowers	30
3.	Advances overdue for 15 months	10
4.	Advances overdue for more than 30 months but less than 36 months (secured by mortgage of plant worth ₹ 3 lakhs)	5
5.	Non-recoverable unsecured advances	3
6.	Small advances not exceeding ₹ 25,000 to each borrower (unsecured)	2

Solution:

COMPUTATION OF PROVISION FOR DOUBTFUL DEBTS

			Provision for doubtful debts	
S. No.	*Category of advances*	*₹ lakhs*	*%*	*₹*
1.	Standard assets	30	.40	12,000
2.	Sub-standard assets	10	15	1,50,000
3.	Doubtful assets	5	Unsecured portion + 40% of secured portion	3,20,000
4.	Loss assets	3	100	3,00,000
5.	Small advances (sub-standard)	2	20	40,000
		50		8,22,000

Illustration 12.3: 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 2015-16:

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 3 years (secured by mortgage of machinery worth ₹ 1,000 lakhs)	1,800
Non-recoverable assets	3,000

Solution:

COMPUTATION OF PROVISION AGAINST ADVANCES

Classification of Assets	*Amount (₹ in lakhs)*	*%age of Provision*	*Provision (₹ in lakhs)*
Standard	16,000	0.40%	64
Sub-standard	12,000	25%	3,000
Doubtful for 1 year	4,800	25%	1,200
Doubtful 2 to 3 years	3,600	40%	1,440
Doubtful more than 3 years	1,800	100% of unsecured	1,800
Non-recoverable Assets	3,000	100%	3,000
	41,200		10,504

Provision for Taxation

Its treatment till a few years back was on the pattern of bad and doubtful debts. The amount of Provision for Taxation was quietly deducted from Interest and Discount Income. In the Balance Sheet, the amount was merged with "Current and Contingencies Accounts", on the Liabilities side. However, with effect from 1.4.1991, the above practice has undergone a change. In the revised formates, effective from 1.4.1991, the item has to be shown as follows:

The amount of Provision for Taxation has to be charged to the Profit and Loss Account under the hearing "Provision and Contingencies"; in the Balance Sheet, it will be shown under the heading "Other Liabilities and Provisions", on the Liabilities side.

It will be useful here to know the provisions of the Income Tax Act regarding treatment of Provision of Doubtful Debts while creating provision for Taxation. Section 36 (1) (*VII*) (*a*) of the Income Tax Act, 1961, permits banking companies to make adequate provisions from their current profits to provide for risk in relation to advances made by them. The amount of deduction for bad and doubtful debts is as under:-

1. In case of a bank incorporated outside India or a public financial institution—an amount not exceeding 5% of the total income of the banking company or financial institution before making such deduction.
2. In case of a bank incorporated in India:-
   (*i*) an amount not exceeding 5% of the total income of the banking company before making such deduction, and
   (*ii*) an amount not exceeding 10% of the aggregate advances made by rural branches of such bank.

Tutorial Note: In the absence of any specific details, the students may create Provisions for Taxation on Net Profits left after charging Provision for Doubtful Debts.

Rebate on Bills Discounted

This refers to unexpired discount. A banking company charges discount in advance for the full period of the bill of exchange or promisory note discounted with it. The accounting entry made is as follows:

Bill discounted and purchased A/c	Dr.
To Customer's A/c	
To Discount A/c	

Customer's account is credited with the net amount remaining after deducting the amount of discount. The amount credited to the discount account represents the earning of the bank. However, it may be possible that the bills discounted may mature after the close of the financial year. It will not be appropriate to take to the credit of the profit and loss account that part of the discount charged which relates to the next year. An accounting entry is, therefore, passed for unearned discount in the following manner:

Discount A/c	Dr.
To Rebate on bills discounted	
(with the amount of unearned discount relating to the next period)	

Rebate on bills discounted, if already appears in the trial balance is taken to the balance sheet on the "liabilities side". However, if adjustment has to be done after preparation of the trial balance in respect of rebate on bills discounted, the amount of such rebate (*i.e.* the unearned discount) will be deducted from the total discount in the profit and loss account and will also appear as a liability in the balance sheet.

Illustration 12.4: The following information is available in the books of *X* Bank Limited as on 31st March, 2017.

	₹
Bills discounted	1,37,05,000
Rebate on Bills discounted (as on 1.4.2016)	2,21,600
Discount received	10,56,650

Details of bills discounted are as follows:

Value of bill (₹)	Due date	Rate of discount
18,25,000	5.6.2017	12%
50,00,000	12.6.2017	12%
28,20,000	25.6.2017	14%
40,60,000	6.7.2017	16%

Calculate the rebate on bills discounted as on 31.3.2017 and give necessary journal entries.

Solution:

STATEMENT SHOWING REBATE ON BILLS DISCOUNTED

Value	*Due date*	*Days after 31.3.2017*	*Rate of discount*	*Discount amount*
18,25,000	5.6.2016	(30 + 31 + 5) = 66	12%	39,600
50,00,000	12.6.2017	(30 + 31 + 12) = 73	12%	1,20,000
28,20,000	25.6.2017	(30 + 31 + 25) = 86	14%	93,021
40,60,000	6.7.2017	(30 + 31 + 30 + 6) = 97	16%	1,72,633
1,37,05,000		Rebate on bills discounted on 31.3.2017		4,25,254

Books of *X* Bank Ltd.

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
	Rebate on bills discounted Account Dr. To Discount on bills Account (Being opening balance of rebate on bills discounted account transferred to discount on bills account)	2,21,600	2,21,600
	Discount on bills Account Dr. To Rebate on bills discounted Account (Being provision made on 31st March, 2017)	4,25,254	4,25,254
	Discount on bills Account Dr. To Profit and Loss Account (Being transfer of discount on bills, of the year, to profit and loss account)	8,52,996*	8,52,996

* Credit to Profit and Loss A/c = ₹ 10,56,650 + ₹ 2,21,600 – ₹ 4,25,254 = ₹ 8,52,996.

Interest on Doubtful Debts

Interest earned by a banking company on doubtful debts can be treated in any of the following ways in the accounts of a banking company:

(*a*) *Interest Suspense Method.* The interest earned may be credited to Interest Suspense Account opened for this purpose.

(*b*) *Cash Method.* No entry is passed for such interest till it is actually received.

(*c*) *Accrual Method*. Interest Account may be credited with the full amount of interest due on doubtful debts and simultaneously an adequate provision for bad and doubtful debts may becreated.

It may be noted, as discussed earlier, that the doubtful debts come within the category of non-performing assets and *therefore interest income on such doubtful advances should not be recognised and taken to the profit and loss account*. The method (*b*) is therefore best under the present circumstance. However, in the following illustrations we are explaining each of the above methods:

Illustration 12.5: When closing the books of a banks on 31 March, 2013 (for the year 2012–13), you find in the 'Loan Ledger' an unsecured balance of ₹ 2,00,000 in the account of a merchant whose financial condition is reported to you as bad and doubtful. Interest on the same account amounting to ₹ 20,000 (for 2012–13) remains to be recorded.

During the year 2013–14 the bank accepts 75 paise in a rupee on account of the total payment of debt from the merchant as on 31 March, 2013.

Pass the necessary journal entries and prepare the necessary ledger accounts in respect of the above under each of the alternative methods.

Solution:

(I) Interest Suspense Method

JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
2013	Merchant's A/c	Dr.	20,000	
31 Mar.	To Interest suspense A/c			20,000
	(For interest due on doubtful debt of ₹ 2,00,000 credited to interest suspense A/c)			
	P & L A/c	Dr.	2,00,000	
	To Provision for bad debts			2,00,000
	(For creation of provision for bad debts)			
2014	Cash A/c		1,65,000	
31 Mar.	To Merchant's A/c			1,65,000
	(For dividend of 75 paise in a rupee received from the merchant)			
	Interest suspense A/c	Dr.	5,000	
	Bad debts A/c	Dr.	50,000	
	To Merchant's A/c			55,000
	(Amount of interest not received reversed and balance of the account transferred to bad debts account)			
	Interest suspense A/c	Dr.	15,000	
	To Profit and loss A/c			15,000
	(Amount of interest received against interest suspense A/c credited to the Profit and loss A/c)			
	Provision for bad debts A/c	Dr.	50,000	
	To Bad debts A/c			50,000
	(Bad debts written off against provision)			

Ledger Accounts

MERCHANT'S ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2003		
1st Apr.	To Balance b/d	2,00,000	31 Mar.	By Balance c/d	2,20,000
2013					
31 Mar.	To Interest suspense A/c	20,000			
		2,20,000			2,20,000
2013			2004	By Cash	1,65,000
1 April	To Balance b/d	2,20,000	31 Mar.	By Interest suspense A/c	5,000
				By Bad debts	50,000
		2,20,000			2,20,000

INTEREST SUSPENSE ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
31 Mar.	To Balance c/d	20,000	31 Mar.	By Merchant's A/c	20,000
		20,000			20,000
2014			2013		
31 Mar.	To Merchant's A/c	5,000	1 Apr.	By Balance b/d	20,000
	To P and L A/c	15,000			
		20,000			20,000

(II) Cash Method

JOURNAL ENTRIES

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
2013	P & L A/c Dr.	2,00,000	
31 Mar.	To Provision for bad debts A/c		2,00,000
	(For creating of provision for bad debts)		
2014	Cash A/c Dr.	1,65,000	
31 Mar.	To Interest A/c		15,000
	To Merchant's A/c		
			1,50,000
	(For amount received from the merchant 75 per cent of the interest due and of the amount of the advance)		
	Bad Debts A/c Dr.	50,000	
	To Merchant's A/c	50,000	
	(For writing off as irrecoverable the balance of the amount due from the merchant)		
	Provision for bad debts A/c Dr.	50,000	
	To Bad debts A/c	50,000	
	(For writing off bad debts against provision)		

Ledger

MERCHANT'S ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2003		
1 Apr.	To Balance b/d	2,00,000	31 Mar.	By Balance c/d	2,00,000
2013			2004		
1 Apr.	To Balance b/d	2,00,000	31 Mar.	By Cash	1,50,000
				By Bad debts A/c	50,000
		2,00,000			2,00,000

INTEREST ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2004		
31 Mar.	To P & L A/c	15,000	31 Mar.	By Cash	15,000
		15,000			15,000

BAD DEBTS ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2004		
31 Mar.	To Merchant's A/c	50,000	31 Mar.	By Provision for bad debts	50,000
		50,000			50,000

(III) Accrual Method

JOURNAL ENTRIES

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
2013				
31 Mar.	Merchant's A/c	Dr.	20,000	
	To Interest for bad debts A/c			20,000
	(For interest due from the merchant on the loan)			
	P & L A/c	Dr.	2,20,000	
	To Provision for bad debts A/c			2,20,000
	(For creation of provision for bad debts)			
2014				
31 Mar.	Cash	Dr.	1,65,000	
	Bad Debts A/c	Dr.	55,000	
	To Merchant			2,20,000
	(For amount received from the merchant and the amount written off as irrecoverable)			
	Provision for bad debts A/c	Dr.	55,000	
	To Bad debts A/c			55,000
	(For writing off bad debts against the provision)			

Ledger Accounts

MERCHANT'S ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2012			2013		
1 Apr.	To Balance b/d	2,00,000	31 Mar.	By Balance c/d	2,20,000
2013					
31 Mar.	To Interest A/c	20,000			
		2,20,000			2,20,000
2013			2014		
1 Apr.	To Balance b/d	2,20,000	31 Mar.	By Cash	1,65,000
				By Bad debts A/c	55,000
		2,20,000			2,20,000

INTEREST ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
31 Mar.	To P & L A/c	20,000	31 Mar.	By Merchant's A/c	20,000
		20,000			20,000

PROVISION FOR BAD DEBTS ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2013			2013		
31 Mar.	To Balance c/d	2,20,000	31 Mar.	By P & L A/c	2,20,000
		2,20,000			2,20,000
2014			2013		
31 Mar.	To Bad debts A/c	55,000	01 April	By Balance b/d	2,20,000
	To Balance c/d	1,65,000			
		2,20,000			2,20,000

BAD DEBTS ACCOUNT

Date	*Particulars*	₹	*Date*	*Particulars*	₹
2014			2014		
31 Mar.	To Merchant's A/c	55,000	31 Mar.	By Provision for	
		55,000		bad debts A/c	55,000

Note: While creating a provision for bad debts at the end of March, 2014, the balance in the Provision for Bad Debts Account remaining unutilised in respect of the merchant, will be taken into account.

The illustrations given in the following pages will help the readers in understanding and preparing the final accounts of a Banking Company.

Capital Adequacy

Capital Adequacy Ratio (CAR) is a specialized ratio used by banks to determine the adequacy of their capital keeping in view their risk exposures. Banking regulators require a minimum capital adequacy ratio so as to provide the banks with a cushion to absorb losses before they become insolvent. This improves stability in financial markets and protects deposit-holders. Basel Committee on Banking Supervision

NOTES

of the Bank of International Settlements develops rules related to capital adequacy which member countries are expected to follow.

A bank has to comply with the capital adequacy ratio requirements at two levels: (a) the consolidated level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its capital strength and risk profile after consolidating the assets and liabilities of its subsidiaries / joint ventures / associates etc. except those engaged in insurance and any non-financial activities; and (b) the standalone level capital adequacy ratio requirements, which measure the capital adequacy of a bank based on its standalone capital strength and risk profile. Accordingly, overseas operations of a bank through its branches are covered in both the above scenarios.

Check Your Progress

1. What are non-banking assets?
2. How is risk weighted asset ratio calculated?
3. Name the schedule of the Banking Regulation Act used for the preparation of balance sheet.
4. On what basis are the performing and non-performing assets of a company recognised?
5. What are the items shown under Reserves and Surplus?
6. Mention the categories of other liabilities and provisions under Schedule 5 in the banking balance sheet.

12.5 ACCOUNTS FOR INSURANCE COMPANIES

Before studying about the accounting treatment for insurance companes. Let's learn about the main players in this segment. The main players in the insurance business are as under:

Life Insurers

(*i*) Life Insurance Corporation of India (LIC): Established under the Life Insurance Corporation of India Act, 1956 and wholly owned by the Government of India. It controls more than 90 per cent of the life insurance business in India.

(*ii*) A number of private players have come into being in life insurance business since April 2000. These private players are as under:

(*a*) HDFC Standard Life Insurance Co. Ltd.

(*b*) Max Life Insurance Co. Ltd.

(*c*) ICICI Prudential Life Insurance Co. Ltd.

(*d*) Birla SunLife Insurance Co. Ltd.

(*e*) SBI Life Insurance Co. Ltd.

(*f*) Bajaj Allianz Life Insurance Co. Ltd.

(*g*) PNB MetLife India Insurance Co. Pvt. Ltd.

(*h*) Aviva Life Insurance Co. India Pvt. Ltd.

(*i*) Exide Life Insurance

(*j*) IDBI Federal Life Insurance

(*k*) India first Life Insurance Company

(*l*) Peerless Group

(*m*) Edelweiss Tokio Life Insurance

General Insurers

(*i*) General Insurance Corporation of India (GIC): It was set up in 1971 on nationalisation of general insurance business. It was originally a holding company for the following general insurance companies:

(*a*) The Oriental Insurance Company Limited

(*b*) The New India Assurance Company Limited

(*c*) National Insurance Company Limited

(*d*) United India Insurance Company Limited

However, *w.e.f.* December, 2000, General Insurance Corporation of India has become a national reinsurer for general insurance business while each of its above four subsidiary companies have been de-linked from it and made as independent insurance companies.

(*ii*) Since April, 2000, a number of private general insurers have also entered insurance business.

They include the following:

(*a*) Royal Sundaram Alliance Insurance Co. Ltd.

(*b*) Reliance General Insurance Co. Ltd.

(*c*) IFFCO Tokio General Insurance Co. Ltd.

(*d*) Tata AIG General Insurance Co. Ltd.

(*e*) Bajaj Allianz General Insurance Co. Ltd.

(*f*) ICICI Lombard General Insurance Co. Ltd.

(*g*) Cholamandalam General Insurance Co. Ltd.

(*h*) Export Credit Guarantee Corporation Ltd.

(*i*) HDFC-ERGO General Insurance Co. Ltd.

(*j*) Agriculture Insurance Company of India

(*k*) Apollo Munich Health Insurance

(*l*) Bharti AXA General Insurance

(*m*) Export Credit Guarantee Corporation of India

(*n*) L & T General Insurance

(*o*) Liberty Videocon General Insurance

(*p*) Reliance General Insurance

(*q*) Religare

(*r*) Star Health and Allied Insurance

(*s*) Universal Sompo General Insurance Company

Some have stayed afloat, others have shut shop.

Insurance Repository

On 16th September 2013, IRDA launched “insurance repository” services in India. It is a unique concept and first to be introduced in India. This system enables policy holders to buy and keep insurance policies in dematerialized or electronic form. Policy holders can hold all their insurance policies in an electronic format in a single account called Electronic Insurance Account (EIA). Insurance Regulatory and Development Authority of India has issued licences to five entities to act as Insurance Repository:

CDSL Insurance Repository Limited (CDSL IR), SHCIL Projects Limited Karvy Insurance Repository Limited NSDL Database Management Limited CAMS Repository Services Limited.

