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ADVANCED FINANCIAL ACCOUNTING & REPORTING

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STUDY NOTE - 1

Introduction to IAS, USGAAP, Indian Accounting Standard

This Study Note includes:

- Framework of Accounting
- Indian Accounting Standard
- US GAAP
- International Accounting Standards
- International Financial Reporting Standards
- Comparative Analysis of the Indian Accounting Standard, IFRS and USGAAP

1.1 Framework of Accounting

1.1.1 Introduction

Most of the world's work is done through organizations-groups of people who work together to accomplish one or more objectives. In doing its work, an organization uses resources-labor, materials, various services, buildings, and equipment. These resources need to be financed, or paid for. To work effectively, the people in an organization need information about the amounts of these resources, the mean of financing them and the results achieved through using them. Parties outside the organization need similar information to make judgments about the organization. Accounting is a system that provides such information.

Organizations can be classified broadly as either for-profit or nonprofit. As these names suggest, a dominant purpose of organizations in the former category is to earn a profit, whereas organizations in the latter category have other objectives, such as governing, providing social services, and providing education. Accounting is basically similar in both types of organizations.

1.1.2 Meaning of Accounting

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

“Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof.

As per this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. This recording is done in Journal or subsidiary books, also known as primary books. Every good record keeping system includes suitable classification of transactions and events as well as their summarization for ready reference. After the transaction and events are recorded, they are transferred to secondary books. i.e. Ledger. In ledger transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarized in profit & loss account and balance sheet. Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of a country, for example, rupee in India, dollar in the U.S.A. and like. The transactions and events must have at least in par, financial characteristics. The inauguration of a new branch of a bank is an event without having financial character, while the business disposed of by the branch is an event having financial character. Accounting also interprets the recorded, classified and summarized transactions and events.

1.1.3 Objectives and Functions of Accounting

The main objectives are Systematic recording of transactions, Ascertainment of results of recorded transactions and the financial position of the business, providing information to the users for rational decision-making and to know the solvency position. The functions of accounting are Measurement, Forecasting, Decision-making, Comparison & Evaluation, Control, Government Regulation and Taxation.

Accounting concepts

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.

Accounting principles

"Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exists."

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;
2. They must be simple, understandable and explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.

Accounting conventions

Accounting conventions emerge of accounting practices, commonly known as accounting, principles, adopted by various organizations above a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

1.1.4 Fundamental Accounting Assumptions

The Financial Statements are prepared with the following three Fundamental Accounting Assumptions. Unless otherwise specified the readers of the Financial Statements assume that the Financial Statements are prepared in line with these assumptions. They are Going Concern, Consistency & Accrual. Accounting Standard 1 describes them as follows

Going Concern: The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Consistency It is assumed that accounting policies are consistent from one period to another.

Accrual Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Statement.)

1.1.5 Limitations of Accounting

The Financials Statements are prepared on the basis of the above-mentioned assumptions, conventions and the Accounting Principles which the accountant chooses to adopt. These bring in lot of subjectivity to the Financial Statements and hence these basis assumptions conventions and principles become the limitation of accounting.

The Financial Statements as the name states, accounts only for the items that can be measured by Money. There are lots of items that money cannot measure but still are the most valuable assets for the enterprise, like Human Resources, which the Financial Statements does not depict.

The language of accounting has certain practical limitations and, therefore, the financial statements should be interpreted carefully keeping in mind all various factors influencing the true picture.

1.1.6 Financial Statements

Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

Users and Their Information Needs

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their information needs. These needs include the following:

(a) *Investors*. The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

(b) *Employees*. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(c) *Lenders*. Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) *Suppliers and other trade creditors*. Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

(e) *Customers*. Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

(f) *Governments and their agencies*. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(g) *Public*. Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

The Objective of Financial Statements

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since

(a) they largely portray the financial effects of past events, and

(b) do not necessarily provide non-financial information.

1.1.7 Qualitative Characteristics of Financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The qualitative characteristics are

- Understandability
- Relevance
- Reliability
- Comparability.
- Faithful Representation
- Substance Over Form
- Neutrality
- Prudence
- Completeness

Among these characteristics most important are Prudence and Substance over form.

Prudence

The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Accounting Standards

Accounting standards codify acceptable accounting practices. They are the primary source of the Generally Accepted Accounting Principles (GAAP) and, therefore, they are at the top in the hierarchy of GAAP. Other sources of GAAP are technical pronouncements issued by various professional bodies, regulating the accounting and auditing profession, that stipulate accounting principles and methods.

Accounting standards are issued by institutions that are authorized to set accounting standards. The standard-setting body that issues accounting standards is constituted by representatives from various stake holders such as the accounting profession, the industry and regulators. The process of formulating standards is a long ‘due-diligence’ process. The process is somewhat akin to a ‘political process’ because the objective is to establish accounting standards.

(a) that are practical in the sense that those can be implemented with reasonable costs and efforts; and

(b) that are acceptable to all stake holders.

Most countries have their own accounting standard setting bodies. In USA Statements of Financial Accounting Standards (SFAS) are issued by the Financial Accounting Standards Board (FASB). In India accounting standards are issued by the Institute of Chartered Accountants of India (ICAI). With globalization of capital markets, a trend towards convergence of accounting practices in different territories emerged in 1970s. The International Account Standards Committee (IASC) was formed in 1973 to formulate International Accounting Standards (IAS). In 2001 IASC was restructured and now it is known as International Accounting Standards Board (IASB). Accounting standards issued by IASB are called International Financial Reporting Standards (IFRS). Each territory (a country or a group of countries like European Union) has initiated actions to harmonise its accounting practices with accounting principles and methods stipulated in IAS / IFRS. Many countries use IAS / IFRS without modification.

Details of Indian Accounting Standards, US GAAP and IFRS are discussed in the ensuing Sections.

l.2 Accounting Standards - Applicability, Interpretation, Scope and Compliance

Introduction

Accounting standards are written , policy documents issued by expert accounting body or by Government or other regulatory authorities covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statement.

The main purpose of formulating accounting standard is to standardize the diverse accounting policies with a view to eliminate to the extent possible the incomparability of information provided in financial statements and add reliability to such financial statements. To discuss on whether such standards are necessary in present days it will be beneficial to go through the advantages and disadvantages which they are said to provide.

ADVANTAGES:

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant's resistance against the pressure from directors to use accounting policy which may be suspect in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistent basis from period to period.
5. It helps the users compare the financial statements of two or more organisaitons engaged in same type of business operation.

DISADVANTAGES:

1. Users are likely to think that said statements prepared using accounting standard are infallible.
2. They have been derived from social pressures which may reduced freedom.
3. The working rules may be rigid or bureaucratic to some user of financial statement.
4. The more standards there are, the more costly the financial statements are to produce.

Accounting Standard No.	**Title of Accounting Standard**
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories (Revised)
AS- 3	Cash Flow Statements (Revised)
AS-4	Contingencies and Events (Occurring after the Balance Sheet Date)
AS-5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)
AS-6	Depreciation Accounting
AS-7	Construction Contracts (Revised)
AS- 8	Accounting for Research and Development (stands withdrawn after introduction of AS-26)

AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets.
AS-11	The Effect of Changes in Foreign Exchange Rates (Revised)
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Employee Benefits (Revised)
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related Party Disclosures
AS-19	Leases
AS-20	Earnings Per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of Interests in Joint Venture
AS-28	Impairment of Assets
AS-29	Provisions, Contingent Liabilities and Contingent Assets
AS-30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

Applicability of Accounting Standards:

A three tier classification has been framed to ensure compliance of accounting standards for reporting enterprises.

Level I Enterprises:

- Enterprises whose equity or debt securities are listed whether in India or outside India.
- Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board resolution in this regard.
- Banks including co-operative banks
- Financial institutions
- Enterprises carrying insurance business
- Enterprises whose turnover exceeds Rs.50 crores
- Enterprises having borrowings in excess of Rs.10 crores at any time during the accounting period.

- Holding companies and subsidiaries of enterprises falling under any one of the categories mentioned above.

Level II Enterprises:

- Enterprises whose turnover exceeds Rs.40 lakhs but does not exceed Rs.50 crores.
- Enterprises having borrowings in excess of Rs.1 crore but not in excess of Rs.10 crores at any time during the accounting period.
- Holding companies and subsidiaries of enterprise falling under any one of the categories mentioned above.

Level III Enterprises:

- Enterprises which are not covered under Level I and Level II.

Accounting Standard	Applicability (Based on the three tier classification)
AS1,2,4-16,22,26,28	All Enterprises
AS 3,17,18,24,	Not applicable to Level II and Level III enterprises in their entirety.
AS 19,20,29	All enterprises but relaxation given to Level I and Level II enter prises for certain disclosure requirements.
AS 21,23,27	Not applicable to Level II and Level III enterprises
AS 25	Not mandatorily applicable to Level II and Level III enterprises
AS 30,31,32	W.e.f. accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years.

It will be mandatory for on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity.

1.3 US GAAPS

GAAP refers to accounting policies and procedures that are widely used in practice. Unlike India where accounting has its basis in law , US GAAP has evolved to be a collection of pronouncements issued by a particular accounting organization. US GAAP are the accounting rules used to prepare financial statements for publicly traded companies and many private companies in United States. Generally accepted accounting principles for local and state governments operates under different set of assumptions, principles, and constraints, as determined by the Governmental Accounting Standards Board. (GASB).

In the United States, as well as in other countries practicing under the English common law system, the government does not set accounting standards, in the belief that the private sector has the better knowledge and resources. The Securities and Exchange Commission (SEC) has the ultimate authority to set US accounting and financial reporting standards for public (listed) companies. The SEC has delegated this responsibility to the private sector led by the Financial Accounting Standards Board (FASB). Other private sector bodies including the American Institute of Certified Public Accountants (AICPA) and the FASB's Emerging Issues Task Force(EITF) also establish authoritative accounting Standard Board(FIN) also provide implementation and interpretation guidance. The SEC has the Statutory authority to establish GAAP for filings made with it. While allowing most of the Standard settings to be done in the private sector, the SEC is still very active in both its oversight responsibility as well as establishing guidance and interpretations, as it believes appropriate. US GAAP have the reputation around the world of being more perspective and detailed than accounting standards in other countries. In order to organize and make clear what is meant by US GAAP, a GAAP hierarchy has been established which contains four categories of accounting principles. The sources in the higher category carry more weight and must be followed when conflicts arise. The table given below summaries the current GAAP hierarchy for financial statements of non-governmental entities.

1.3.1 Established Accounting Principles in the US

Category(a)

Financials Accounting Standards Board(FASB) statements and Interpretations, American Institute of Certified Public Accountants (AICPA), Accounting Principles Board (APB) Opinions , and AICPA Accounting Research Bulletins(ARB).

Category(b)

FASB Technical Bulletins, cleared AICPA Industry Audit and Accounting Guides, and cleared AICPA Statement of Position (SOPs).