Appointment of Ombudsman

Insurance Industry has Ombudsman in 17 cities. Each ombudsman is empowered to redress customer grievances in respect of insurance contracts on personal lines where the insured amount is less than ₹ 20 lakhs, in accordance with the Ombudsman Scheme.

Insurance Regulatory & Development Authority (IRDA)

IRDA has been established to regulate and control insurance business.

Composition of IRDA

Insurance Regulatory and Development Authority (IRDA) has been established under the Insurance Regulatory and Development Authority Act passed by Parliament in 1999. The composition of *IRDA* as per the Section 4 of the IRDA Act is as under:

(*i*) A Chairman;

(*ii*) Not more than Five Whole-time Members; and

(*iii*) Not more than Four Part-time Members.

All the above officials are appointed by the Government of India.

Duties, Powers and Functions of IRDA

The following are the duties, powers and functions of IRDA as laid down in Section 14 of the IRDA Act, 1999:

(1) Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

(2) Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include:

(*a*) issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;

(*b*) protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

(*c*) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents;

(*d*) specifying the code of conduct for surveyors and loss assessors;

(*e*) promoting efficiency in the conduct of insurance business;

(*f*) promoting and regulating professional organisations connected with the insurance and re-insurance business;

(*g*) levying fees and other charges for carrying out the purposes of this Act;

(*h*) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;

(*i*) control and regulations of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under Section 64U of the Insurance Act, 1938;

(*j*) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

(*k*) regulating investment of funds by insurance companies;

(*l*) regulating maintenance of margin of solvency;

(*m*) adjudication of disputes between insurers and intermediaries or insurance intermediaries.

Legal Framework

The insurance is a federal subject in India. The primary legislations which deal with various aspects relating to accounts and audits of an insurance business are as under:

(1) The Insurance Act, 1938 (including Insurance Rules, 1939);

(2) The Insurance Regulatory and Development Authority Act, 1999;

(3) The Insurance Regulatory and Development Authority Regulations, 2002;

(4) The Companies Act, 2013; and

(5) The General Insurance Business (Nationalisation) Act, 1972 (including Rules framed there under).

12.6 PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET OF INSURANCE COMPANIES

The following are some of the basic provisions relating to preparation of financial statements of insurance companies:

Application of Accounting Standards

Every Balance Sheet, Revenue Account (Policy Holders Account) Receipts and Payments Account [Cash Flow Statement] and Profit and Loss Account [Shareholders' Account] of the insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to the insurer carrying on general insurance business, except that:

(*i*) Accounting Standard 3 (AS 3)—Cash Flow Statements shall be prepared only under the Direct Method.

(*ii*) Accounting Standard 13 (AS 13)—Accounting for Investments shall not be applicable.

(*iii*) Accounting Standard 17 (AS 17)—Segment Reporting shall apply irrespective of whether the securities of the insurer are traded publicly or not.

The Ministry of Corporate Affairs has notified 40 Indian Accounting Standards (Ind ASs) for *IFRS* convergence in India. The Ind ASs are being gradually applied w.e.f. 1st April, 2016 to companies incorporated in India. However, as regards insurance companies Ind ASs shall apply as when it is so notified by the Insurance Regulatory Development Authority (IRDA). However an insurer or insurance company shall provide Ind AS compliant financial statement data for the purposes of preparation of consolidated financial statements by its parent or investor or venturer, as required by the parent or investor or venturer to company with the requirements of these rules.

Disclosures Forming Part of Financial Statements

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*) Guarantees given by or on behalf of the company
   (*e*) Statutory demands/liabilities in dispute, not provided for
   (*f*) Reinsurance obligations
   (*g*) Others (to be specified)
2. Encumbrances to assets of the company in and outside India.
3. Commitments made and outstanding for loans, investments and fixed assets.

4. Claims, less re-insurance, paid to claimants in/outside India.
5. Actuarial assumptions for claim liabilities in the case of policies exceeding four years.
6. Aging of claims—distinguishing between claims outstanding for more than six months and other claims.
7. Premiums, less reinsurance, written from business in/outside India.
8. Extent of premium income recognised, based on varying risk pattern, category wise, with basis and justification therefore, including whether reliance has been placed on external evidence.
9. Value of contracts in relation to investments, for:
   (*a*) Purchases where deliveries are pending, and
   (*b*) Sales where payments are overdue.
10. Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.
11. Historical costs of those investments valued on fair value basis.
12. Computation of managerial remuneration.
13. Basis of amortisation of debt securities.
14. (*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 Account' and on realisation reported in Profit and Loss Account.
    (*b*) Pending realisation, the credit balance in the 'Fair Value Change Account' is not available for distribution.
15. Fair value of investment property and the basis therefor.
16. Claims settled and remaining outstanding for a period of more than six months on the balance sheet date.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the *ICAI*, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer shall be stated in the manner required under Accounting Standard (AS) 1 issued by *ICAI*.
2. Any departure from the accounting policies as aforesaid shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India.
2. Segregation into performing/non-performing investments for purpose of income recognition as per the directions, if any, issued by the Authority.
3. Percentage of business sector-wise.

4. A summary of financial statements for the last five years, in the manner as may be prescribed by the authority.
5. Accounting Ratios as may be prescribed by the Authority.
6. Basis of allocation of Interest. Dividends and Rent between Revenue Account and Profit and Loss Account.

General Instructions for Preparation of Financial Statements

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account and Profit and Loss Account should be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated as gross value, the amounts of income tax deducted at source being included under 'advance taxes paid'.
4. Income from rent shall not include any notional rent.
5. (*I*) For the purposes of financial statements, unless the context otherwise requires—

    (*a*) the expression 'provision' shall, subject to note (*II*) below, mean any amount written off 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 or loss of which the amount cannot be determined with substantial accuracy;

    (*b*) the expression 'reserve' shall not, subject to as aforesaid, include any amount written off 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;

    (*c*) the expression capital reserve shall not include any amount regarded as free for distribution through the profit and loss account; and the expression 'revenue reserve' shall mean any reserve other than a capital reserve, and

    (*d*) The expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

    (*II*) Where,

    (*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

    (*b*) any amount retained by way of providing for any known liability is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of these accounts as a reserve and not as a provision.
6. The company should make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.
7. Risks assumed in excess of the statutory provisions, if any, shall be separately disclosed indicating the amount of premiums involved and the amount of

risks covered. The auditor shall, however, make an appropriate qualification in this regard in his report.

8. Any debit balance of profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance, if any, shall be shown separately.

Management Report

There shall be attached to the financial statements, a management report containing, *inter alia*, the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority;
2. Certification that all the dues payable to the statutory authorities have been duly paid;
3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;
4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India;
5. Confirmation that the required solvency margins have been maintained;
6. Certification to the effect that the values of all the assets have been reviewed on the date of the Balance Sheet and that in his (insurer's) belief the assets set forth in the Balance Sheets are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings—"Loans", "Investments", "Agents Balances", "Outstanding Premiums", "Interest, Dividends and Rents Outstanding", "Interest. Dividends and Rents accruing but not due", "Amounts due from other persons or Bodies carrying an insurance business", "Sundry Debtors". "Bills Receivable", "Cash" and the several items specified under "Other Accounts".
7. Certification to the effect that no part of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 relating to the application and investment of the life insurance funds;
8. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same;
9. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;
10. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;
11. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown;
12. Review of asset quality and performance of investment in terms of portfolios, *i.e.*, separately in terms of real estate, loans, investments, etc.

13. A responsibility statement indicating therein that:
    (*i*) in the preparation of financial statements, the applicable accounting standards, principles and policies have been followed along with proper explanations relating to material departures, if any;
    (*ii*) the management has adopted accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the operating profit or loss and of the profit or loss of the company for the year;
    (*iii*) the management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act, 1938, Companies Act, 1956, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
    (*iv*) the management has prepared the financial statements on a going concern basis; and
    (*v*) the management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.

Format of Financial Statements

The insurance companies were till recently presenting their financial statements, *i.e.,* Balance Sheet, Profit and Loss Account and Revenue Account, as per the forms prescribed in Schedules 1, 2 and 3 respectively of the Insurance Act, 1938.

The Act has been amended by the Insurance (Amendment) Act, 2000. As a result the insurance companies are now required to prepare their financial statements as per the form specified by the Insurance Regulatory and Development Authority. The salient features regarding preparation of the financial statements as given in the Regulations issued by IRDA in 2002 are being summarised as under:

Life Insurers: Insurers carrying on the life insurance business should comply with the requirements of Schedule *A* of the Regulations which among other things, gives the following forms:

Revenue Account	Form *A—RA*
Profit and Loss Account	Form *A—PL*
Balance Sheet	Form *A—BS*

General Insurers: Insurers doing general insurance business should comply with the requirements of Schedule B of the Regulations which among other things, gives the following Forms:

Revenue Account	Form *B—RA*
Profit and Loss Account	Form *B—PL*
Balance Sheet	Form *B—BS*

It may be noted that both Life Insurers and General Insurers are required to prepare Revenue Account and Balance Sheet in summarised form. However, in both the cases, there are 15 Schedules: 4 Schedules relate to the Revenue Account and 11 Schedules relate to Balance Sheet giving detailed information. In both the cases, the Profit and Loss Appropriation Account is dispensed with and the appropriation items have been accommodated in the Profit and Loss Account.

On account of amendment in the Section 3(*II*) of the Income Tax Act, 1961 providing for a uniform accounting year, all insurance companies also close their annual accounts on 31st March each year *w.e.f.* accounting year ending 31 March, 1989.

We are giving below the prescribed format of the Revenue Account, Profit and Loss Account and the Balance Sheet with necessary details as required by Insurance Regulatory and Development Authority.

A. Format of Life Insurance Business

In this case Revenue Account (Policyholders' Account) Profit and Loss Account (Shareholders' Account) and Balance Sheet are prepared as per Form *A-RA* Form, *A-PL* and Form *A-BS* respectively.

FORM *A-RA*

Name of the Insurer: ....…

Registration No. and Date of Registration with the IRDA ....…

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20..........…

Policyholders' Account (Technical Account)

Particulars	*Schedule*	*Current Year (₹'000)*	*Previous Year (₹'000)*
Premiums earned—net			
(*a*) Premium			
(*b*) Re-insurance ceded	1		
(*c*) Re-insurance accepted			
Income from Investments			
(*a*) Interest, Dividends and 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*)			
TOTAL (*A*)			
Commission	2		
Operating Expenses related to Insurance Business	3		
Provision for doubtful debts			
Bad debts written off			
Provision of Tax			
Provisions (other than taxation)			
(*a*) For diminution in the value of investments (Net)			
(*b*) Others (to be specified)			
TOTAL (*B*)			
Benefits Paid (Net)	4		
Interim Bonus Paid			
Change in valuation of liability in respect of life policies			
(*a*) Gross**			
(*b*) Amount ceded in Re-insurance			
(*c*) Amount accepted in Re-insurance			
Total (*C*)			

NOTES

Surplus (Deficit) (*D*) = (*A*) – (*B*) – (*C*)			
Appropriations Transfers to Shareholders' Account Transfer to Other Reserves (to be specified) Balance being Funds for Future Appropriations			
TOTAL (*D*)			

Notes:

* Represents the deemed realised gain as per norms specified by the Authority

** Represents Mathematical Reserves after allocation of bonus

The total surplus shall be disclosed separately with the following details

(*a*) Interim Bonus Paid

(*b*) Allocation of Bonus to policyholders

(*c*) Surplus shown in the Revenue Account

(*d*) Total Surplus: [(*a*) + (*b*) + (*c*)]

See Notes appended at the end of Form *A-PL*.

FORM *A-PL*

Name of the Insurer: ....…

Registration No. and Date of Registration with the IRDA ....…

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20…

Shareholders' Account (Non-technical Account)

Particulars	*Schedule*	*Current Year (₹'000)*	*Previous Year (₹'000)*
Amounts transferred from/to the Policyholders Account (Technical Account) Income From Investments (*a*) Interest, Dividends and Rent—Gross (*b*) Profit on sale/redemption of Investments (*c*) Loss on sale/redemption of Investments Other Income (To be specified)			
TOTAL (*A*)			
Expense 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 on tax (*e*) Transfer to reserves/other accounts (to be specified)			
Profit carried … to the Balance Sheet			

NOTES

Notes 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 ceded or accepted are to be brought into account gross (*i.e.,* before deducting commissions) under the head re-insurance premiums.

(*c*) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(*d*) items of expenses and income in excess of one per cent of the total premiums (less re-insurance) or ₹ 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 paid and taxes deducted at source".

(*h*) Income from rent shall include only the realised rent. It shall not include any notional rent.

FORM *A-BS*

Name of the Insurer: ....

Registration No. and Date of Registration with the IRDA ....

BALANCE SHEET AS AT 31ST MARCH, 20…

Particulars	*Schedule*	*Current* Year *(₹'000)*	*Previous* Year *(₹'000)*
SOURCES OF FUNDS			
SHAREHOLDERS' FUNDS:			
SHARE CAPITALP	5		
Reserves and Surplus	6		
CREDIT/[DEBIT] FAIR VALUE CHANGE ACCOUNT			
Sub-total			
BORROWINGS	7		
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			
Shareholders'	8		
Policyholders'	8A		
ASSETS HELD TO COVER LINKED LIABILITIES	8B		
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*)			
MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)	15		
DEBIT BALANCE IN PROFIT AND LOSS ACCOUNT (Shareholders' Account)			
TOTAL			

CONTINGENT LIABILITIES

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Partly paid-up investments		
2. Claims, other than against policies, not acknowledged as debts by the company		
3. Underwriting commitments outstanding (in respect of shares and securities)		
4. Guarantees given by or on behalf of the Company		
5. Statutory demands/liabilities in dispute, not provided for		
6. Re-insurance obligations to the extent not provided for in accounts		
7. Other (to be specified)		
TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE-1

Premium

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. First year Premiums		
2. Renewal Premiums		
3. Single Premiums		
TOTAL PREMIUM		

SCHEDULE-2

Commission Expenses

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		

NOTES

Note:

The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE-3

Operating Expenses Related to Insurance Business

	Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1.	Employees' Remuneration and Welfare Benefits		
2.	Travel, Conveyance and Vehicle Running Expenses		
3.	Training Expenses		
4.	Rents, Rates and Taxes		
5.	Repairs		
6.	Printing and Stationery		
7.	Communication Expenses		
8.	Legal and 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 and Bank Charges		
13.	Others (to be specified)		
14.	Depreciation		
	Total		

Note:

Items of expenses and income in excess of one per cent of the total premiums (less re-insurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE-4

Benefts 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 Re-insurance): (*a*) Claims by Death, (*b*) Claims by Maturity, (*c*) Annuities/Pension Payment, (*d*) Other benefits, specify 3. Amount accepted in re-insurance (*a*) Claims by Death, (*b*) Claims by Maturity, (*c*) Annuities/Pension Payment, (*d*) Other benefits, specify		
TOTAL		

Notes:

(*a*) Claims include specific claims settlement costs, wherever applicable.

(*b*) Legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

SCHEDULE-5

Share Capital

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Authorised Capital Equity Shares of ₹ … each		
2. Issued Capital Equity Shares of ₹ … each		
3. Subscribed Capital Equity Shares of ₹ … each		
4. Called-up Capital Equity Shares of ₹ … each *Less*: Calls Unpaid *Add*: 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		

Notes:

(*a*) Particulars of the different classes of capital should be separately stated.

(*b*) The amount capitalised on account of issue of bonus shares should be disclosed.

(*c*) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE 5-*A*

Pattern of Shareholding

[As certified by the Management]

Shareholder	*Current Year*		*Previous Year*	
	Number of Shares	*% of Holding*	*Number of Shares*	*% of Holding*
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 Profit and Loss Account, if any *Less*: Amount utilised for Buy-back 6. Catastrophe Reserve 7. Other Reserves (to be specified) 8. Balance of profit in Profit and Loss Account		
TOTAL		

Note:

Additions to and deductions from the reserves shall be disclosed under each of the specified heads.

SCHEDULE-7

Borrowings

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Debentures/Bonds 2. Banks 3. Financial Institutions 4. Others (to be specified)		
TOTAL		

Notes:

(*a*) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(*b*) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

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		
(*ab*) 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		
(*ab*) 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		

Note:

See Notes appended at the end of Schedule-8B.

SCHEDULE-8*A*

Investments—Policyholders

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		
(*ab*) 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. (*a*) Shares		
(*aa*) Equity		
(*ab*) 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		

Note:

See Notes appended at the end of Schedule-8B.

SCHEDULE-8*B*

Assets Held to Cover Linked Liabilities

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		
(*ab*) 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. (*a*) Shares		
(*aa*) Equity		
(*ab*) 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		

Notes: (Applicable to Schedules-8, 8*A* and 8*B*):

(*a*) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(*i*) Holding company and subsidiary shall be construed as defined in the Companies Act, 1956.

(*ii*) Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(*iii*) Joint control is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(*iv*) Associate is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(*v*) Significant influence (for the purpose of this schedule) means participation in the financial and operating policy, decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personal or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessary preclude an investor from having significant influence.

(*b*) Aggregate amount of a company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(*c*) Investment made out of Catastrophe Reserve should be shown separately.

(*d*) Debt securities will be considered as "held to maturity" securities and will be measured at historical costs subject to amortisation.

(*e*) Investment Property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

(*f*) Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall be classified as short-term investments.

SCHEDULE-9

Loans

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Security-wise Classification		
Secured		
(*a*) On Mortgage of Property		
(*aa*) In India		
(*ab*) 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 Government		
(*b*) Bank 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		
(*ab*) Outside India		
(*b*) Non-standard Loans *less* Provisions		
(*aa*) In India		
(*ab*) Outside India		
TOTAL		
4. Maturity-wise Classification		
(*a*) Short-Term		
(*b*) Long-Term		
TOTAL		

Notes:

(*a*) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long-term loans shall be the loans other than short-term loans.

(*b*) Provisions against non-performing loans shall be shown separately.

(*c*) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.

(*d*) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

SCHEDULE-10

Fixed Assets

(₹ *'000*)

Particulars	*Cost/Gross Block*				*Depreciation*				*Net Block*	
	Opening	*Additions*	*Deduction*	*Closing*	*Up to Last Year*	*For the Year*	*On Sales/ Adjustments*	*To Date*	*As at year end*	*Previous Year*
Goodwill Intangibles (specify) Land—Freehold Leasehold Property Buildings Furniture and Fittings Information Technology Equipment Vehicles Office Equipment Others (Specify nature)										
TOTAL										
Work-in-progress										
Grand Total										
Previous Year										

Note:

Assets included in land, property and building above exclude Investment Properties as defined in Note (*e*) to Schedule-8.

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)		
(*ab*) Others		
(*b*) Current Accounts		
(*c*) Other (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 included in 2 and 3 above		
Cash and Bank Balances		
1. In India		
2. Outside India		
TOTAL		

Note:

Bank balances may include remittances in transit. If so, the nature and amount shall be separately stated.

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 sources (Net of provision for taxation)		
6. Other (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 re-insures)		
6. Due from business/holding company		

7.	Deposit with Reserve Bank of India (Pursuant to Section 7 of the Insurance Act, 1938)		
8.	Other (to be specified)		
	TOTAL (*B*)		
	Total (*A*) + (*B*)		

NOTES

Notes:

(*a*) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(*b*) The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.

(*c*) Sundry debtors will be shown under item 8 (Others).

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		

NOTES

SCHEDULE-15

Miscellaneous Expenditure

(To the extent not written off or adjusted)

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Discount allowed in issue of shares/debentures 2. Others (to be specified)		
TOTAL		

Notes:

(*a*) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:

1. some benefit from the expenditure can reasonably be expected to be received in future, and
2. the amount of such benefit is reasonable determinable.

(*b*) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

B. Format of Final Accounts of General Insurance Business

In this case, the insurer, should prepare the Revenue Account, Profit and Loss Account (Shareholders' Account) and Balance Sheet in Form *B-RA*, Form *B-PL* and Form *B-BS* respectively.

The insurer should prepare Revenue Account separately for **fire, marine** and miscellaneous business and separate schedules should be prepared for marine cargo, marine other than marine cargo and the following classes of miscellaneous insurance business: 1. Motor, 2. Workmen's Compensation/Employers' Liability, 3. Public/Product Liability, 4. Engineering, 5. Aviation, 6. Personal Accident, 7. Health Insurance, 8. Others

FORM *B-RA*

Name of the Insurer: ....

Registration No. and Date of Registration with the IRDA ....

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 and 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*)			

Notes:

See Notes appended at the end of form *B-PL*.

FORM *B-PL*

Name of the Insurer: …

Registration No. and Date of Registration with the IRDA …

Profit and Loss Account 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, Dividend and Rent—Gross			
(*b*) Profit on sale of investments			
Less: Loss on sale of investments			
3. OTHER INCOME (To be specified)			
TOTAL (*A*)			
4. PROVISIONS (Other than taxation)			
(*a*) For diminution in the value of investments			
(*b*) For doubtful debts			
(*c*) Others (to be specified)			
5. OTHER EXPENSES			
(*a*) Expenses other than those related to Insurance Business			
(*b*) Bad debts written off			
(*c*) Others (To be specified)			
TOTAL (*B*)			
Profit before Tax			
Provision for Taxation			
APPROPRIATIONS			
(*a*) Interim Dividends paid during the year			
(*b*) Proposed Final Dividend			
(*c*) Dividend Distribution Tax			
(*d*) Transfer to any Reserves or Other Accounts (to be specified)			
Balance of profit/loss brought forward from last year			
Balance carried forward to Balance Sheet			

Notes: To Forms *B-RA* and *B-PL*

(*a*) Premium income received from business concluded in and outside India shall be separately disclosed.

(*b*) Re-insurance premiums whether on business ceded or accepted are to be brought into account gross (*i.e.*, before deducting commissions) under the head reinsurance premiums.

(*c*) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(*d*) Items of expenses and income in excess of one per cent of the total premiums (*less* re-insurance) or ₹ 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 paid and taxes deducted at sources".

(*h*) Income from rent shall include only the realised rent. It shall not include any notional rent.

FORM *B-BS*

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

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*)			
MISCELLANEOUS EXPENDITURE (to	**15**	...	...
the extent not written off or adjusted)		...	...
DEBIT BALANCE IN PROFIT AND		...	...
LOSS ACCOUNT			
TOTAL		...	...

CONTINGENT LIABILITIES

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Partly paid-up investments		
2. Claims, other than against policies, not acknowledged as debts by the company		
3. Underwriting commitments outstanding (in respect of shares and securities)		
4. Guarantees given by or on behalf of the Company		
5. Statutory demands/liabilities in dispute, not provided for		
6. Reinsurance obligations to the extent not provided for in accounts		
7. Others (to be specified)		
TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE-1

Premium Earned [Net]

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Premium from Diet Business Written		
Add: Premium on Re-insurance Accepted		
Less: Premium on re-insurance Accepted		
Net Premium		
Adjustment for change in reserve for unexpired risks		
Total Premium Earned (Net)		

Note:

Re-nsurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of re-insurance premiums.

SCHEDULE-2

Claims Incurred [Net]

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Claims paid		
Direct		
Add: Re-insurance accepted		
Less: Re-insurance ceded		
Net Claims paid		
Add: Claims outstanding at the end of the year		
Less: Claims outstanding at the beginning		
Total Claims Incurred		

Notes:

(*a*) Incurred But Not Reported (IBNR), Incurred But Not Enough Reported [IBNER] claims should be included in the amount for outstanding claims.

(*b*) Claims includes specific claims settlement cost but not expenses of management.

(*c*) The surveyor fees, legal and other expenses shall also form part of claims cost.

(*d*) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realisation.

SCHEDULE-3

Commission

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
Commission paid Direct *Add*: Re-insurance Accepted *Less*: Re-insurance Ceded		
Net Commission		

Note:
The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

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. Training Expenses		
4. Rents, Rates and Taxes		
5. Repairs		
6. Printing and Stationery		
7. Communication		
8. Legal and Professional Charges		
9. 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		
(*c*) in any other capacity		
10. Advertisement and Publicity		
11. Interest and Bank Charges		
12. Others (to be specified)		
13. Depreciation		
TOTAL		

Note:
Items of expenses and income in excess of one per cent of the total premiums (*less* re-insurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE-5

Share Capital

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Authorised Capital Equity Shares of ₹ … each		
2. Issued Capital Equity Shares of ₹ … each		
3. Subscribed Capital Equity Shares of ₹ … each		
4. Called-up Capital Equity Shares of ₹ … 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		

Notes:

(*a*) Particulars of the different classes of capital should be separately stated.

(*b*) The amount capitalised on account of issue of bonus shares should be disclosed.

(*c*) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE-5A

Share Capital

Pattern of Shareholding

[As Certified by the Management]

Shareholder	*Current Year*		*Previous Year*	
	Number of Shares	*% of Holding*	*Number of Shares*	*% of Holding*
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. General Reserves *Less*: Debit balance in Profit and Loss Account *Less*: Amount utilised for Buy-back		

5. Catastrophe Reserve		
6. Other Reserve (to be specified)		
7. Balance of Profit & Loss Account		
TOTAL		

Note:

Additions to and deductions from the reserves should be disclosed under each of the specified heads.

SCHEDULE-7

Borrowings

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Debentures/Bonds		
2. Banks		
3. Financial Institutions		
4. Others (to be specified)		
TOTAL		

Notes:

(*a*) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(*b*) Amounts due within 12 months from the date of Balance Sheet should be shown separately

SCHEDULE-8

Investments

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		
(*ab*) 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		
(*ab*) 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		

Notes:

(*a*) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed; at cost.

(*i*) Holding company and subsidiary shall be construed as defined in the Companies Act, 1956.

(*ii*) Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(*iii*) Joint control is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(*iv*) Associate-is an enterprise in which the company as significant influence and which is neither a subsidiary nor a joint venture of the company.

(*v*) Significant influence (for the purpose of this schedule) means participation in the financial and operating policy, decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy-making process, material inter-company transactions, interchange of managerial personal or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(*b*) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(*c*) Investments made out of catastrophe reserve should be shown separately.

(*d*) Debt securities will be considered as "held to maturity" securities and will be measured at historical cost subject to amortisation.

(*e*) Investment property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

(*f*) Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall be classified as short-term investments.

SCHEDULE-9

Loans

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Security-wise Classification		
Secured		
(*a*) On Mortgage of Property		
(*aa*) In India		
(*ab*) 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*) Bank 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		
(*ab*) Outside India		
(*b*) Non-performing loans *less* provisions		
(*aa*) In India		
(*ab*) Outside India		
TOTAL		
4. Maturity-wise Classification		
(*a*) Short Term		
(*b*) Long Term		
TOTAL		

Notes:

(*a*) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long-term loans shall be the loans other than short-term loans.

(*b*) Provisions against non-performing loans shall be shown separately.

(*c*) The nature of the security in case of all long-term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.

(*d*) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

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)		
(*ab*) 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 included in 2 and 3 above.		

Note:

Bank balance may include remittances in transit. If so, the nature and amount should be separately stated.

SCHEDULE-10

Fixed Assets

(₹ '000)

Particulars	*Cost/Gross Block*				*Depreciation*				*Net Block*	
	Opening	*Additions*	*Deduction*	*Closing*	*Up to Last Year*	*For the Year*	*On Sales/ Adjustments*	*To Date*	*As at year 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										

Note:

Assets included in land, property and building above exclude Investment Properties as defined in Note (*e*) to Schedule-8.

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 of 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 re-insures)		
6.	Due from Subsidiaries/holding		
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*)		

Notes:

(*a*) The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.

(*b*) The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.

(*c*) Sundry Debtors will be shown under item 9 (others)

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.	Due to Officers/Directors		
10.	Others (to be specified)		
	TOTAL		

NOTES

SCHEDULE-14
Provisions

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Reserve for Unexpired Risk 2. For Taxation (*less* advance tax paid and taxes deducted at source) 3. For Proposed Dividends 4. For Dividend Distribution tax 5. Others (to be specified)		
TOTAL		

SCHEDULE-15
Miscellaneous Expenditure
(To the Extent not Written off or Adjusted)

Particulars	*Current Year (₹'000)*	*Previous Year (₹'000)*
1. Discount Allowed in issue of Shares/Debentures 2. Others (to be specified)		
TOTAL		

Notes:

(*a*) No item shall be included under the head 'Miscellaneous Expenditure' and carried forward unless:

1. some benefit from the expenditure can reasonably be expected to be received in future, and
2. the amount of such benefit is reasonable determinable.

(*b*) The amount to be carried forward in respect of any item included under the head 'Miscellaneous Expenditure' shall not exceed the expected future revenue/other benefits related to the expenditure.

12.6.1 Special Terms

It will be useful to understand the meaning of the following terms connected with the insurance business.

Revenue account: The revenue account has to be prepared in all types of insurance business (*viz*. life, fire, marine and miscellaneous) in the form specified by the Insurance Regulatory and Development Authority. The account discloses the profit or loss made by an insurance business during a particular period. Of course, in the case of life insurance business, the situation is different since the profit or loss is ascertained only every alternate year. The excess of the revenue income over the revenue expenditure is not profit, but only a reserve termed as the "life assurance fund", to be carried forward for comparing with the net liability as per acturial valuation for ascertaining the profit or loss made by the life insurance business.

Life assurance fund: As explained above, the life assurance (or insurance) fund represents the excess of revenue income over revenue expenditure relating to the life insurance business. The fund is available to meet the aggregate liability on all outstanding policies. While preparing the revenue account, the opening balance in the life insurance fund account is shown on the credit side. After putting all items of income and expenditure in the revenue account, the balance of the account represents the closing balance of the life assurance fund.

Reserve for unexpired risk: This term is peculiar to general insurance business. It simply represents the income received by the insurance company in advance in the form of insurance premiums. Since the insurance company charges premiums in advance, it is appropriate to carry forward a part of the premium income received by the insurance company during a particular year to the next year to meet any loss that may arise with respect to the policies issued during the preceding year. As a corollary of this, reserve for unexpired risk has to be created as the amount representing that part of premium written which is attributable to, and to be allocated to the succeeding accounting periods and shall not be less than as required under 64V(1)(*ii*)(*b*) of the IRDA Act, as given under:

(*i*) Fire and miscellaneous business, 50 per cent;

(*ii*) Marine cargo business, 50 per cent; and

(*iii*) Marine hull business, 100 per cent of the premium, net of re-insurances, during the preceding twelve months.

Moreover an insurance company may keep additional reserve if it feels the necessity.

The treatment of reserve for unexpired risk in the final accounts of an insurance company is as follows:

(*a*) If it appears only in the trial balance, it should be taken to the liabilities side of the balance sheet.

(*b*) If it appears as an adjustment, it should be charged to the revenue account and shown also on the liabilities side of the balance sheet.

(*c*) If it appears in the trial balance and also as an adjustment, the difference of the two (i.e. Desired Reserve for Unexpired Risk at end less Reserve for Unexpired Risk in the beginning) should be taken to Revenue Account The Desired Reserve for unexpired Risk at end should be shown on the liabilities side of the balance sheet.

The treatment for any additional reserve for unexpired risk, would also be on the same pattern.

Catastrophe Reserve: Such a reserve is created to meet any loss due to natural calamity. It is to be created in accordance with the norm, if any prescribed by the IRDA. Investment of funds out of catastrophe reserve shall be made in accordance with the prescription of the authority. Till date the authority has not prescribed any norms for creation of such reserve.

Annuity: Annuity means annual payment. The Life Insurance Corporation guarantees to pay a certain sum of money regularly as long as the insured lives in consideration of a lump sum of money received in the beginning. The amount paid is termed as annuity. It appears as an expense in the revenue account. The consideration received by the Corporation is termed as "consideration for annuities granted". It is treated as an income in the revenue account.

Policy: Policy is a formal written document containing the terms of the contract of insurance. A general insurance policy may be for a specific event (*e.g.* for a particular voyage in case of marine insurance) or for a specific period. This period cannot exceed a year.

NOTES

A life insurance policy may be of the following types:

(*a*) *Endowment policy*. It is a policy which matures on the policy-holder reaching a certain age or on his death, whichever is earlier.

(*b*) *With profit policy*. A policy which entitles the policy-holder, in addition to a guaranteed sum payable on maturity, a share in the profit made by the Life Insurance Corporation.

(*c*) *Without profit policy*. A policy which entitles the policy-holder to get only a fixed sum on maturity of the policy.

(*d*) *Whole life policy*. It is a policy which matures only on the death of the insured.

Claims: Claims refer to the amount due by the insurance company to various persons who have suffered loss on account of the events insured against. This is the first item on the expenditure side of the revenue account of an insurance company. Claims can be classified into the following categories:

(*a*) Claims intimated, accepted and paid.

(*b*) Claims intimated, accepted but not paid.

(*c*) Claims intimated, but not yet accepted and paid.

(*d*) Claims rejected.

It should be noted that keeping in view the convention of conservatism, "claims intimated" are taken at par with "claims intimated and accepted but not paid".

Thus, while ascertaining outstanding claims, claims which have been intimated whether paid or not are to be considered. The following entry is passed for outstanding claims at the end of the accounting year:

Claims A/c	Dr.
To Claims intimated and accepted but not paid A/c	
To Claims intimated but not accepted and not paid A/c	

At the beginning of the next year, a reverse entry is passed so that claims intimated the previous year when paid do not influence the claims account of the next year. In case a claim intimated to the company is subsequently rejected by it, the amount of such a claim is transferred to the insurance fund account (life, fire, marine, as the case may be) and not to the credit of the claims account.