Category(c)

Consensus positions of the FASB Emerging Issues Task Force (EITF) and cleared Accounting Standards Executive Committee of AICPA(ACSEC)Practice Bulletins.

Category(d)

AICPA Accounting Interpretations, FASB Implementation Guides (QSAs), and widely recognized and prevalent Industry practices.

1.3.2 Other Accounting literature

Other accounting literature, including FASB concepts statements, APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; Pronouncements of other professional associations or regulatory agencies ; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles.

The US GAAP provisions differ somewhat from International Financial Reporting Standards though efforts are underway to reconcile the differences so that reports created under international standards will be acceptable to the SEC for companies listed on US markets.

1.3.3 AICPA

The AICPA sets generally accepted professional and technical standards for CPAs in many areas. Until the 1970's, the AICPA held a monopoly in this field. In the 1970's however, it transferred its responsibility for setting generally accepted accounting principles (GAAP) to the newly formed Financial Accounting Standards Board (FASB). Following this, it retained its standards setting function in areas such as financial statement auditing, professional ethics, attest services, CPA firm quality control , CPA tax practice and financial planning practice. Before passage of the Sarbanes-Oxley law, AICPA standards in these areas were considered "generally accepted" for all CPA practitioners.

Accounting Principles Board(APB) Opinions were published by Accounting Principles Board(APB). APB was the main organization setting the US GAAP and its opinions are still an important part of it.

1.3.4 FASB

The Financial Accounting Standards Boards(FASB) is private, not-for- profit organization whose primary purpose is to develop generally accepted accounting principles in the United States (US GAAP). The FASB's mission for the private sector is similar to that of the Governmental Accounting Standards Board for local and state governments in the United States. The FASB was created in1973, replacing the Accounting Principles Board of the American Institute of Certified Public Accountants (AICPA). The FASB.s mission is 'to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."

The U.S. Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under Securities Exchange Act of 1934. The SEC designated the FASB as the organization responsible for setting accounting standards for public companies in the U.S.

FASB has so far issued 158 Statements of Financial Accounting Standards (FAS).

1.3.5 Components of US GAAP

Given below are important components of US GAAP:

- FASB Statement of Financial Accounting Standards (FAS).
- FASB Interpretations(FIN).

- FASB Statements of Financial Accounting Concepts(FAS Conc.)
- FASB Technical Bulletins(FTB).
- AICPA Accounting Research Bulletins(ARB).
- AICPA Accounting Principles Board Opinions(APB Opinions)
- AICPA Accounting Interpretations(AIN)

Not only there are an extremely large number of different standards under US GAAP, the volume and complexity is also increasing. This complexity of US GAAP makes it critically important that the independent accountants that are assisting a company in filing with SEC are acknowledgeable and experts in US GAAP.

1.4 International Accounting Standards

1.4.1 Introduction

The International Accounting Standard Board (IASB) was formulated and began in operations in 2001. The objective of IASB is as follows

"Committed to developing, in public interest, asingle set of high quality, global accouting standards that require transparent and comparable information in general purpose financial statements"

The IASB is selected, overseen and funded by the International Accounting Standards Committee (IASC) Foundation, consisting of 22 trustees. The responsibility of the trustees, besides others include,

- Appointment of members of the IASB and Standards Advisory Council and the IFRIC
- Monitoring the IASB's effectiveness and adherence to its due process and consultation procedures
- Establishing and maintaining appropriate financing arrangement
- Approve of the budget for the IASC Foundation and
- Responsibility for constitution changes.

1.4.2 Extract of the International Accounting Standards

The following are the Extract of the International Accounting Standards and International Financial Reporting Standards, prepared by IASC Foundation staff (The same has not been approved by the IASB. For the requirements reference must be made to International Financial Reporting Standards.)

International Accounting Standard 1

Presentation of Financial Statements

Objective

This Standard prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of Previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

Scope

An entity shall apply this Standard in preparing and presenting general purpose financial statements in accordance with International Financial Reporting Standards (IFRSs).

International Accounting Standard 2

Inventories

International Accounting Standard 2 *Inventories* (IAS 2) replaces IAS 2 *Inventories* (revised in 1993) and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. The Standard also supersedes SIC-1 *Consistency—Different Cost Formulas for Inventories.*

Reasons for revising IAS 2

The International Accounting Standards Board developed this revised IAS 2 as part of its project on Improvements to International Accounting Standards. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the project were to reduce or eliminate alternatives, redundancies and conflicts within the Standards, to deal with some convergence issues and to make other improvements. For IAS 2 the Board's main objective was a limited revision to reduce alternatives for the measurement of inventories. The Board did not reconsider the fundamental approach to accounting for inventories contained in IAS 2.

Objective and scope

The objective and scope paragraphs of IAS 2 were amended by removing the words 'held under the historical cost system', to clarify that the Standard applies to all inventories that are not specifically excluded from its scope.

Scope clarification

IN6 The Standard clarifies that some types of inventories are outside its scope while certain other types of inventories are exempted only from the measurement requirements in the Standard. Paragraph 3 establishes a clear distinction between those inventories that are entirely outside the scope of the Standard (described in paragraph 2) and those inventories that are outside the scope of the measurement requirements but within the scope of the other requirements in the Standard.

International Accounting Standard 7

Cash Flows Statements

Objective

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities.

Scope

An entity shall prepare a statement of cash flows in accordance with the requirements of this Standard and shall present it as an integral part of its financial statements for each period for which financial statements are presented.

This Standard supersedes IAS 7 Statement of Changes in Financial Position, approved in July 1977.

Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents. This is the case regardless of the nature of the entity's activities and irrespective of whether cash can be viewed as the product of the entity, as may be the case with a financial institution. Entities need cash for essentially the same reasons however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors. Accordingly, this Standard requires all entities to present a statement of cash flows.

International Accounting Standard 8

Accounting Policies, Changes in Accounting Estimates and Errors

Objective

The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. The Standard is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

Disclosure requirements for accounting policies, except those for changes in accounting policies, are set out in IAS 1 *Presentation of Financial Statements.*

Scope

This Standard shall be applied in selecting and applying accounting policies, and accounting for changes in accounting policies, changes in accounting estimates and corrections of prior period errors.

The tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies are accounted for and disclosed in accordance with IAS 12 *Income Taxes.*

International Accounting Standard 10

Events after the Balance Sheet Date

Objective

The objective of this Standard is to prescribe:

(a) when an entity should adjust its financial statements for events after the reporting period; and

(b) the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.

The Standard also requires that an entity should not prepare its financial statements on a going concern basis if events after the reporting period indicate that the going concern assumption is not appropriate.

Scope

This Standard shall be applied in the accounting for, and disclosure of, events after the reporting period.

International Accounting Standard 11

Construction Contracts

Objective

Accounting for construction contracts involves measurement and recognition of costs and revenue in the books of "Contractor". Objective of this standard is the allocation of contract revenue and contract costs to the period in which the work is performed.

Scope

This Standard shall be applied in accounting for construction contracts in the financial statements of contractors.

Definitions

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

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

International Accounting Standard 12

Income Taxes

Objective

The objective of this Standard is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

(a) The future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's statement of financial position; and

(b) Transactions and other events of the current period that are recognized in an entity's financial statements.

It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognize a deferred tax liability (deferred tax asset), with certain limited exceptions.

Scope

This Standard shall be applied in accounting for income taxes.

International Accounting Standard 16

Property, Plant and Equipment

Objective

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such Investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Scope

This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.

International Accounting Standard 17

Leases

Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to leases.

Scope

This Standard shall be applied in accounting for all leases other than:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; and

(b) licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

However, this Standard shall not be applied as the basis of measurement for:

(a) property held by lessees that is accounted for as investment property (see IAS 40 Investment Property);

(b) investment property provided by lessors under operating leases (see IAS 40);

(c) biological assets held by lessees under finance leases (see IAS 41 Agriculture);

or

(d) biological assets provided by lessors under operating leases (see IAS 41).

International Accounting Standard 18

Revenue

Objective

Income is defined in the Framework for the Preparation and Presentation of Financial Statements as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Income encompasses both revenue and gains. Revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties.

The objective of this Standard is to prescribe the accounting treatment of revenue arising from certain types of transactions and events.

The primary issue in accounting for revenue is determining when to recognize revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Scope

This Standard shall be applied in accounting for revenue arising from the

following transactions and events:

(a) the sale of goods;

(b) the rendering of services; and

(c) the use by others of entity assets yielding interest, royalties and dividends.

International Accounting Standard 19

Employee Benefits

Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an entity to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Scope

This Standard shall be applied by an employer in accounting for all employee benefits, except those to which IFRS 2 Share-based Payment applies.

International Accounting Standard 20

Accounting for Government Grants and Disclosure of Government Assistance

Scope

This Standard shall be applied in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance.

This Standard does not deal with:

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

(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable income or are determined or limited on the basis of income tax liability (such as income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates);

(c) government participation in the ownership of the entity;

(d) government grants covered by IAS 41 *Agriculture.*

International Accounting Standard 21

The Effects of Changes in Foreign Exchange Rates

International Accounting Standard 21 The Effects of Changes in Foreign Exchange Rates (IAS 21) replaces IAS 21 The Effects of Changes in Foreign Exchange Rates (revised in 1993), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. The Standard also replaces the following

Interpretations:

- SIC-11 *Foreign Exchange—Capitalisation of Losses Resulting from Severe Currency Devaluations*
- SIC-19 *Reporting Currency—Measurement and Presentation of Financial Statements under IAS 21 and IAS 29*
- SIC-30 *Reporting Currency—Translation from Measurement Currency to Presentation Currency*.

Scope

IN5 The Standard excludes from its scope foreign currency derivatives that are within the scope of IAS 39 *Financial Instruments*: Recognition and Measurement. Similarly, the material on hedge accounting has been moved to IAS 39.

International Accounting Standard 23

Borrowing Costs

Objective

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

Scope

An entity shall apply this Standard in accounting for borrowing costs.

The Standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

(a) a qualifying asset measured at fair value, for example a biological asset; or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

This Standard uses the following terms with the meanings specified:

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

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

Borrowing costs may include:

(a) interest on bank overdrafts and short-term and long-term borrowings;

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

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of finance leases recognised in accordance with IAS 17 *Leases*; and

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

International Accounting Standards 24

Related Party Disclosures

Objective

The objective of this Standard is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.

Scope

This Standard shall be applied in:

(a) identifying related party relationships and transactions;

(b) identifying outstanding balances between an entity and its related parties;

(c) identifying the circumstances in which disclosure of the items in (a) and (b) is required; and

(d) determining the disclosures to be made about those items.

This Standard requires disclosure of related party transactions and outstanding balances in the separate financial statements of a parent, venturer or investor presented in accordance with IAS 27 Consolidated and Separate Financial Statements.

Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's financial statements. Intragroup related party transactions and outstanding balances are eliminated in the preparation of consolidated financial statements of the group.