In case of life insurance claims by death and claims by maturity have to be shown separately in the revenue account.

(*i*) *Claims by death*. It refers to the amount paid on account of the death of the insured.

(*ii*) *Claims by maturity*. It refers to the claims paid by the Corporation on the policy-holder reaching the age mentioned in the policy. This is possible in case of endowment policies where money is payable upon the policy holder reaching the age mentioned in the policy.

Reinsurance: Reinsurance means transferring the whole, or a part of, the risk undertaken by an insurer to another insurer. Reinsurance is usually resorted to in those circumstances where an insurer feels that he has undertaken a larger risk than what he can bear. Both reinsurer and the original insurer share the premium in proportion to the risk undertaken by them. They also bear the loss in proportion to their risk. The amount of premiums and the claims are shown in the revenue account after making adjustments for premium received or paid and claims admitted or recovered under reinsurance contracts. Reinsurance is possible both in the case of life and general insurance. However, it is more popular in the case of general insurance.

Commission on reinsurance accepted: Insurance companies pay commission to their agents who bring business to them. Such commission is termed "direct commission". They also pay commission to those insurers who have given them business through reinsurance. Commission paid to such insurers is termed as "commission on reinsurance accepted". It is an expense for the company paying the commission.

Commission on reinsurance ceded: Insurance companies earn commission from other insurance companies for giving them business under reinsurance contracts. Such commission is termed as commission on reinsurance ceded. It appears as an income in the revenue account of the insurance company receiving the commission.

Premium: It refers to the consideration received by an insurance company in consideration of the risk undertaken by it. In case of Life Insurance, the premium received is to be shown under two sub-headings in the revenue account:

(*a*) *First year's premium*. It is the premium paid by a policy-holder in the first year of the life policy.

(*b*) *Renewal premiums*. They are the premiums paid by the policy-holder in later years.

In case a policy-holder pays all the premiums in a lump sum it is referred to as "single premium".

Bonus: Bonus refers to the share of profit which a policy-holder gets from the Life Insurance Company. In case of life insurance 95% of the profit earned by the Life Insurance Corporation is to be distributed among the policy-holders. Such profit is to be distributed among the policy-holders who hold "with profit policies". The bonus may be of the following types:

(*a*) *Cash bonus*. It refers to the bonus payable in cash. It is paid soon after the profit is ascertained by the Life Insurance Corporation.

(*b*) *Reversionary bonus*. It is payable only on the maturity of the policy together with the policy amount.

(*c*) *Interim bonus*. It is payable on the maturity of a policy pending ascertainment of profit. Bonus in cash is shown separately in the revenue account while interim bonus and reversionary bonus are included in the amount of claims.

(*d*) *Bonus in reduction of premium*. This refers to the bonus which is payable in cash but which is utilised by the policy-holder to adjust the premium due from him. The amount of such a bonus is to be shown separately in the revenue account as an expense. The premium income should be shown after giving due credit to the premium account for the bonus utilised in reduction of premium. The term is used in case of general insurance policies.

In case of general insurance, the policy cannot be taken for a period exceeding a year. It is to be renewed after the expiration of each year. Whenever a policy is renewed or a fresh policy is taken with some other insurance company, it is a standard practice that the company renewing or issuing a new policy grants a relaxation in the premium at the prescribed rate if the insured had not made any claim during the period of the preceding policy. This rate of reduction in premium goes on increasing every year for usually 3 years. This maximum rate of reduction is generally 65% of the gross premium due. Such a reduction in premium is also termed as “bonus in reduction of premium” and is to be shown separately in the revenue account as an expense. The premium income should be shown in the revenue account at the gross figure *i.e.* without deducting the bonus in reduction of premium. For example, if the net premium received is ₹ 1,000 and the bonus in reduction of premium ₹ 200, the premium income should be shown as ₹ 1,200 and bonus in reduction of premium should separately be shown as an expense of ₹ 200 in the revenue account.

Surrenders: This term is used in the case of life insurance business. In case a policy-holder is not in a position to pay the future premiums on his policy, he may surrender his rights under the life insurance policy to the Life Insurance Corporation. The Corporation will pay him the surrender value of the policy as per the rules of the Corporation. The amount so paid appears as an expense under the heading “surrenders less reinsurances” in the revenue account.

Interest, dividends and rents: This is shown as an item of income in the revenue account. It should be noted that any income tax on this item is to be shown as a reduction in the revenue account itself. In any case, the tax liability of the insurance company will be determined on the basis of the gross income on account of interest, dividends and rents.

Premium Deficiency: Premium deficiency shall be recognized if the sum of expected claim, costs, related expenses and maintenance costs exceed related reserve for unexpired risks.

Acquisition Costs: Acquisition costs, if any shall be expensed in the period in which they are incurred.

12.6.2 Life Insurance Companies Annual Accounts

NOTES

As stated earlier, life insurance business in India can now be carried on only by the Life Insurance Corporation of India, established under the Life Insurance Corporation of India Act, 1956. However, the various provisions of the Insurance Act, 1938 relating to final accounts continue to apply to the Life Insurance Corporation. While ascertaining the profit in the case of life insurance business, it must be kept in mind that life insurance contracts are for a long period. The Life Insurance Corporation agrees to pay a specific amount to the insured on the maturity of the policy. The insured undertakes the liability to pay the premium to the Corporation in agreed instalments. Thus, on a particular date, the premium expected to be received in future will generally be much less than the amount payable by way of claim. For example, the Corporation issues a policy of ₹ 10,000 on 1 January 1991 in favour of Mr. *A*, who agrees to pay an annual premium of ₹ 1,000 for 10 years. On 31 December, 1998, the Corporation can expect to get only two premiums (*i.e.*, on 1 January, 1999 and 1 January, 2000 amounting in all to ₹ 2,000). However, the Corporation will have to pay a sum of ₹ 10,000 by 1 January, 2001. Thus there is an excess of ₹ 8,000. While preparing the accounts on 31 December 1998, the Corporation must keep the possibility of *A*'s death in mind since his death will result in the stoppage of payment of premium besides his policy money becoming immediately due to his legal representatives. It is, therefore, important for the Corporation to ascertain with respect to policies issued and still in force the amount of claims that are expected to arise and the premiums that are expected to be received. The excess of the claims expected to arise over the premiums expected to be received is known as the "net liability of the Corporation". This is technical work which is done by actuaries well versed in the intricacies of the life insurance business. The Life Insurance Corporation of India gets these calculations made every two years. The profit of the Corporation is, therefore, also found out only after a two year period. This fact must be kept in mind while preparing the revenue account of the life insurance business.

The following illustrations will be helpful to the students in understanding the preparation of financial statements of insurance companies.

Illustration 12.6: The revenue account of a life insurance company shows the life assurance fund on 31st December, 2016 at ₹ 62,21,310 before taking into account the following items:

(*i*) Claims covered under reinsurance ₹ 12,000.

(*ii*) Bonus utilised in reduction of life insurance premium ₹ 4,500.

(*iii*) Interest accrued on securities ₹ 8,260.

(*iv*) Outstanding premium ₹ 5,410.

(*v*) Claims intimated but not admitted ₹ 26,500.

What is the Life Assurance Fund after taking into account the above omissions?

Solution:

STATEMENT OF LIFE ASSURANCE FUND

	₹		₹
Balance of Fund as on 31 December, 2006			
Add: Bonus utilised in reduction of premium*	4,500		62,21,310
Interest on securities	8,260		
Premium outstanding	5,410		18,170
			62,39,480
Less: Claims intimated but not admitted	26,500		
Less: Covered under reinsurance	12,000	14,500	
Add: Bonus in reduction of premium*		4,500	19,000
Add: Balance of correct life assurance fund			62,20,480

*It appears on both sides of the Revenue Account. Net effect is nil.

Illustration 12.7: The following balances appeared in the books of the Happy Mutual Life Assurance Society Ltd. as on 31st March, 2016:

(₹ *in lakhs*)

Particulars	*Dr.*
Claims less re-insurances paid during the year:	
By Death	2,200
By Maturity	1,500
Annuities	6
Furniture and Office Equipment at cost (including ₹ 40 lakhs bought during the year)	250
Printing and Stationery	77
Cash with Bank in Current Account	1,350
Cash and Stamps in hand	30
Surrenders *less* Re-assurances	40
Commission	250
Expenses of Management	3,100
Sundry deposits with Electricity Companies, etc.	1
Advance Payment of Income-tax	50
Sundry Debtors	50
Agents Balances	100
Income-tax	450
Income-tax on Interest, Dividends and Rents	500
Loans and Mortgages	150
Loans on policies	3,250
Investments (₹ 250 lakhs deposited with the Reserve Bank of India)	52,000
House Property at cost (including ₹ 85 lakhs added during the year)	5,400
	70,754
Life Assurance Fund at the beginning of the year	50,000
Premiums *less* re-assurances	15,000
Claims *less* Re-assurances outstanding at the beginning of the year:	
By Death	900
By Maturity	600

Credit balances pending adjustment	60
Consideration for annuities granted	2
Interest, Dividends and Rents	1,800
Registration and other Fees	2
Sundry Deposits	100
Taxation Provision	300
Premium Deposits	1,150
Sundry Creditors	350
Contingency Reserve	150
Furniture and Office Equipment Depreciation Account	40
Building Depreciation Account	300
	70,754

From the foregoing balances and the following information, prepare the balance sheet of the Happy Mutual Life Assurance Society Ltd. as on 31st March, 2016 and its revenue account for the year ended on that date:

(*i*) Claims *less* re-assurances outstanding at the end of the year

By Death: ₹ 600 lakhs; By Maturity: ₹ 400 lakhs.

(*ii*) Expenses outstanding ₹ 60 lakhs and Prepaid ₹ 15 lakhs.

(*iii*) Provide ₹ 45 lakhs for depreciation on Buildings; ₹ 15 lakhs for depreciation on Furniture and Office Equipment; and ₹ 110 lakhs for taxation.

(*iv*) Premiums Outstanding ₹ 2,028 lakhs; Commission thereon ₹ 65 lakhs.

(*v*) Interests, Dividends and Rents Outstanding (net) ₹ 30 lakhs and Interest and Rent Accrued (net) ₹ 250 lakhs.

Solution:

Happy Mutual Life Assurance Society Ltd.
REVENUE ACCOUNT
for the year ended 31-3-2016

(*₹ in lakhs*)

Particulars	*Schedule*	*₹*
Premium earned net	1	17,028
Income from Investments:		
Interest, Dividend and Rent (Gross)		2,180
Other Income:		
Annuities granted		2
Registration and Other Fees		2
Total (*A*)		19,212
Commission	2	315
Operating Expenses	3	3,282
Provision for tax		760
Total (*B*)		4,357
Benefits paid (net)	4	3,246
Total (*C*)		3,246
[Surplus (*D*) = (*A*) – (*B*) – (*C*)]		11,609

Happy Mutual Life Assurance Society Ltd.
BALANCE SHEET
as on 31-3-2016

(*₹ in lakhs*)

Particulars	*Schedule*	*₹*
Sources of Funds:		
Share Capital	5	—
Reserve and Surplus	6	61,759
Borrowings	7	1,250
Total		63,009
Application of Funds:		
Investments	8	56,805
Loans	9	3,400
Fixed Assets	10	195
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

Schedule 1

(*₹ in lakhs*)

Premium	15,000	
Add: Outstanding	2,028	17,028

Schedule 2
COMMISSION EXPENSES

(*₹ in lakhs*)

Commission Paid	250	
Add: Commission on re-insurance accepted	65	315

Schedule 3
OPERATING EXPENSES

(*₹ in lakhs*)

Expenses of Management paid	3,100	
Add: Unpaid	60	
	3,160	
Less: Pre-paid	15	3,145
Printing and Stationery		77
Depreciation:		
Building	45	
Furniture	15	60
		3,282

Schedule 4
BENEFITS PAID (NET)

(₹ *in lakhs*)

Insurance Claims:		
Claims by Death:		
Paid	2,200	
Add: Outstanding at the end of the year	600	
	2,800	
Less: Outstanding in the beginning	900	1,900
Claims by Maturity:		
Paid	1,500	
Add: Outstanding at the end of the year	400	
	1,900	
Less: Outstanding in the beginning	600	1,300
Other Benefits:		
Annuities		6
Surrenders *less* re-insurance		40
		3,246

Schedule 6
RESERVES AND SURPLUS

(₹ *in lakhs*)

Contingency Reserve	150	
Other—Life Assurance Fund	61,609	61,759

Schedule 7
BORROWINGS

(₹ *in lakhs*)

Premium Deposits	1,150	
Sundry Deposits	100	1,250

Schedule 8
INVESTMENTS

(₹ *in lakhs*)

Sundry Other Investments		51,750
Investment in House property	5,315	
Add: Addition	85	
	5,400	
Less: Depreciation	345	5,055
		56,805

Schedule 9
LOANS

(₹ *in lakhs*)

On Mortgages	150	
On Policies	3,250	3,400

Schedule 10
FIXED ASSETS

(₹ *in lakhs*)

Furniture cost *less* depreciation		195

Schedule 11
CASH AND BANK BALANCES

(₹ *in lakhs*)

Cash in hand including stamps	30	
Cash with Banks on Current Account	1,350	1,380

Schedule 12
ADVANCES AND OTHER ASSETS

(₹ *in lakhs*)

Prepaid expenses	15	
Interest, dividends and rent outstanding	30	
Interest, dividends and rent accruing	350	
Advance payment of income tax	50	
Agents' balances	100	
Outstanding premium	2,028	
Deposit with Reserve Bank of India	250	
Deposits with electricity companies	1	
Sundry debtors	50	2,874

Schedule 13
CURRENT LIABILITIES

(₹ *in lakhs*)

Sundry creditors	350	
Claims Outstanding	1,000	
Credit Balances Pending adjustment	60	
Expenses Outstanding	60	
Commission due but not yet paid	65	1,535

Schedule 14
PROVISIONS

(₹ *in lakhs*)

Provision for Tax		110

Check Your Progress

7. Mention the accounting standards that are applicable to insurance companies.
8. Which Schedule of the Insurance Act prescribes the provisions related to preparation of financial statements for general insurers?
9. What is life assurance fund?
10. How is reinsurance treated in case of accounting for insurance company?

12.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A banking company may have to take possession of certain assets charged in its favour on account of the failure of a debtor to repay the loan in time. Such an asset is termed as a non-banking asset.
2. The risk weight asset ratio is calculated by dividing capital funds by risk adjusted assets and multiplying it with 100.
3. The Balance Sheet of a banking company has to be prepared in Form A of the Schedule III attached to the Banking Regulation Act.

4. Banks are to recognise their income on accrual basis in respect of income on performing assets and on cash basis in respect of income on non-performing assets.
5. The categories of Reserves and Surplus include statutory reserves, capital reserves, share premium, revenue and other reserves and balance of profit.
6. The categories of other liabilities and provisions under Schedule 5 in the banking balance sheet include bills payable, inter-office, interest accrued and others.
7. The following are the Accounting Standards which applicable to insurance companies like AS 3, AS 13 and AS 17.
8. Schedule B of the Insurance Act prescribes the provisions related to preparation of financial statements for general insurers.
9. The life assurance fund represents the excess of revenue income over revenue expenditure relating to the life insurance business.
10. The amount of premiums in case of reinsurance and claims are shown in the revenue account after making adjustments for premiums received or paid and claims admitted or recovered under reinsurance contracts.

12.8 SUMMARY

- Banking business in India is largely governed by the Banking Regulation Act 1949.
- The important provisions of the Banking Regulation Act 1949 includes prescribed form, accounting year, prohibition of trading, non-banking assets, share capital, payment of dividend, payment of commission, brokerage etc.
- The Profit and Loss Account of a banking company has to prepared in Form B of Schedule III attached to the Banking Regulation Act.
- The schedules in relation to the Profit and Loss Account includes Schedules on interest earned, other income, interest expended, and operation expenses, etc.
- The Balance Sheet of a Banking company has to prepared in Form A of Schedule III attached to the Banking Regulation Act.
- The schedules in relation to the Balance Sheet that needs consideration include schedules on capital, reserves and capital, deposits, borrowings, other liabilities, cash and balance with RBI, investments, advances, fixed assets, other assets, etc.
- The insurance business in India is divided into life insurance and general insurance.

NOTES

- The primary legislations which deal with various aspects relating to accounts and audits of an insurance business are the Insurance Act 1938, IRDA Act 1999, Insurance Regulatory and Development Authority Regulations 2002, Companies Act 2013 and General Insurance Business Act 1972, etc.
- The Accounting Standards applicable to insurance businesses include AS 3, AS 13 and AS 17.
- As regards insurance companies, IndAss shall apply as when it is so notified by the IRDA.
- The insurance companies were till recently presenting their financial statements as per the prescribed in Schedules 1, 2 and 3 respectively of the Insurance Act 1938. This act has been amended in the year 2000. As a result the insurance companies are now required by the IRDA as given by the regulations issued by IRDA in 2002.
- Special terms which require consideration in case of preparation of the financial statements of insurance companies include revenue account, life assurance fund, reserve for unexpired risk, catastrophe reserve, annuity, claims, reinsurance, commission on reinsurance, premium, bonus, etc.