International Accounting Standard 26

Accounting and Reporting by Retirement Benefit Plans

Scope

This Standard shall be applied in the financial statements of retirement benefit plans where such financial statements are prepared.

Definitions

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

Retirement benefit plans are arrangements whereby an entity provides benefits for employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Funding is the transfer of assets to an entity (the fund) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

For the purposes of this Standard the following terms are also used:

Participants are the members of a retirement benefit plan and others who are entitled to benefits under the plan.

Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

Actuarial present value of promised retirement benefits is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

Vested benefits are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

International Accounting Standard 27

Consolidated and Separate Financial Statement

Objective

The objective of IAS 27 is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control. The Standard specifies:

(a) the circumstances in which an entity must consolidate the financial statements of another entity (being a subsidiary);

(b) the accounting for changes in the level of ownership interest in a subsidiary;

(c) the accounting for the loss of control of a subsidiary; and

(d) the information that an entity must disclose to enable users of the financial statements to evaluate the nature of the relationship between the entity and its subsidiaries.

International Accounting Standard 28

Investment in Associates

Introduction

International Accounting Standard 28 *Investments in Associates* replaces IAS 28 *Accounting for Investments in Associates* (revised in 2000) and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. The Standard also replaces the following Interpretations:

- SIC-3 *Elimination of Unrealized Profits and Losses on Transactions with Associates*
- SIC-20 *Equity Accounting Method—Recognition of Losses*
- SIC-33 *Consolidation and Equity Method—Potential Voting Rights and Allocation of Ownership Interests*.

Scope

The Standard does not apply to investments that would otherwise be associates or interests of ventures in jointly controlled entities held by venture capital organizations, mutual funds, unit trusts and similar entities when those investments are classified as held for trading and accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Those investments are measured at fair value, with changes in fair value recognized in profit or loss in the period in which they occur.

Furthermore, the Standard provides exemptions from application of the equity method similar to those provided for certain parents not to prepare consolidated financial statements. These exemptions include when the investor is also a parent exempt in accordance with IAS 27 *Consolidated and Separate Financial Statements* from preparing consolidated financial statements (paragraph 13(b)), and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents (paragraph 13(c)).

International Accounting Standard 29

Financial Reporting in Hyperinflationary Economies

This Standard shall be applied to the financial statements, including the consolidated financial statements, of any entity whose functional currency is the currency of a hyperinflationary economy.

International Accounting Standard 31

Interests in Joint Ventures

Introduction

IN1 International Accounting Standard 31 *Interests in Joint Ventures* (IAS 31) replaces IAS 31 *Financial Reporting of Interests in Joint Ventures* (revised in 2000), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Scope

The Standard does not apply to investments that would otherwise be interests of venturers in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities when those investments are classified as held for trading and accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Those investments are measured at fair value, with changes in fair value being recognised in profit or loss in the period in which they occur. Furthermore, the Standard provides exemptions from application of

proportionate consolidation or the equity method similar to those provided for certain parents not to prepare consolidated financial statements. These exemptions include when the investor is also a parent exempt in accordance with IAS 27 *Consolidated and Separate Financial Statements* from preparing consolidated financial statements [paragraph 2(b)], and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents [paragraph 2(c)].

International Accounting Standard 32

Financial Instruments: Presentation

Objective

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement*, and for disclosing information about them in IFRS 7 *Financial Instruments: Disclosures*.

Scope

This Standard shall be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*. However, in some cases, IAS 27, IAS 28 or IAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using IAS 39; in those cases, entities shall apply the disclosure requirements in IAS 27, IAS 28 or IAS 31 in addition to those in this Standard. Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

(b) employers' rights and obligations under employee benefit plans, to which IAS 19 *Employee Benefits* applies.

(c) [deleted]

(d) insurance contracts as defined in IFRS 4 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies IAS 39 in recognising and measuring the contracts, but shall apply IFRS 4 if the issuer elects, in accordance with paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring them.

(e) financial instruments that are within the scope of IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IAS 39).

(f) financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 *Share-based Payment* applies, except for

  (i) contracts within the scope of paragraphs 8–10 of this Standard, to which this Standard applies,

  (ii) paragraphs 33 and 34 of this Standard, which shall be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans,

and all other share-based payment arrangements.

This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's **expected purchase, sale or usage requirements**.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash. A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and accordingly, is within the scope of this Standard.

International Accounting Standard 33

Earnings per Share

Objective

The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Even though earnings per share data have limitations because of the different accounting policies that may be used for determining 'earnings', a consistently determined denominator enhances financial reporting. The focus of this Standard is on the denominator of the earnings per share calculation.

Scope

This Standard shall apply to

(a) the separate or individual financial statements of an entity:

   (i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

   (ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market; and

(b) the consolidated financial statements of a group with a parent:

   (i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

   (ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market.

An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with IAS 27 *Consolidated and Separate Financial Statements*, the disclosures required by this Standard need be presented only on the basis of the consolidated information. An entity that chooses to disclose earnings per share based on its separate financial statements shall present such earnings per share information only in its statement of comprehensive income. An entity shall not present such earnings per share information in the consolidated financial statements.

If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of IAS 1 *Presentation of Financial Statements* (as revised in 2007), it presents earnings per share only in that separate statement.

International Accounting Standard 34

Interim Financial Reporting

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

Scope

This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period. However, governments, securities regulators, stock exchanges, and accountancy bodies often require entities whose debt or equity securities are publicly traded to publish interim financial reports. This Standard applies if an entity is required or elects to publish an interim financial report in accordance with International Financial Reporting Standards. The International Accounting Standards Committee* encourages publicly traded entities to provide interim financial reports that conform to the recognition, measurement, and disclosure principles set out in this Standard. Specifically, publicly traded entities are encouraged:

(a) to provide interim financial reports at least as of the end of the first half of their financial year; and

(b) to make their interim financial reports available not later than 60 days after the end of the interim period.