12.9 KEY WORDS

- **Capital adequacy ratio:** It is the ratio of capital funds to risk weighted assets.
- **Risk adjusted assets:** It refers to the weighted aggregate of funded assets and not funded or off-balance sheet items.

12.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the conditions essential for the commencement of banking business in India as per the Banking Regulation Act?
2. List the RBI guidelines with regards to dividends.
3. How are interest on doubtful debts treated?
4. What are the main players in the insurance business?
5. Write a short note on IRDA and its duties and responsibilities.
6. List the primary legislations which deal with various aspects relating to accounts and audits of an insurance business in India.

NOTES

Long Answer Questions

1. What are the categories of capital fund as per the Basel Committee?
2. Explain the preparation of Profit and Loss Account and Balance Sheet in case of Banking accounts.
3. Discuss the treatment of assets in Banking accounts.
4. How is a provision for taxation and bills discounted made in case of banking accounts?
5. Describe the disclosures forming part of financial statements and general instructions for preparation of financial statements for life insurance and general insurance.
6. Examine the special terms connected with the insurance business.

12.11 FURTHER READINGS

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UNIT 13 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

NOTES

Structure

13.0 Introduction
13.1 Objectives
13.2 IFRS: Meaning
13.2.1 Advantages and Disadvantages of IFRS
13.3 Answers to Check Your Progress Questions
13.4 Summary
13.5 Key Words
13.6 Self Assessment Questions and Exercises
13.7 Further Readings

13.0 INTRODUCTION

Accounting standards are rules according to which accounting statements have to be prepared. They can be termed as statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. Accounting Standards may vary from country to country or industry to industry depending upon specific requirements. In this unit, you will learn about the global accounting standard of IAS and IFRS.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe the meaning of IFRS
- Explain the objectives of IFRS
- Discuss the scope and assumptions of IFRS
- Examine the advantages and disadvantages of IFRS

13.2 IFRS: MEANING

International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations (called founder-members) signed the agreement and constitution for its formation. The Committee has its headquarters at London. Its interpretative arm was known as Standard Interpretation Committee (SIC).

The objective of the committee was "to formulate and publish in the public interest standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance." The formulation of such standards will bring uniformity in terminology, approach and presentation of results. This will not only help in a correct understanding and exchange of economic and financial information but also in facilitating a smooth flow of international investment.

Between 1973 and 2000, the *IASC* issued several Accounting Standards, known as International Accounting Standards (IASs) Since 2001, the *IASC* was renamed as the International Accounting Standard Board (IASB). The *IASB* has now taken over the work of *IASC*. Its members (currently 15 full time members) are responsible for the development and publication of *IFRSs* and approving interpretations as developed by *IFRIC* as discussed later.

The *IASB* has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on which there was no previous *IAS*. Besides this, the *IASB* has replaced some *lASs* with new *IFRSs*. Thus, now the *lASs* issued by the *IASC* and *IFRSs* issued by the *IASB* all come within the purview of *IASB*. An International Financial Reporting Interpretation Committee (IFRIC) has also been formed to provide interpretations of the standards similar to previous SIC.

The *IASB* works closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

Objectives of IASB: The broad objectives of *IASB* as per the IFRS Foundation, (not for profit private sector organisation) can be summarised as under.

(*a*) To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions;

(*b*) To promote the use and rigorous application of those standards;

(*c*) To pay attention to the needs of medium and small scale enterprises and emerging economies in tunc with (*a*) and (*b*) objectives stated above; and

(*d*) To promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

Meaning of IFRS: It is a set of international accounting standards developed by the International Accounting Standards Board (IASB) providing the mode of reporting particular type of transactions and events in the financial statements. They include standards and interpretations issued by the International Accounting Standards Board (IASB) and its predecessor body, viz., International Accounting Standards Committee (IASC). They comprise:

(*a*) International Financial Reporting Standards;

(*b*) International Accounting Standards, and

(*c*) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Objective of IFRS: The basic objective of IFRSs is to make international comparison of financial statements of business enterprises as easy as possible. At present it is difficult since each country has its own set of rules. IFRSs have been designed as a common global language for business affairs to synchronize accounting standards across the globe. They are progressively replacing the many different national accounting standards. They require the accountants to maintain books of account in a manner that the financial statements based on them are comparable, understandable, reliable and relevant as per the requirements of users—both internal and external.

Scope of IFRS: The scope of IFRS is as under.

(*i*) IFRS apply to the general purpose financial statements and other financial reporting by profit-oriented entities— those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form.

Explanations:

(*a*) General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows.

(*b*) Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.

(*ii*) Entities other than profit-oriented business entities may also find IFRSs appropriate.

(*iii*) IFRSs apply to individual company and consolidated financial statements.

IFRS Assumptions: There are four underlying assumptions in IFRS as detailed below.

1. **Accrual basis:** The assumption that the financial effect of transactions and events are recognised as they occur, not when cash is received or paid.
2. **Going concern:** The assumption that a business entity will be in operation for the foreseeable future.
3. **Measuring unit:** Measuring unit for valuation of capital is the current purchasing power. In other words assets should be reflected in the financial statements at their fair value.
4. **Unit of constant purchasing power:** The value of capital should be adjusted at end of the financial year to inflation prevailing in the economy.

IFRS Around the World

IFRS is a globally accepted financial reporting framework. It is used over 110 countries but in both the US and the UK, the Generally Accepted Accounting Principles (GAAP) is the more widely used set of guidelines for accountants.

Currently the Financial Accounting Standards Board (FASB) of USA and the IASB are working on numerous joint projects designed to improve the GAAP and the IFRS with the goal to ultimately make the standards fully compatible.

In India also we are following GAAP *i.e.*, accounting standards as prescribed by Institute of Chartered Accountants of India. Of course steps are being taken for converging the Indian Accounting Standards with IFRS.

IFRS Main Financial Statements

Types : The IFRS financial statements include the following.

- A Statement of Financial Position. It comprises Assets, Liabilities and Equity
- A Statement of Comprehensive Income. It includes two separate statements (*i*) an Income Statement and (*ii*) a Statement of Comprehensive Income. The Statement of Comprehensive Income reconciles the Profit or Loss as per Income Statement to total comprehensive income
- A Statement of Changes in Equity
- A Cash Flow Statement or Statement of Cash Flows
- Notes, comprising a summary of the significant accounting policies

Objective: A financial statement should present true and fair picture of the business affairs of an organisation. Since these statements are used by different constituents of the regulators/society, they are required to present the true view of financial position of the organisation.

Qualitative characteristics: As per IFRS, the main characteristics required in its main financial statement include:

- Understandability
- Relevance
- Reliability
- Comparability

Current Status of IAS/IFRS and Interpretations The current status of International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), and Interpretations issued by Standing Interpretation Committee (SIC), International Financial Reporting Interpretation Committee (IFRIC) is as under.

International Accounting Standards (IASs) All 41 IASs have been issued out of which 12 have been withdrawn. Thus, at present 28 IAS are in operation. They are as under.

IAS 1. Presentation of Financial Statements.

IAS 2. Inventories.

IAS 7. Cash Flow Statements.

IAS 8. Accounting Policies, Changes in Accounting Estimates and Errors.

IAS 10. Events after the Balance Sheet Date.

IAS 11. Construction Contracts.

IAS 12. Income Taxes.

IAS 16. Property, Plant and Equipment.

IAS 17. Leases..

IAS 19. Employee Benefits.

IAS 20. Accounting for Government Grants and Disclosure of Government Assistance.

IAS 21. The Effects of Changes in Foreign Exchange Rates.

IAS 23. Borrowing Costs

IAS 24. Related Party Disclosures.

IAS 26. Accounting and Reporting by Retirement Benefit Plans.

IAS 27. Consolidated and Separate Financial Statements.

IAS 28. Investments in Associates.

IAS 29. Financial Reporting in Hyperinflationary Economies.

IAS 31. Interests in Joint Ventures.

IAS 32. Financial Instruments: Presentation

IAS 33. Earnings per share.

IAS 34. Interim Financial Reporting.

IAS 36. Impairment of Assets.

IAS 37. Provisions, Contingent Liabilities and Contingent Assets.

IAS 38. Intangible Assets.

IAS 39. Financial Instruments: Recognition and Measurement. (Superseded by IFRS 9 where IFRS 9 is applied)

IAS 40. Investment Property.

IAS 41. Agriculture.

International Financial Reporting Standards (IFRSs) In all the following IFRSs have been issued out of which one is under reconsideration. The list is as under.

No.	*Title*	*Originally issued*	*Effective*
IFRS I	First-time Adoption of International Finacial Reporting Standard	2003	Jan. 1, 2004
IFRS 2	Share-based Payment	2004	Jan. 1, 2005
IFRS 3	Business Combinations	2004	Apr. l, 2004
IFRS 4	Insurance Contracts	2004	Jan. 1, 2005
IFRS 5	Non-current Assets held for Sale and Discontinued Operations	2004	Jan. 1,2005
IFRS 6	Exploration for and Evaluation of Mineral Resources	2004	Jan. 1, 2006
IFRS 7	Financial instrument: Disclosures	2005	Jan. 1, 2007
IFRS 8	Operating Segments	2006	Jan. 1, 2009
IFRS 9	Financial instruments	2009 (updated 2014)	Jan. 1, 2018
IFRS 10	Consolidated Financial Statements	2011	Jan. 1, 2013
IFRS 11	Joint Arrangements	2011	Jan. 1, 2013
IFRS 12	Disclosure of Interests in Other Entities	2011	Jan. 1, 2013
IFRS 13	For Value Measurement	2011	Jan. 1, 2013
IFRS 14	Regulatory Deferral Accounts	2014	Jan. 1, 2016
IFRS 15	Revenue from Contracts with Customers	2014	Jan. 1, 2017
IFRS 16	Leases	2016	Jan. 1, 2019
IFRS 17	Insurance contracts financial	2017	Jan. 1, 2023

Interpretations Issued by SIC/IFRIC: The following interpretations have been issued as given under.

SIC 7	Introduction of the Euro
SIC 10	Government Assistance - No Specific Relation to Operating Activities
SIC 12	Consolidation - Special-Purpose Entities
SIC 13	Jointly Controlled Entities - Non-monetary Contributions by Ventures
SIC 15	Operating Leases - Incentives
SIC 21	Income Taxes - Recovery of Revalued Non-Depreciable Assets

SIC 25	Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders.
SIC 27	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
SIC 29	Service Concession Arrangements: Disclosures
SIC 31	Revenue - Barter Transactions lnvolving Advertising Services
SIC 32	Intangible Assets - Web Site Costs
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFR1C 2	Members' Shares in Co-operative Entities and Similar Liabilities
IFRIC 4	Determining Whether an Arrangement contains a Lease
IFRIC 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds.
IFRIC 6	Liabililies arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, Financial Reporting in Hyperinflationary Economies
IFRIC 8	Scopc of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 11	IFRS 2: Group and Treasury Share Transactions
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes
IFRIC 14	IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and their Interaction
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-cash Assets to Owners
IFRIC 18	Transfers of Assets from Customers
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21	Levies
IFRIC 22	Foreign Currency Transactions and Advance Consideration
IFRIC 23	Uncertainty over Income Tax Treatments

13.2.1 Advantages and Disadvantages of IFRS

The following are the advantages of IFRS:

- It simplifies the process of accounting for different accounting users and entities.
- It streamlines and makes the understanding of the accounting statements consistent.
- It makes companies following the standard practices more competitive and attractive in the global market.
- It will make the comparison of different entities across the world more easier.
- It acts like a global gold standard in terms of accounting practices.

The following are the disadvantages of IFRS:

- Differences in items of the financial statements will still not have similar reasons due to different national laws and conditions affecting them. So understanding the reasoning behind differences will still not be easier.
- IFRS is highly influenced by cultural and environment factors including language and legal issues making a dent in its comparison capabilities.
- Different historical practices in the countries will have a bearing on how the interpretive IFRS are applied.
- It may be a costly affair for companies since it requires certain level of global understanding of business practices and therefore specialized skills.
- IFRS may also drive up costs of the companies when they will have to bring changes to the internal operations and training to be in tune with the global accounting standards and their applicability.

Check Your Progress

1. When was the IASC renamed as the International Accounting Standard Board?
2. Name the interpretive arm of the IASB.
3. Which IFRS deals with the provisions for consolidated financial statements?

NOTES

13.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The IASC was renamed as the International Accounting Standard Board in 2001.
2. The interpretive arm of the IASB is the International Financial Reporting Interpretation Committee.
3. IFRS 10 deals with the provisions for consolidated financial statements.

13.4 SUMMARY

- The International Accounting Standards Committee came into existence in 1973 along with its interpretive arm for formulation of such standards to bring uniformity in terminology, approach and presentation of results.
- Since 2001, the IASC was renamed International Accounting Standard Board. Its members are responsible for the development and publication of IFRSs and approving interpretations as developed by IFRIC.
- The IASB has issued a new set of pronouncements known as International Financial Reporting Standards on topics which there was no previous IAS.
- The objectives of IASB are to development set of high quality acceptable financial reporting standards, to promote the use and rigorous application of those standards, to pay attention to needs of small and medium enterprises and promote and facilitate adoption of IFRSs.
- IASB now comprises of IFRSs, IASs, IFRICs and SICs.
- The underlying assumptions of IFRS are accrual basis, going concern, measuring unit and unit of constant purchasing power.

13.5 KEY WORDS

- **International Accounting Standards Board:** Previously known as IASC, it is an accounting committee with 15 full time members from different nations who issue the IASs, SICs and IFRSs.
- **International Financial Reporting Standards:** It refers to the set of international accounting standards developed by the International Accounting Standards Board providing the mode of reporting particular type of transactions and events in the financial statements.

13.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. Write a short note on the history and structure of IASC.
2. List the objectives of IASB.
3. What standards are comprised under the ambit of IASB?
4. Briefly discuss the acceptance of IFRS around the world.

Long Answer Questions

1. Discuss the objectives, scope and assumptions of the IFRS.
2. Describe the aspects of types, objectives, qualitative characteristics and current status of the IFRS main financial statements.

13.7 FURTHER READINGS

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NOTES

UNIT 14 HUMAN RESOURCE GOVERNMENT AND RESPONSIBILITY ACCOUNTING

Structure

14.0 Introduction
14.1 Objectives
14.2 Characteristics of Human Resource Accounting and Application Methods
14.3 Principles of Government Accounting
14.4 Principles of Responsibility Acccounting
14.4 Answers to Check Your Progress Questions
14.5 Summary
14.6 Key Words
14.7 Self Assessment Questions and Exercises
14.8 Further Readings

14.0 INTRODUCTION

It is a widely accepted fact that success of any organisation, business or otherwise, to a great extent, depends upon the quality, calibre and character of the people working in it. An organisation having vast physical resources, with latest technology, may find itself in the midst of severe financial crisis in case it does not have right people to manage and conduct its affairs. Thus, in spite of all technological developments, the importance of human resources has in no way diminished. It is unfortunate that even till now accountants have not been in a position, to evolve a generally accepted system to value and record this important asset, *viz.*, the human resources.

Government Accounting is of special significance in our country because of the fact that the government has the largest volume of monetary transactions. Maintenance of detailed government accounts is necessary to provide adequate information for different kinds of Revenues and Expenses.

Responsibility accounting is a system of control by delegating and locating the responsibility for costs. It is similar to any other system of cost such as standard costing or budgetary control but with greater emphasis towards fixing of the responsibility of the persons entrusted with the execution of specific job.

In this unit, you will learn about these three specialized areas of accounting.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the characteristics of human resource accounting
- Explain the application methods used under human resource accounting
- Examine the principles of government accounting
- Describe the principles and practices of responsibility accounting

14.2 CHARACTERISTICS OF HUMAN RESOURCE ACCOUNTING AND APPLICATION METHODS

The concept of considering human beings as an asset is an old phenomenon. One may recall, in this connection, the importance which emperor Akbar gave to the nine jewels (courtiers). The history of our freedom movement will not be complete without mentioning the names of Shri Motilal Nehru, Mahatma Gandhi, Sardar Vallabhbhai Patel and several other distinguished freedom fighters. However, no effort was made to assign any monetary value to such individuals in the Balance Sheet of the nation or of the organisation.

The first attempt to value the human beings in monetary terms was made by Sir William Petty as early as 1691. Petty was of the opinion that labour was "the father of wealth" and it must be included in any estimate of national wealth. Further efforts, in this connection, were made by William Far in 1853, Earnest Engle in 1883.

However, the real work on the subject started from 1960, when behavioural scientists vehemently criticised, the conventional accounting practice of not valuing the human resources along with other material resources. As a result, accountants and economists all over the world became conscious of the fact the appropriate methodology and procedures have to be developed for finding the cost and value of the people to the organisation. Over a period of three decades, a number of experts have worked on it and produced certain models for evaluating human resources. The notable among them are Shultz (1960), William C. Pyle (1967), Flam Holtz (1971, 1972 and 1975), Morese (1973), Lav and Schwartz (1971), Jaggi and Lav (1974), Kenneth Sinclare (1978), etc.