Each financial report, annual or interim, is evaluated on its own for conformity to International Financial Reporting Standards. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with this Standard does not prevent the entity's annual financial statements from conforming to International Financial Reporting Standards if they otherwise do so.

If an entity's interim financial report is described as complying with International Financial Reporting Standards, it must comply with all of the requirements of this Standard. Paragraph 19 requires certain disclosures in that regard.

International Accounting Standard 36

Impairment of Assets

Introduction

International Accounting Standard 36 *Impairment of Assets* (IAS 36) replaces IAS 36 Impairment of Assets (issued in 1998), and should be applied:

(a) on acquisition to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004.

(b) to all other assets, for annual periods beginning on or after 31 March 2004. Earlier application is encouraged.

Objective

The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Scope

This Standard shall be applied in accounting for the impairment of all assets,

other than:

(a) inventories (see IAS 2 Inventories);

(b) assets arising from construction contracts (see IAS 11 Construction Contracts);

(c) deferred tax assets (see IAS 12 Income Taxes);

(d) assets arising from employee benefits (see IAS 19 Employee Benefits);

(e) financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement;

(f) investment property that is measured at fair value (see IAS 40 Investment Property);

(g) biological assets related to agricultural activity that are measured at fair value less estimated point-of-sale costs (see IAS 41 Agriculture);

(h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of IFRS 4 Insurance Contracts; and

(i) non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

International Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

Scope

This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous; and

(b) [deleted]

(c) those covered by another Standard.

International Accounting Standard 38
Intangible Assets

Objective

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Scope

This Standard shall be applied in accounting for intangible assets, except:

(a) intangible assets that are within the scope of another Standard;

(b) financial assets, as defined in IAS 32 *Financial Instruments: Presentation*;

(c) the recognition and measurement of exploration and evaluation assets (see IFRS 6 *Exploration for and Evaluation of Mineral Resources*); and

(d) expenditure on the development and extraction of, minerals, oil, natural gas and similar non-regenerative resources.

International Accounting Standard 39
Financial Instruments: Recognition and Measurement

Objective

The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in IAS 32 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in IFRS 7 *Financial Instruments: Disclosures*.

Scope

This Standard shall be applied by all entities to all types of financial instruments

International Accounting Standard 40
Investment Property

Objective

The objective of this Standard is to prescribe the accounting treatment for investment property and related disclosure requirements.

Scope

This Standard shall be applied in the recognition, measurement and disclosure of investment property.

International Accounting Standard 41

Agriculture

Objective

The objective of this Standard is to prescribe the accounting treatment and disclosures related to agricultural activity.

Scope

This Standard shall be applied to account for the following when they relate to agricultural activity:

(a) biological assets;

(b) agricultural produce at the point of harvest; and

(c) government grants covered by paragraphs 34–35.

1.5 International Financial Reporting Standards

IFRS 1: FIRST TIME ADOPTION OF IFRS

- IFRS-1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. In particular, the IFRS requires an entity to do the following in the opening IFRS balance sheet that it prepares as a starting point for its accounting under IFRSs:
- Recognise all assets and liabilities whose recognition is required by IFRSs;
- Do not recognise items as assets or liabilities if IFRSs do not permit such recognition;
- Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, which are different type of asset, liability or component of equity under IFRSs; and
- Apply IFRSs in measuring all recognised assets and liabilities.

Who is first time adopter?

- An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement in those financial statements of compliance with IFRSs.

Opening IFRS Balance Sheet & Comparative Balance Sheet

- An entity has to prepare an opening IFRS Balance Sheet at the date of transition to IFRSs.
- This should be the starting point for its accounting under IFRSs.
- It is not required to present that opening balance sheet in its first IFRS based financial statements.
- However, to comply with IAS -1 "Presentation of Financial Statements" , an entity's IFRS based financial statements should include at least one year of comparative information under IASB GAAP [Para 36 , IFRS-1].

Example:

Company B proposes to prepare and present IFRS for the calendar year 2011, i.e. Balance Sheet Date 31.12.2011. How should the company carry out transition?

Steps to be taken

- Prepare opening IFRS Balance Sheet as on 1.1.2011 – this is termed as transition date; the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.
- The company has to present comparative information for one year, such comparatives should be as per IASB GAAP – so it has to restate the accounts of 2010 as per IFRS.
- Prepare and present first IFRS based Financial Statements for 2011 ; it is the first annual financial statements in which an entity adopts IFRSs by an explicit and unreserved statement.
- Then effectively the company has apply IFRS on and from 1.1.2010.
- Accounting policies: Select its accounting policies based on IFRSs in force at 31st Dec, 2011.

Paras 7-9 of IFRS- 1 requires adoption of current version of IFRSs which would enhance comparability because information in a first time adopter's first financial statements is prepared on a consistent basis over time and would provide comparative information prepared using latest version of the IFRSs.

Moreover, the entity will get exemptions from applying certain standards as given in Paras 13-34B , 36-36C and 37 of IFRS-1.

Actions at a Glance

- Recognise all assets and liabilities whose recognition is required by IFRSs
- Do not recognise items as assets or liabilities which IFRSs do not permit
- Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs
- Carry out measurement of all assets and liabilities so recognized / re-classified in accordance with IFRSs
- Change in accounting policies
- Applying exemptions: The first time adopter may elect for exemptions granted in Paragraphs 13-25H and 36A-36C of IFRS-1.