The present section deals with some of the important models evolved during the last two decades for valuation of human resources.

Concept of Human Resource Accounting

As a result of the various studies conducted by different experts in the areas of accounting and finance, a new branch of accounting known as 'Human Resource Accounting' has come into being. This branch of accounting is primarily based on this concept that the traditional practice of treating all expenditure on human capital formation as an immediate charge against the revenue of the period is not consistent with the term accorded to comparable outlays in physical assets. As a matter of fact, the cost incurred on any asset should be capitalised when it is incurred in order to yield future benefits measurable in monetary terms.

The concept of human resource accounting can be better understood if one goes through some of the important definitions given by the competent authors in the accounting field.

The American Accounting Society Committee on human resource accounting defines it as follows:

"Human resource accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties."

Mr. Woodruff Jr., Vice President of R.G. Barry Corporation defines it as follows:

"Human resource accounting is an attempt to identify and report investments made in human resources of an organisation that are presently not accounted for in conventional accounting practice. Basically it is an information system that tells the management what changes over time are occurring to the human resources of the business."

In simple words, human resource accounting is the art of, valuing, recording and presenting systematically the worth of human resources in the books of account of an organisation. Thus there are three important aspects of human resource accounting:

(i) Valuation of human resources.

(ii) Recording the valuation in the books of account.

(iii) Disclosure of the information in the financial statements of the business.

Let's discuss there steps one by one

(i) Valuation of Human Resources or Application Methods

Following are the important approaches suggested for valuation of human resources.

NOTES

Historical Cost Approach

This approach was developed by Brummet, Flamholtz and Pyle. According to this approach, the actual cost incurred on recruiting, selecting, hiring, training and developing the human resources of the organisation are capitalised and written off over the expected useful life of the human resources. The historical cost of human resources in case of this method is thus treated in the same manner as the cost of any other physical asset. Any expenditure incurred for training or development of the human resources increases, the value of human assets like any other physical asset and therefore, capitalised in a similar manner. Amortization of the human assets is also done in a similar manner. In case the human asset expires before the end of the expected service life period, the whole of the amount not written off is charged against the revenue of the year in which such event takes place. In case the useful life is recognised to be longer than the original expected, amortization is appropriately rescheduled.

Merits. The methods has the following merits:

(i) The method is simple to understand and easy to work out.

(ii) The method follows the traditional accounting concept of matching cost with revenue.

(iii) The method can provide a basis for valuing a firm's returns on its investment on human resources.

Limitations. The method suffers from the following limitations:

(i) The method takes into account only a part of acquisition cost of employee. It does not consider the aggregate value of their potential services.

(ii) It is difficult to estimate the period over which the human resource will provide service to the organisation. It thus creates problems in determining the amount to be amortized over the year.

(iii) The value of human assets according to this method goes on decreasing every year due to amortization. However, in reality, the value of human assets increases over time on account of people gaining experience.

Replacement Cost Approach

This approach was developed by Rensis Likert and Eric G. Flamholtz. This approach values the human resources at their present replacement cost. In other words, human resources of an organisation are to be valued on the basis of the assumption, what would cost the firm, if the existing human resources are required to be replaced with others of equivalent talents and experience.

The approach is similar to the historical cost approach mentioned above except that it allows for changes in the cost for acquiring, training and developing the employees in place of taking their historical cost for capitalisation.

Merits. The method has the following merits:

(i) The approach incorporates the current value of the firm's human resources. Thus, the financial statements prepared according to this approach are more realistic as compared to those prepared under historical cost approach.

(ii) It is almost impossible to ascertain correct replacement cost of existing human resources, since there can be no complete replacement for them.

Limitations. The method has the following limitations:

(i) The method is at variance with conventional accounting practice of valuing assets at historical costs.

(ii) It is almost impossible to ascertain correct replacement cost of existing human resources since there can be no complete replacement for them.

(iii) There is no objective way for determination of replacement cost. Personal prejudices do work. Moreover, there is no foolproof method for verification of replacement cost.

Opportunity Cost Approach

This approach has been suggested by Hekimian and Jones. According to this approach, the value of an employee is determined according to his alternative use. In case an employee has no alternative use, no value will be placed on him. This approach specifically excludes those types of employees who can be hired readily from outside. The approach suggests competitive bidding process for the scarce employees in an organisation. It means that the opportunity cost is lined with scarcity. The opportunity cost of an employee or a group of employees in one department is calculated on the basis of the offers (bids) by other departments for those employees. This will be clear from the following example.

A company has two departments *X* and *Y*. The amount of capital employed (in physical assets) in departments *X* and *Y* is ₹ 10 lakh and ₹ 5 lakh respectively. The required rate of return on total capital employed (physical as well as human) is 15%. It is expected that with the employment of a specific group of technocrats, department *X* can make a profit of ₹ 3 lakh while department *Y* can make a profit of ₹ 2.5 lakh.

The capitalised value of profit with the technocrats at the rate of 15% comes to ₹ 20 lakh in case of department *X* and ₹ 16.67 lakh for department *Y*. In case the value of physical assets is deducted form these figures, the value of human resources comes to ₹ 10 lakh in case of department *X* and ₹ 11.67 lakh in case of department *Y*. Hence, department *Y* can offer a higher bid for the technocrats as compared to department *X*.

In terms of salary, department *X* can offer a salary of ₹ 1.50 lakh (₹ 10 lakh × 15%) while department *Y* upto ₹ 1.75 lakh (₹ 11.67 × 15%). Department *Y* can thus also offer a high salary.

Department *Y* will have the technocrats on account of a higher bid and it will include ₹ 11.67 lakh as its investment in human resources.

Merits. According to the authors of this approach, a bidding process, such as this, is a promising approach towards (a) more optimal allocation of personnel and (b) a quantitative base for planning, evaluating and developing human assets of the firm.

Limitations. This approach has several limitations:

(i) It has narrowed down the concept of opportunity cost by restricting it to the next best use of the employee within the same organisation.

(ii) It has specifically excluded from its purview those employees who are not scarce or are not being bid by other department. This is likely to result in lowering morale and productivity of the employees, who are not covered by the competitive bidding process.

(iii) The total valuation of human resources base on this method may be misleading and inaccurate. This is because a person may be an expert in a particular area and therefore may be useful for one department but useless for another department. Thus, he may be a valuable person for the department he is working and command a high value. However, he may have a lower price in the bid by the other department where his services are not at all required.

Standard Cost Approach

This approach has been suggested by David Watson. According to this approach, standard costs of recruiting, hiring, training and developing per grade of employees are determined year after year. The standard cost so arrived at for all human beings employed in the organisation is the value of human resources for accounting purposes.

The approach is easy to explain and can work as a suitable basis for control purposes through the technique of variance analysis. However, determination of the standard cost for each grade of employee is a ticklish process.

Present Value of Approach

According to this approach, the value of human resources of an organisation is determined according to their present value to the organisation. For determination of the present value, a number of valuation models have been developed. Some of the important models are as follows:

Present Value of Future Earnings Model This model has been developed by Lav and Schwartz (1971). According to this model, the value of human resources is ascertained as follows:

(i) All employees are classified in specific groups according to their age and skill.

(ii) Average annual earnings is determined for various ranges of age.

(iii) The total earnings which each group will get upto retirement age are calculated.

(iv) The total earnings calculated as above are discounted at the rate of cost of capital. The value thus arrived at will be the value of human resources/assets.

(v) The following formula has been suggested for calculating the value of an employee according to this model.

$$V_r = \sum_{t=r}^{T} \frac{I(t)}{(1+R)^{t-r}}$$

where

V_r = the value of an individual r years old

$I(t)$ = the individual's annual earnings upto the retirement

t = retirement age

r = present age of the employee

R = discount rate

Illustration 14.1: From the following details compute the value of human resources of an employee group with an average age of 58 years.

(i) Annual Average Earning of an employee till the retirement age ₹ 20,000

(ii) Age of retirement 60 years

(iii) Cost of capital 10%

(iv) No. of employees in the group 10

Solution

$$V_r = \sum_{t=r}^{T} \frac{I(t)}{(1+R)^{(t-r)}}$$

$$= \frac{20{,}000}{(1+0.10)^{(60-58)}} + \frac{20{,}000}{(1+0.10)^{(60-59)}}$$

$$= \frac{20{,}000}{(1+0.10)^{2}} + \frac{20{,}000}{(1+0.10)^{1}} = 16{,}528.93 + 18{,}181.82 = ₹\ 34{,}710.75$$

Alternatively the value of an employee can be computed with the help of Annuity Table. The present value of an annuity of ₹ 1 for two years at 10% is 1.736. Hence, the present value of ₹ 20,000 for two years comes to 20,000 × 1.736 = ₹ 34,720. This is almost the same as calculated above.

Since the total number of employees in the group are 10, hence the total value of human resources of this group comes to 34,710 × 10 = ₹ 3,47,100.

NOTES

Illustration 14.2: From the following information in respect of Excellent Ltd., calculate the total value of human capital according to Lev and Schwartz model:

Distribution of Employees at Excellent Ltd.

Age	*Unskilled*		*Semi-skilled*		*Skilled*	
	No.	*Av. annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹ '000)*
30–39	50	3	30	3.5	20	5
40–49	20	4	15	5	15	6
50–54	10	5	20	6	5	7

You may apply 15% discount factor.

Solution

The present value of earnings of each category of employees is ascertained as below:

(A) Unskilled employees

Age group 30–39. Assuming that 50 employees are just 30 years old.

	Present Value ₹
₹ 3,000 p.a. for next 10 years	15,057
₹ 4,000 p.a. for years 11 to 20	4,960
₹ 5,000 p.a. for years 21 to 25	1,025
	21,042

Age group 40–49. Assuming that all 20 employees are just 40 years old.

₹ 4,000 p.a. for next 10 years	20,076
₹ 5,000 p.a. for years 11 to 15	4,140
	24,216

Age group 50–54. Assuming that all 10 employees are just 50 years old.

₹. 5,000 p.a. for next 5 years	16,760

The present Value of each employee under other categories on the same pattern can be calculated as given below:

(B) Semi-skilled employees

	Present Value ₹
Age group 30–39:	
₹ 3,500 p.a. for next 10 years	17,567
₹ 5,000 p.a. for years 11 to 20	6,200
₹ 6,000 p.a. for years 21 to 25	1,230
	24,997
Age group 40–49:	
₹ 5,000 p.a. for next 10 years	25,095
₹ 6,00 p.a. for years 11 to 15	4,968
	30,063
Age group 50–54:	
₹ 6,000 p.a. for next 5 years	20,112

(C) Skilled employees:

		Present Value ₹
Age group 30–39:		
	₹ 5,000 p.a. for next 10 years	25,095
	₹ 6,000 p.a. for years 11 to 20	7,440
	₹ 7,000 p.a. for years 21 to 25	1,435
	33,970	
Age group 40–49:		
	₹ 6,000 p.a. for next 10 years	30,114
	₹ 7,000 p.a. for years 11 to 15	5,796
	35,910	
Age group 50–54:		
	₹ 7,000 p.a. for next 5 years	23,464

Total Value at Human Capital

Age	*Unskilled*		*Semi-skilled*		*Skilled*		*Total*	
	No.	*Av. annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹ '000)*	*No.*	*Av. annual earnings (₹ '000)*
30–39	50	10,52,100	30	7,49,910	20	6,79,400	100	24,81,410
40–49	20	4,94,320	15	4,50,945	15	5,38,650	50	14,73,915
50–54	10	1,67,600	20	4,02,240	5	1,17,320	35	6,87,160
	80	17,14,020	65	16,03,095	40	13,35,370	185	46,42,285

Limitations. The method suffers from several limitations:

(1) A person's value to an organisation is not entirely determined by the salary paid to him. A person may like to work at a salary which is less than what he actually deserves. Moreover, salary does not remain constant over a period of time. They tend to change in response to social, political and economic conditions. Hence, they cannot be predicted with precision and accuracy.

(2) The model ignores the possibility that an individual may leave the organisation for reasons other than death or retirement. Thus, it overstates an employee's expected service life and his future earnings.

(3) The model does not take into account the changes which people make during their career, from one role to another, at one or more times within the organisation itself. This may result in the changes in their expected future earnings and ultimately the value of human resources.

(4) The model also ignores other considerations such as seniority, bargaining capacity, skill experience, etc., which may result in payment of higher or lower salaries to employees. Thus, the salaries paid to employees may not really represent the employees real worth to the organisation.

Reward valuation model: This model has been suggested by Flamholtz (1971). This is an improvement on 'present value of future earnings model' since it takes into consideration the possibility or probability or an employee's movement from one role to another in his career and also of his leaving the firm earlier, than his death or retirement. According to this model, the ultimate measure of an individual's value to an organisation is his expected realisable value. The realisable value is estimated on the basis of the present worth of the set of future services he is expected to provide *during* the period he is likely to remain with the organisation. *The model suggests a five step approach for this purpose.*

1. Determination of the period for which a person is expected to serve the organisation.
2. Identification of 'service states' (*i.e.* roles or posts) that the employee might occupy during his service career including the possibility of his quitting the organisation.
3. Estimation of the probable period for which a person will occupy each possible 'service state' (posts or roles) in future in the organisation.
4. Estimation of the value derived by the organisation when a person occupies a particular position, *i.e.* a service state for the specific time period. Such value can be determined either by multiplying the price of the services (articles) with the quantity of the services (articles) to be rendered (produced) or the income expected to be derived from the services to be rendered.
5. The total value of the services derived by the organisation by different employees or group of employees is determined. The value thus arrived is discounted at a predetermined rate to get the present value of human resources.

Limitations: The model suffers from nearly all the drawbacks from which the present value of future earnings model suffers. Moreover, it is difficult to obtain reliable data for determining the value derived by an organisation during the period a person occupies a particular position. The model also ignores the fact that individuals operating in a group may have a higher value for the organisation as compared to individuals working independently.

Net Benefit Model: This approach has been suggested by Morse (1973). According to this approach, the value of human resources is equivalent to the present value of net benefits derived by the organisation from the service of its employees. The method involves the following steps.

1. The gross value of services to be rendered in future by the employees in their individual as well as their collective capacity is determined.
2. The value of future payments (both direct and indirect) to the employees is determined.
3. The excess of the value of future human resources (as per 1 above) over the value of future payments (as per 2 above) is ascertained. This, as a

matter of fact, represents the net benefit to the organisation on account of human resources.

4. The present value of the net benefit is determined by applying a predetermiend discount rate (generally the cost of capital). This amount represents the value of human resources to the organisation.

Certainty Equivalent Net Benefit Model: This approach has been suggested by Pekin Ogan (1976). This, as a matter of fact, is an extension of 'net benefit approach' as suggested by Morse. According to this approach, the certainty with which the net benefits in future will accrue should also be taken into account, while determining the value of human resources. The approach requires determination of the following:

1. Net benefit from each employee as explained under 'net benefit approach' above.
2. Certainty factor at which the benefits will be available.
3. The net benefits from all employees multiplied by their certainty factor will give certainty-equivalent net benefits. This will be the value of human resources of the organisation.

Aggregate Payment Approach

This approach has been suggested by Prof. S.K. Chakraborty (1976). As a matter of fact, he is the first Indian to suggest a model for valuation of human resources of an organisation. According to his model, the human resources are to be valued as a group and not on individual basis.

Professor Chakraborty's model for valuation of human resources involves the following steps:

1. All the employees of an organisation are divided in two groups, managerial and non-managerial.
2. The average tenure of the employment of the employees in the group is estimated on the basis of past experience.
3. The average salary of the group is determined on the basis of the salary/wage structure prevalent in the organisation.
4. The value of human resources is now determined by multiplying the average salary of the group with the average tenure of the employees in that group.
5. The value determined under '4' above, is discounted at the expected average after tax return on capital employed over the average tenure period, to ascertain the present value of the estimated future payment. Dr. Chakraborty suggests that the adoption of such a long-term rate will avoid fluctuations in the value of "human asset" from year to year simply due to changing annual rates of return.

Professor Chakraborty has also suggested that the recruitment, hiring, selection, development and training cost of each employee should be recorded separately. This should be treated as deferred revenue expenditure and may be written off over the expected average stay of the employee in the organisation. The deferred portion, not written off, should be shown in the Balance Sheet of the organisation. If there is pre-mature exit of an employee on account of death, retirement, etc., the balance of the deferred revenue expenditure attributable to that person should be written off against the income of the year of exit itself.

As regards disclosure of accounting information relating to human resource, Professor Chakraborty has suggested that 'human assets' should be shown under the heading "Investments in the Balance Sheet" of an organisation. He has not favoured its inclusion under the heading fixed assets since it would cause problem of depreciation, capital gains and losses, in the event of their exit. Similarly, he has not favoured their inclusion in current assets on the ground that this will not be in conformity with the general meaning of the term.

Total Cost Concept

This approach has been suggested by Prof. N. Dasgupta (1978). According to him the various approaches suggested in the previous pages take into account only those persons, who are employed and ignore those who are unemployed. In case the value of human resources of the nation is to be determined, it should be done in a manner that it brings in its purview both employed and unemployed persons. The system should be such that it fits in preparation of a balance sheet, showing the human resources not only of a firm but also of the whole nation.

According to Prof. Dasgupta; the total cost incurred by the individual, the state and the organisation in bringing the individual up to that position in the organisation (in case of a nation making him fit for appropriate employment) should be taken as the value of a person on the day, he starts serving the organisation or becomes fit for appropriate employment. It will include his education, training expenses which he and the state have incurred. The value should be further adjusted by the amount of intelligence (higher or lower which he has). The amount spent by the organisation on recruitment, training, familiarising and developing human beings employed in the organisation should be considered separately. However, it should also be treated as a cost increasing the value of human beings. In case the number is large, the valuation can be done groupwise.

The value determined on the aforesaid manner should be adjusted at the end of each year by the organisation on the basis of his age, seniority, status, performance, experience, leadership, managerial capabilities, etc. The measurement can be done with the help of psychologists and other concerned experts. The revised value would be the value of the employee at the end of the year.

Prof. Dasgupta's model seems to be sound theoretically. However, its practical application may be difficult since it will involve a number of abstract factors, which may not be capable of being expressed in monetary terms precisely and objectively.

(ii) Recording and Disclosure in Financial Statements

In the preceding pages, we have explained the various models dealing with the mode of valuation of human resources as an asset. The "present value of future earnings" model, as suggested by Lav and Schwartz, has been found to be most popular model on account of convenience and objectivity. The exponents of human resource valuation models in most cases have not dealt, with the mode of recording and disclosure of the accounting information relating to human resources in the books of account or financial statements of the organisation. This has been left to the discretion of the accounting bodies who have yet to develop a generally accepted basis for valuation, recording and disclosure of human resource accounting information in the financial statements of an organisation. In most cases, the human resource accounting information is given in the form of supplementary information attached to the financial statements.

Prof. N. Dasgupta has suggested in his total cost approach (explained earlier) the following mode for disclosure of human resources in the balance sheet of an organisation.

According to him, the human resources valued as per his model should be shown both on the 'assets' as well as 'liabilities' sides of the balance sheet. On the assets side, it should be shown after the fixed assets as Human Assets classified into two parts—(i) value of individuals, (ii) value of firm's investment. On the "liabilities" side, it should be shown after the capital as Human Assets Capital by that amount at which it has been shown on the asset side against 'value of individuals.' He has given the following example to clarify his point.

Example. A firm has started its business with a capital of ₹ 1,00,000. It has purchased fixed assets worth ₹ 50,000 in cash. It has kept ₹ 26,000 as working capital and incurred ₹ 24,000 on recruitment training and developing the engineers and a few workers. The value of engineers and workers is assessed at ₹ 80,000.

The items will be shown in the balance sheet as follows:

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Balance Sheet
(Including Human Resources)

Liabilities	₹	*Assets*	₹
Capital	1,00,000	Fixed Assets	50,000
Human Assets Capital	80,000	Human Assets:	
		(i) Individuals' Value	80,000
		(ii) Value of Firm's Investment	24,000
		Current Assets	26,000
	1,80,000		1,80,000

Importance of Human Resource Accounting

Human Resource Accounting provides useful information to the management, financial analysts and employees, as shown below:

1. Human Resource Accounting helps the management in the decision-making process relating to the various matters.
   (a) Employment, locating and utilisation of human resources.
   (b) Transfers, promotion, training and retrenchment of human resources.
   (c) Planning of physical assets vis-a-vis human resources.
   (d) Evaluating the expenditure incurred for imparting further education and training to employees in terms of the benefits derived by the firm.
   (e) Identifying the causes of high labour turnover at various levels and taking preventive measures to contain it.
   (f) Locating the real cause of low return on investment, that is whether it is due to improper or under-utilisation of physical assets or human resource or both.
2. A financial analyst is interested in understanding and assessing the inner strength of firm. Such inner strength does not merely depend on the physical assets owned and possessed by the firm. It also depends upon the type of human resources available to the firm. The vigilant, dynamic and responsible management can steer the company well through most adverse and unfavourable circumstances. In case the human resources, specially the managerial resources at the disposal of the firm are impartially and systematically valued and disclosed in the financial statements, it will be a valuable information for persons interested in making long-term investment in the firm.
3. The Human Resource Accounting helps individual employees in improving their performance and bargaining power. It makes each of them conscious of the contribution that he is making towards the betterment of the firm vis-a-vis the expenditure incurred by the firm on him.

Objections Against Human Resource Accounting

The following are some of the common objections against Human Resource Accounting.

1. Human being cannot be owned like other physical assets. They, therefore, cannot command any value.
2. Tax laws do not recognise human beings as assets. Hence, human resource accounting remains merely as a theoretical concept.
3. There is no generally accepted model for valuation of human resources. The mode of presentation has also yet to be codified.
4. The valuation of human resources depends on a large number of abstract factors not measurable in precise monetary terms. Hence, the valuation lacks objectivity and preciseness.

The above objections are basically because of human resource accounting being a new concept. The opinion are still to be crystalised. It is yet not less satisfying that the accountants these days have realised that disclosure of human resources in the financial statements "is a must" if they have to show a true and fair view of the state of affairs of the business. In course of time, proper techniques are bound to be developed for valuation of human resources and generally acceptable formats will be evolved by the accountants for disclosure of this vital information in the financial statements of the firm.

Check Your Progress

1. What is the point of difference between the historical and replacement cost approach?
2. Why is the practical application of total cost concept of valuation of human resources difficult?

14.3 PRINCIPLES OF GOVERNMENT ACCOUNTING

In this section, you will learn about the various aspects of government accounting.

Objectives of Government Accounting

The various objectives of Government Accounting can be summarised as follows:

(1) Providing information about revenues: Government Accounting aims to provide information about the revenues of the government during the year. The government revenues can be classified into two categories: (i) Tax Revenues and (ii) Non-tax Revenues. The information about both the types of revenues has to be sufficient in detail to enable the government to estimate the future revenues and decide about the possibility of taking steps for any increase or decrease in revenue. This is possible only when taxes and other revenues are segregated so as to provide information about each one of them with sufficient details.

(2) **Providing information about expenditure:** Government Accounting aims to provide information about the expenditure on different items. This is necessary because Parliament or the State Legislature, as the case may be, will like to know whether the amounts spent by the government on different activities are within the limits sanctioned by it or not.

(3) **Providing information about loans and deposits:** Government borrows heavy sums from different parties. Similarly it lends money also. Government Accounting provides information about the loans and deposits which the government has to pay to its creditors and also debts due by others to the government.

(4) **Information about cash availability:** This information is necessary to enable the government to run its operations smoothly. Government Accounting provides information about the present availability of cash and receipts and payments in the near future. The reconciliation of the government's bank account with its bankers is also necessary for this purpose.

Difference Between Government Accounting and commercial Accounting

The Government accounting is different from Commercial accounting because of the difference between the objectives of the government and those of a commercial undertaking. The main objective of a commercial undertaking is to trade and make profit while the main function of a government is to administer the country and to render various services.

The differences between the two can be summarised as follows:

(1) **System of accounting:** The accounts of a commercial concern are usually kept on accrual system and according to the double entry system of book-keeping. In case of a manufacturing concern appropriate cost records are also maintained to ascertain the cost of production of each product so that its selling price may appropriately be fixed. Accounts are maintained not only in respect of persons with whom the business has commercial relations but with respect to each asset and liability and each income and expenditure. The overall objectives of maintaining accounts of a commercial concern is to prepare its Profit and Loss

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Account and the Balance Sheet. The Profit and Loss Account tells about the profitability while the Balance Sheet discloses the financial position of the business.

The government of a country is more interested in knowing what will be the likely expenditure for administering the country and how it can be collected by way of taxation, loans, etc. so as to impose the least burden on the tax payers. There is no place for profit or loss in government activities. For example, law and order is not a profit or loss operation nor free education for the children is. Government has, therefore, not to prepare a Profit and Loss Account except for some of its commercial activities carried on by some public sector undertakings. It is, therefore, of no use to the government to know and record in the books of account the amount of taxes which may be recovered on a distant date in future. It is much more important for the government to know how much cash is available for spending on socially useful activities. Hence, government accounts are mostly kept on cash basis.

(2) Final accounts: Every commercial undertaking prepares a Profit and Loss Account and a Balance Sheet at the end of the accounting period. The Profit and Loss Account is a summary of all incomes and expenses including goods purchased and sold for in the business, while the balance sheet contains details of all liabilities and assets of the business.

In case of Government accounting, no Profit and Loss Account or Balance Sheet is prepared. However, the following two accounts or statements are prepared:

(i) Government Account; and

(ii) Statement of Balancing Accounts.

Government Account is the net result of all income and expenditure including expenditure on capital accounts, while the Statement of Balancing Accounts represents cases where government has either to pay or receive in cash for the amounts already borrowed or loans granted.

It may be noted that physical assets are shown year after year in the Balance Sheet of a commercial concern. However, they are not shown repeatedly in the government accounts. For example, the money spent by a business on construction of building, roads, etc. will be shown in its balance sheet year after year till these assets are written off. However, the money spent by the government in construction national highways will be charged to the government account in the year in which the expenditure has been incurred, and will not be carried forward year after year though the national highway does constitute a useful asset for the nation.

(3) **Classification of accounts:** In case of commercial accounting, all transactions are classified broadly into three categories of accounts—real, nominal, and personal. However, in case of Government accounting, classification of accounts is in a way more elaborate than Commercial accounting. In Government accounting there involves broadly three accounts: (i) Consolidated Fund, (ii) Public Account, and (iii) Contingency Fund. However, there are minute elaborations for recording the financial transactions of the government. For example, even in the Consolidated Fund there are three main divisions: (i) Revenue and Expenditure Heads, (ii) Capital Receipts and Disbursement Heads, and (iii) Public Debt and Loans and Advances. Within each division the transactions are grouped into sections which are further divided into major Heads of Account. The major heads are sub-divided into minor heads, sub-heads and detailed heads.

(4) **Independence of accounts and audit function:** In case of Commercial accounting, audit function is independent of the accounts function; while in case of Government accounting, in most cases, the functions both of maintenance of accounts and their audit are handled by the Indian Audit and Accounts Department.

General Principles of Government Accounting

The following are the general principles of Government accounting.

(1) **Responsibility for maintaining accounts:** The responsibility of maintaining proper government accounts is that of the Indian Audit and Accounts Department except that of the Railways, Defence and transactions outside India. Recently, the practice of maintenance of accounts by the Ministries concerned has also been introduced in some cases.

(2) **System Accounting:** Accounting system Government accounts are generally kept according to Single Entry System. However, in respect of those transactions where the government functions as lender, borrower, or remitter, double entry system is also followed to ascertain the exact balances, e.g., accounts relating to public debt, loans and advances, etc. In case of such transactions, Journal and Ledger are kept and correctness of the balances is verified by preparing a Trial Balance.

(3) **Government commercial undertakings:** In case of commercial undertakings owned by the government, the accounts are maintained on accrual system and according to the double entry system of book-keeping. The Trading and the Profit and Loss Account and Balance Sheet of the undertaking is also prepared. In order to have an effective control over costs and profits, appropriate management accounting

techniques like budgeting, ratio analysis, funds flow analysis, etc. are also used.

(4) Recording of transactions: In case of Government Accounting, the transactions are recorded in the initial accounts and consolidated under different heads in such a form that the information is available about the combined results of all the transactions that had taken place during the period. For instance, the expenditure under establishment and contingencies head is consolidated, duly analysed under various component units into which allotment under these heads had been split up.

(5) Classification of income and expenditure: In Government Accounting, classification of income and expenditure is done first according to the administrative activities and then according to their nature. For example, in case of Revenue Account, expenditures are first classified under the following heads:

(i) General Services, (ii) Social Services, (iii) Economic Services, (iv) Grants-in-aid and contribution. General Services are then further classified as:

(a) Organs of the State, (b) Fiscal Services, (c) Interest Payment and Servicing of Debt, (d) Administrative Services, (e) Defence Services, etc.

Similarly, income or revenues are classified as tax revenue and non-tax revenue. Tax revenue are further classified as (i) Taxes on Incomes and Expenditure, (ii) Taxes on Property and Capital Transactions, (iii) Taxes on Commodities and Services, etc. Similarly, non-tax revenue is classified as fiscal services, interest receipts, dividends and profits, social services, etc. Each item of income or expenditure is then further classified into several major heads followed by several minor heads, sub-heads, etc.

(6) Maintenance of internal accounts: The book-keeping work or maintenance of internal accounts is the responsibility of the authorities concerned or of the treasury.

(7) Combined finance and revenue account: A combined finance and revenue account of the Union and State is prepared incorporating summarises of accounts compiled by the Indian Accounts and Audit Department and other agencies. The account reveals the results of all government transactions arising both in and outside India.

(8) Combination of accounts and audit functions: In case of Government Accounting, the Doctrine of Independence of audit function from accounting function is not valid in all cases except in case of Railway and Defence Departments. The Indian Audit and Accounts Department is responsible for both maintenance of government accounts as well as their audit.

Classification of Government Accounts

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In order to facilitate control, the Constitution of India provides for maintenance of the following accounts: (1) Consolidated Fund, (2) Public Account, and (3) Contingency Fund.

These funds and accounts are maintained separately for the Government of India and each State Government. Each Union Territory having a Legislative Assembly has a separate Consolidated Fund. Its public account is included in that of the Government of India. The accounts of Union Territories not having Legislative Assemblies—Delhi, Chandigarh, Andaman & Nicobar Islands—form part of the accounts of the Government of India.

A brief explanation about each of the above funds/accounts is given below:

(1) **Consolidated fund:** The fund comprises of the following: (i) All revenues received by the Government.

(ii) All loans raised by the Government by issue of treasury bills, loans, or by ways and means advances.

(iii) All moneys received by the Government in repayment of loans.

Thus, the sources of consolidated funds are (a) Revenues, (b) Loans and ways and means advances, and (c) Recoveries of loans granted by the Government.

Appropriations out of the consolidated fund have to be made in the manner provided in the Constitution. It involves submission of demands for grants in the prescribed manner before the appropriate body—Parliament or the State Legislature, as the case may be.

(2) **Public account:** This account or fund is maintained for receipts which does not go to the consolidated fund. The public account records all transactions relating to debt (other than those included in the consolidated fund), deposits, advances, remittances, etc. The transactions under debt, deposit and advances in the public account are such in respect of which the government incurs a liability to repay to money received or as a claim to recover the amount paid. The transactions under Remittance and Suspense in the public account are booked only for a temporary period till they are transferred to the correct accounts in the Consolidated Fund or the Public Account. Some of the examples of the transactions booked in the public account are: (i) Provident Fund Account, (ii) Deposits received from Panchayats for custody with the Government, (iii) Advances granted by the Government for cost of survey marks recoverable from the land-holders, etc.

(3) **Contingency fund:** This fund is of the nature of an imprest. Advances from this fund can be made for meeting unforeseen expenditure, pending authorisation such expenditure by the Parliament or the State Legislature, as the case may be. The contingency fund is at the disposal of the President/Governor and, therefore, only he can issue authority for its use.

Form of Government Accounts

The Government accounts have to be kept in such a form as may be prescribed by the President of India on the advice of the Comptroller and Auditor General of India. The broad classification of the Government Accounts has already been given above. The contents, shape and form of accounts are largely regulated by legislative requirements and situation.

Each Government has to prepare a Statement of its estimated annual receipts and expenditure and present it to the legislature. The Annual Financial Statement is also known as the Government Budget. The budget gives the receipts and expenditure of the Government of India or the State Government, as the case may be, for the financial year (1st April to 31st March) which has to be approved by the State Legislative Assembly or the Parliament, as the case may be. Once the budget is approved, an Appropriation Bill is introduced to provide for appropriations out of Consolidated Fund for meeting demands for grants. It may be noted that no expenditure can be incurred out of Consolidated Fund without the appropriation bill being passed by the appropriate legislative authority—the Parliament or the State Legislature, as the case may be. Hence, delay in passing appropriation bill may result in bringing the government operations to a standstill.

Classification of expenditure in Government Accounts

A unique feature of Government accounting is that the accounts of various State governments and the Union of India are kept quite separately. Each Government (Union or State, as the case may be) keeps three funds/ accounts:

(1) Consolidated Fund,

(2) Contingency Fund, and

(3) Public Account.

(1) Consolidated fund: In the consolidated fund, there are three main divisions:

(i) Revenue Division: This division records the proceeds of taxation and other receipts and the expenditure therefrom. The net result represents the revenue deficit or surplus during the year.

The revenue receipt heads comprise the following:

(a) Tax Revenue, e.g., taxes on income and expenditure, taxes on property and capital transactions, taxes on commodities and service, etc.