Prohibition of retrospective application of some aspects of other IFRSs

The first time adopter should follow the prohibition of applying retrospective application relating to:

i. Derecognizing of financial assets and financial liabilities ,

ii. Hedge accounting ,

iii. Estimates, and

iv. Assets classified as held for sale and discontinued operations. [Paragraphs 26-34B of IFRS-1]

IFRS-2 SHARE BASED PAYMENTS

- IFRS-2 Share Based Payment was issued by the International Accounting Standards Board in February 2004. The Standard has been effective since 2005.
- IFRS 2 requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity.

Types of Share Based Transactions

These are of three types –

1. Equity-settled transactions for goods or services acquired by an entity

2 Cash settled but price or value of the goods or services is based on equity instruments of the entity and.

3. Transactions for goods or services acquired by the entity in which either the entity can settle or supplier can claim settlement by equity instruments of the entity.

Recognition of Share Based Payment

The following are recognition criteria under Paras 7-9 of IFRS-2 :

(i) The goods or services received or acquired in a share-based payment transaction are recognised when the goods are obtained or as the services are received. The entity shall recognise a corresponding increase in equity is recognised if the goods or services were received in an equity-settled transaction.

(ii) The goods or services received or acquired in a share-based payment transaction are recognised when the goods are obtained or as the services are received. The entity shall recognise a corresponding increase in liability if the goods or services were acquired in a cash-settled transaction. For example, in case of employee stock option, it is difficult to assess the fair value of the service rendered, and therefore, the transaction should be measured at fair value of the equity.

(iii) The goods or services received in a share-based payment transaction may qualify for recognition as an asset. If they are not so qualified then they are recognised as expense.

For example, inventories (which forms part of operating activities acquired through a share based payment, the entity should pass the following journal entries :

Purchases A/c Dr.

To Equity Share Capital A/c (face value component)

To Securities Premium A/c (premium component)

Timing of Recognition

- The term 'service acquired or received has' has wider connotation in the context of 'vesting period' and 'vesting condition'. If employees are granted share options conditional upon the achievement of a performance condition as well as length of service , the length of the vesting period would vary depending on when that performance condition is satisfied and it would available only to the eligible category of employees .

Example

- An entity plans to grant 100 equity shares per employee of Class-I , 50 equity shares of per employee of Class –II and 30 equity shares per employee of Class –III if PAT of company exceeds $ 1000 million on a cumulative basis.
- This benefit will be available only such employees who will continue till the end of the financial year in which the target performance achieved.
- The entity would estimate the length the vesting period in terms of estimated time required to achieve the performance, say 3 years , and percentage of employees under different class who will continue till the end 3rd financial year from the grant date.

Assume the following % of employees will continue:

Class –I : 90% of 100 employees,

Class –II : 80% of 200 employees and

Class –III : 70% of 800 employees.

The fair value per equity share as on the grant date is RO. 100.

Then initial value of the share based payment works out to be –

RO. 33,80,000 [100 shares × 90% × 100 employees + 50 shares × 80% × 200 employees + 30 shares × 70% × 800 employees] × RO.100.

This will be allocated over three years which is the expected vesting period.

- In transaction of equity settled share based payment, if the counterparty is not required to complete a specified period of service to be eligible to unconditionally entitled to the grant then it is presumed that the required service has been completed. So the transaction should be recognised in full on the grant date [Para 14, IFRS-2].
- There are generally situations in employee stock option that the eligible employees should complete specified service period.
- In such a case the transaction should be recognised over the vesting period. If the employee is granted share options conditional upon performance condition (other than market condition), then the options vest during the expected fulfilment period .
- Market conditions are adjusted in the fair value of option. [Para 15, IFRS-2].

IFRS 3: BUSINESS COMBINATIONS

- A **Business** is integrated set of activities, and assets conducted and managed for the purpose of providing (a) a return to investors and (b) lower costs or other economic benefits to policyholders or participants. It is generally consists of inputs, processes, and resulting outputs that are or will be used to generate revenue. A business can be part of a whole entity / company. But a standalone asset may or not be a business. Paragraphs B 7-B12 of IFRS 3 explain various identification criteria of business.
- A **Business Combination** is an act of bringing together of separate entities or businesses into one reporting unit. The result of business combination is one entity (the acquirer) obtains control of one or more businesses. If an entity obtains control over other entities which are not businesses, the act is not a business combination.

Recognition of assets and liabilities

"As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree" [Para 10, IFRS 3].

Check List

- Identify assets and liabilities within the Framework for Preparation and Presentation Financial Statements and;
- Check the liabilities which do not arise out of business combination ;
- Recognise assets (like identifiable intangibles) which were not recognised by the acquiree since these were internally generated intangibles ;
- Do not recognise any liability which constitute remunerations to the past owners of the acquiree or its employees for future services or which constitute reimbursement of the acquirer's acquisition costs;

- Identification of assets or liabilities which are assumed because of pre-existing relationship – the acquirer takes over the sundry debtors of the acquiree which was due by the acquirer for goods purchased or services received. The acquirer takes over all assets and liabilities of the acquiree excluding cash. This example, debtors of the acquiree should excluded from the list of assets acquired as it was a pre-existing relationship.
- Consider exception of recognition principle for contingent liabilities stated in Paras 22& 23 , IFRS 3;
- Effect of deferred tax [Paras 24-25, IFRS 3] ;
- Employee benefits [Para 26, IFRS 3];
- Indemnification assets [Paras 27-28, IFRS 3];
- Operating lease [Paras B28-30 , Appendix B, IFRS 3];
- Reaquired Rights [Paras B35-36 , Appendix B, IFRS 3];
- Share based awards [Para 30, IFRS 3]
- Assets held for sale [Para 31, IFRS 3]

IFRS 4: INSURANCE CONTRACTS

Objective

The objective of this IFRS is to specify the financial reporting for insurance contracts by any entity that issues such contracts (described in this IFRS as an insurer) until the Board completes the second phase of its project on insurance contracts.