(b) Non-tax Revenue, e.g., interest receipts, dividends and profits, amount charged for fiscal services, etc.

(c) Grants-in-aid and contribution.

The expenditure heads comprise the following:

(a) General service, e.g., fiscal services, interest payment and servicing of debt, administrative services, defence services etc.

(b) Social services, e.g., education, sports, arts and culture, health and family welfare, information and broadcasting, etc.

(c) Economic services, e.g., agriculture and allied services, energy, transport, communications, etc.

(d) Grants-in-aid and contribution.

(ii) Capital Division: This division consists of capital receipts and capital disbursements. Under the head 'capital receipts', receipts of capital nature (e.g., sale proceeds of discarded assets, such as machinery, originally purchased for the construction of the project) are recorded. While, capital expenditure includes expenditure of considerable magnitude incurred with the object of increasing tangible assets or reducing recurring liabilities (e.g., capital outlay on large project or major ports or payments in the form of commutation of pensions, etc.).

(iii) Public Debt, Loans and Advances Division: This division consists of loans raised by the government whether temporary or permanent and also loans and advances made by the government together with the repayment of the former and the recovery of the latter.

Under each of the divisions, mentioned above, the transactions are grouped into sections. Sections are sub-divided into major heads of account, which are further sub-divided into minor heads, sub-heads and detailed heads. Moreover, under each of these heads, the expenditure is further classified as "voted" and "charged", depending upon the nature of the expenditure. For example, under tax revenue, the major heads are taxes over income and expenditure, taxes on property and capital transactions. Stamps judicial, stamps non-judicial, registration fee, etc. may be the sub-heads under Stamps and Registration Fees.

It may be noted that any appropriation out of the consolidated fund can be done only after proper authorisation in the manner as provided in the Constitution.

(2) **Contingency fund:** This fund is maintained for meeting any unforeseen expenditure pending authorisation of such expenditure by the Parliament or the State Legislature. The fund is at the disposal of the President/Governor and only they can authorise its use.

(3) **Public account:** The public account is meant for receiving all other public moneys received by or on behalf of the government, which does not relate to the consolidated fund. The approval of the Parliament or the State Legislature is not required for paying money out of this fund. There are two main features of this account:

(i) Debt and Deposit Division: This division deals with receipts and payments other than those falling under the 'debt heads' of the consolidated fund in respect of which the government incurs liability to repay the money (e.g., earnest money, deposits of contractors, court deposits, etc.) or as a claim to recover the amounts paid (e.g., advances of pay and travelling allowances to government servants on transfers).

(ii) Remittance Division: This division deals with merely adjusting heads (e.g., cash remittances from one

Treasury to another, transfer between different accouting circles, etc.).

The classification of government expenditure is generally done in a manner that it has a close reference to department in which an expenditure occurs rather than its objective. The President or the Governor has the power to issue general or special orders as to the head of the account, under which a particular transaction or a class of transactions is to be included. This is done by the President or the Governor in consultation with the Comptroller and Auditor General of India.

The primary responsibility for the classification of the bills, vouchers, etc., is of the concerned administrative authorities. The concerned authority should make a note of the following on every voucher, bill received by it from the Treasury:

(i) The major, the minor and the detailed head, under which the charge has to be booked. (ii) The Union or State, to which the charge belongs.

(iii) The charges to be taken as 'voted' or 'changed' expenditure.

The officials of the Comptroller and Auditor General of India, while auditing the government accounts, have also to see that each income, expenditure or receipt for disbursement has been correctly and properly classified.

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Check Your Progress

3. What are the two categories of government revenues?
4. Mention the two accounts or statements which are opened in case of government accounting.
5. How are government accounts classified?

14.4 PRINCIPLES OF RESPONSIBILITY ACCCOUNTING

In the process of responsibility accounting there is identification of costs with the person responsible. This helps in having a better control over costs because, strictly speaking, cost control is not as much a control over costs as it is a control over the people who incur the costs.

According to Charles T Horngren, Responsibility Accounting is 'a system of accounting that recognizes various responsibility centres throughout the organization and that reflects the plan of action of each of these centres by allocating particular revenues and costs to the one having the pertinent responsibility.'

According to Robert Anthony, Responsibility Accounting is 'that type of management accounting that collects and reports both planned and actual accounting information in terms of responsibility centres.'

The definitions given above make it clear that the organization should be classified into suitable responsibility centres, so that the authority and responsibility of each individual can be very well defined. Each executive must know:

(i) What is expected of him

(ii) What has been his performance

For this purpose the reporting system is so developed that the executive gets the requisite information. Thus, in case of responsibility accounting the main emphasis is on cost control, rather than on cost ascertainment, and on individual, rather than on cost element.

Steps Involved

The objectives of responsibility accounting are achieved by taking the following steps:

(i) The budgets or targets are set in. The targets are communicated to the concerned executives.

(ii) There is a continuous appraisal system of the actual performance. The actual results are communicated to be concerned executive or the responsibility centre.

(iii) The variances are reported to the higher management together with the names of the executives or the responsibility centres entrusted with the job.

(iv) The corrective measures are taken and intimated to the concerned executive or responsibility centre.

Thus, the essence of responsibility accounting is to communicate the right information to the right person at the right time.

Responsibility Centres

Responsibility accounting focuses attention on responsibility centres. Responsibility centre refers to any organization unit that is headed by a responsible manager. 'Responsibility centre is like an engine in that it has inputs which are physical quantities of material, hours of various types of labour, and a variety of services, it works with these resources. Usually, working capital and fixed assets are also required. As a result of the work, it produces outputs, which are classified as goods, if they are tangible or as services, if they are intangible. These goods or services go either to other responsibility centres within the company or to customers in the outside world.'

Responsibility accounting measures both inputs and output of the responsibility centres in monetary terms, wherever feasible. The input is termed as the 'cost' while the output is termed as 'revenue' of the responsibility centre. However, where monetary measurement of output is not possible (e.g., services rendered by the accounting department to the organization), it may be measured in terms of total cost of goods or services transferred or as number of units of output.

Types of Responsibility Centres

Responsibility centres can be of three types: (a) Expenses centres, (b) Profit centres and (c) Investment centres.

(a) Expenses Centres: In case of certain responsibility centres, it is neither possible nor necessary to measure the output in terms of monetary units. Most of the service departments come in this category. For example, it is almost impossible to measure the monetary value of the finance or the accounting department's contribution to the company. The accounting system, therefore, records the cost incurred in respect of these centres but not the revenue incurred. Such centres are, therefore, termed as expenses centres.

(b) Profit Centres: A centre whose performance is measured in terms of both—the expenses it incurs and revenue it earns—is termed as a profit centre. The output of a responsibility centre may either be meant for internal consumption or for outside customers. In the latter case, the revenue is realized when the sales are made. However, in case of internal transfers, a responsibility centre is a profit centre only when the management decides to measure its output in monetary terms. For example, in case of a process industry, the output of one process may be transferred to another process at a profit by taking into account the market price of such output. Such transfers will give that responsibility centre some profit. Of course, such internal transfers do not increase the company's assets but definitely help sometimes in the management control process.

(c) Investment Centres: Investment centre is the ultimate extension of the responsibility idea. It is a centre in which the head of the centre is held responsible for the use of the assets as well as for revenues and expenses. In other words, he is expected to earn a satisfactory return on the assets employed in his responsibility centre.

The concept of investment centre is relatively new and besieged with problems on account of disagreement regarding the computation of the figure of assets employed. Some of the assets are in the physical possession of the responsibility centres while for some assets it may depend upon other responsibility centres or the Head Office of the company. This is particularly true of cash or heavy plant and equipment. Whether such assets should be included in the figure of assets employed of the responsibility centre and if included at how much figure, is a difficult question. On account of these difficulties investment centres are generally used only for relatively large units which have independent divisions both manufacturing and marketing for their individual products.

Responsibility Centres vs Cost Centres

Responsibility centres are different from cost centres. A cost centre is 'a location, person or item of equipment (or group of these) for which costs may be ascertained and used for purposes of cost control.'

Thus, cost centre is used as a means of assembling items of cost, so that they can be assigned to goods and services. Thus, emphasis in case of cost centres is more on the jobs, products or processes whose costs are to be ascertained rather than on persons who may be managing them. On the other hand, responsibility centres are formed on the basis of responsibility delegated to responsible members of the organization with a view to identify costs which can be controlled by each one of them for facilitating working of management control process. Of course, sometimes, cost centres are also used as responsibility centres but they are merely a means to an end.

The difference between a cost centre, as used in cost accounting, and a responsibility centre, as used in responsibility accounting, will be clear with the help of the following illustration:

Illustration 14.3: A factory has two production departments X and Y and two service departments P and Q. Deptt X produces Product A while Deptt Y produces Product B. The following are the details of costs incurred during the month of February 2018:

Direct Material	*Direct Labour* ₹	*Direct Material*	*Direct Labour* ₹
Deptt *X*	14,000	Deptt *X*	8,000
Deptt *Y*	6,000	Deptt *Y*	6,000
Lubricants and Supplies:		*Supervisory Labour:*	
Deptt *X*	500	Deptt *X*	1,300
Deptt *Y*	400	Deptt *Y*	1,700
Deptt *P*	300	Deptt *P*	3,000
Deptt *Q*	200	Deptt *Q*	4,000

The output of Product A is 2,000 units while that of Product B is 1,000 units. Lubricants and supplies of Service Deptts are charged to Production Deptts as a percentage of direct materials while supervisory labour is charged as a percentage to direct labour.

You are required to calculate:

(i) Total costs taking Products A and B as separate cost centres.

(ii) Responsibility costs taking each department as a responsibility centre.

Solution:

(i) Statement of Total Costs

Particulars	*Product A (output 2,000 units)*		*Products B (output 1,000 units)*	
	Total	*Per Unit*	*Total*	*Per Unit*
Direct Material	14,000	7.000	6,000	6.00
Direct Labour	8,000	4.000	6,000	6.00
Lubricants and Supplies	850	.425	550	.55
Supervisory Labour	5,300	2.650	4,700	4.70
	28,150	14.075	17,250	17.25

Working Notes:

1. Lubricants and Supplies:	₹
Direct Material used in Deptts X and Y	20,000
Lubricants and Supplies used in Service Deptts	500

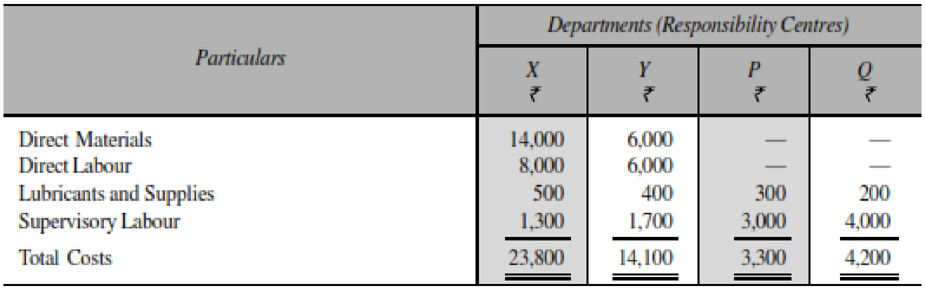
Percentage of Lubricants and Supplies to Direct Material:

Lubricants and Supplies for Product A		
Direct		500
From Service Deptt	14,000 × 2.5/100	350
		850
Lubricants and Supplies for Product B		
Direct		400
From Service Deptt	6,000 × 2.5/100	150
		550

2. Supervisory Labour

		₹
Direct Labour in Deptts X and Y		14,000
Supervisory Labour in Service Deptts		7,000
Percentage of Supervisory Labour to Direct Labour Costs		50%
Supervisory Labour for Product A		
Direct		1,300
From Service Deptt	6,000 × 50/100	4,000
		5,300
Supervisory Labour for Product B		
Direct		1,700
From Service Deptt	6,000 × 50/100	3,000
		4,700

(ii) Statement of Responsibility Costs



Particulars	*Departments (Responsibility Centres)*			
	X ₹	*Y* ₹	*P* ₹	*Q* ₹
Direct Materials	14,000	6,000	—	—
Direct Labour	8,000	6,000	—	—
Lubricants and Supplies	500	400	300	200
Supervisory Labour	1,300	1,700	3,000	4,000
Total Costs	23,800	14,100	3,300	4,200

Part (i) of the solution shows total cost of each product. However, from the statement prepared, it is impossible to find out for which costs which departmental manager is responsible. This is particularly true of service departments' costs which have been charged to products by means of overhead rates. On the other hand, Part (ii) of the solution showing responsibility costs, does identify the amount of costs that each of the four departmental managers is responsible for. Of course, this part does not give information about the total cost of each of the products, though the total cost is the same as in case of Part (i). For management control purposes information about both the aspects is necessary. This is the reason for both cost accounting and

NOTES

responsibility accounting being described as not only closely related but also two parts of the management accounting system.

In the above illustration, only actual figures have been given in respect of each responsibility centre. However, in actual practice each manager is supplied continuously with budgeted figures together with the variances of the actuals from the budgeted not only for the month or the period but up to date. For example, if Deptt X is supplied with this information, the costs statement under responsibility accounting will appear as:

Costs of Deptt X for February

Particulars	Actual Costs		(Over) or Under Budget	
	This Month ₹	Year to data ₹	This Month ₹	Year to data ₹
Direct Materials	14,000	21,000	—	—
Direct Labour	8,000	15,000	(1,000)	(1,500)
Lubricants and Supplies	500	1,000	100	200
Supervisory Labour	1,300	2,600	—	—
Total	23,800	39,600	(900)	(1,300)

* All figures are imaginary.

The above statement shows that department X has spent to date ₹ 1,300 more than what was budgeted. Since these costs are controllable at the level of the manager of department X, he will have to account for this over-spending.

Check Your Progress

6. State the essence of a responsibility centre.
7. What is investment centre?

14.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The approach of replacement cost approach is similar to the historical cost approach except that it allows for changes in the cost for acquiring, training and developing the employees in place of taking their historical cost for capitalisation.
2. The total cost concept seems to be sound theoretically. However, its practical application may be difficult since it will involve a number of abstract factors, which may not be capable of being expressed in monetary terms precisely and objectively.

NOTES

3. The government revenues can be classified into two categories: (i) tax revenues and (ii) non-tax revenues.
4. In case of government accounting, no Profit and Loss Account or Balance Sheet is prepared. However, the following two accounts or statements are prepared: Government accounts and Statement of Balancing Accounts.
5. The constitution of India provides for maintenance of the following accounts: Consolidated Fund, Public Account and Contingency Fund.
6. The essence of a responsibility centre is to communicate the right information to the right person at the right time.
7. Investment centre is the ultimate extension of the responsibility idea. It is a centre in which the head of the centre is help responsible for the use of the assets as well as for revenues and expenses.

14.5 SUMMARY

- Human resource accounting is primarily based on the concept that the traditional practice of treating all expenditure on human capital formation as an immediate charge against the revenue of the period is not consistent with the term accorded to comparable outlays in physical assets.
- There are three important aspects of human resource accounting: valuation of human resources, recording and disclosure of valuation and information in the financial statements of the business.
- There are many different approaches to valuation of human resources: historical cost, replacement cost, opportunity cost, standard cost, present value, aggregate payment and total cost.
- There are several objectives of government accounting including providing information on revenues, expenditure, loans and deposits, cash availability, etc.
- In order to facilitate control, the Constitution of India provides for maintenance of the following accounts: Consolidate fund, Public Account and Contingent Fund.
- Organizations should be classified into suitable responsibility centres so that the authority and responsibility of each individual can be very well defined.
- Responsibility accounting focusses attention on responsibility centres like expenses centres, profit centres and investment centres.

14.6 KEY WORDS

- **Human resource accounting:** It is the art of valuing, recording and presenting systematically the worth of all human resources in the books of account of an organisation.
- **Responsibility accounting:** It is a system of control by delegating and locating the responsibility for costs.
- **Responsibility centre:** It refers to the any organization unit that is headed by a responsible manager.

NOTES

14.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on the origins of the concept of human resource accounting.
2. Mention the limitations of historical cost approach of valuation of human resource accounting.
3. List the steps involved in the aggregate payment approach of valuation of human resources.
4. Briefly explain the recording and disclosure of valuation of human assets in the financial statements.
5. List the objectives of government accounting.
6. State the objectives of responsibility accounting.

Long Answer Questions

1. Explain the replacement cost approach and opportunity cost approach in human resource accounting.
2. Describe the important models of the present value of approach of valuation of human resources.
3. Discuss the importance and objections against the concept of human resource accounting.
4. Differentiate between government and commercial accounting.
5. Examine the principles of government accounting.
6. Explain the classification of expenditures under the government accounting.
7. Discuss the concept and types of responsibility centres.

14.8 FURTHER READINGS

Maheshwari, SN, Sharad K Maheshwari and Suneel K Maheshwari. 2018. *Advanced Accountancy Volume-II, 11/e*. New Delhi: Vikas Publishing House.

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