In particular, this IFRS requires:

(a) limited improvements to accounting by insurers for insurance contracts.

(b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Scope

An entity shall apply this IFRS to:

(a) Insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

(b) Financial instruments that it issues with a discretionary participation feature (see paragraph 35). IFRS 7 Financial Instruments: Disclosures requires disclosure about financial instruments, including financial instruments that contain such features.

This IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 Financial Instruments: Presentation, IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7), except in the transitional provisions in paragraph 45.

An entity shall not apply this IFRS to:

(a) product warranties issued directly by a manufacturer, dealer or retailer (see IAS 18 Revenue and IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

(b) employers' assets and liabilities under employee benefit plans (see IAS 19 Employee Benefits and IFRS 2 Share-based Payment) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 26 Accounting and Reporting by Retirement Benefit Plans).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 Leases, IAS 18 Revenue and IAS 38 Intangible Assets).

(d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either IAS 39, IAS 32 and IFRS 7 or this Standard to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(e) Contingent consideration payable or receivable in a business combination (see IFRS 3 Business Combinations).

(f) Direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder). However, a cedant shall apply this IFRS to reinsurance contracts that it holds.

For ease of reference, this IFRS describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

IFRS 5: NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS

Objective

The objective of this IFRS is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, the IFRS requires:

(a) Assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and fair value less costs to sell, and depreciation on such assets to cease; and

(b) Assets that meet the criteria to be classified as held for sale to be presented separately in the statement of financial position and the results of discontinued operations to be presented separately in the statement of comprehensive income.

Disposal group

- It is a group of assets (and directly associated liabilities) which are to be disposed of through a single transaction.
- The group includes goodwill acquired in business combination if the group is a cash generating unit to which goodwill has been allocated in accordance with the requirements of Paras 80-87 of IAS-36

Impairment of Assets.

- A cash generating unit is the smallest identifiable group of assets that generates cash inflow and that such cash inflow is largely independent of other assets or group assets of the entity.

Discontinued Operations

A component of entity which is either disposed of or classified as held for sale ; and

- represents a major separate line of business or geographical area of operations or
- is part of single co-ordinated plan to dispose of a major separate line of business or geographical area of operations, or
- is a subsidiary acquired exclusively with a view to resale.

Classification criteria

- management is committed to a plan to sell
- the asset is available for immediate sale
- an active programme to locate a buyer is initiated
- the sale is highly probable, **within one year** of classification as held for sale (subject to exceptions stated in Para 9, IFRS-5)
- the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value
- actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

The criteria ' sale is highly probable, **within one year** of classification as held for sale' needs is not evidenced when the management is indecisive whether the particular asset will be sold or leased out.

Basic principles

- The basic principle of classifying ' non-current assets held for sale and disposal groups' is that the carrying value is expected to be realised through a sale transaction rather than through continuing use.
- Assets should be available for immediate sale in their present conditions subject to only the terms and conditions which are usual and customary for sales of such assets. Sale must highly probable.

Measurement & Presentation

- Under this standard assets that meet the criteria to be classified as ' held for sale' should be measured at the lower of carrying amount and fair value less cost to sell , and it will not be required to charge depreciation on such assets. These assets should separately presented on the face of the balance sheet. Result of 'discontinued operations' should presented separately in the Income Statement.

Classification criteria met after the balance sheet date

- If the classification criteria for an asset or disposal group are met after the balance sheet, the entity should not classify such asset or disposal group as held for sale.

- If these criteria are met after the balance sheet date but before the authorization of financial statements, information stated Para 41(a) , (b) & (d) of IFRS-5 should disclosed in notes. [Para 41(a) : description of non-current assets ; (b) description of the circumstance of sale, expected manner and timing of sale and (d) reportable segment to which such assets is presented in accordance with IFRS-8].

Nature of disposal	**Should the transaction be classified as Held for Sale ?**
Sale of 51% of a 100% owned subsidiary, with the remaining 49% becoming an equity accounted associate.	Yes, as the group lost the control
Sale of 44% of a 100% subsidiary. The group continues to control and consolidate the subsidiary.	No, the group continues to control the same assets as previously but has sold an economic interest in those assets
Sale of 75% of a 90% owned subsidiary. The remaining 15% is accounted for as an AFS.	Yes, since it will be recovered principally through a sale transaction
Sale of 30% of a 35% interest in an associate. The remaining interest of 5% is accounted for as an AFS.	Yes, since it will be recovered principally through a sale transaction
Sale of 5% of a 35% owned associated. The remaining interest of 30% continues to be classified as an associate and equity accounting is followed.	No, since it will not be recovered principally through a sale transaction

IFRS 6: EXPLORATION FOR AND EVALUATION OF MINERAL ASSETS

The objective of this IFRS is to specify the financial reporting for the exploration for and evaluation of mineral resources.

In particular, the IFRS requires:

(a) limited improvements to existing accounting practices for exploration and evaluation expenditures.

(b) entities that recognise exploration and evaluation assets to assess such assets for impairment in accordance with this IFRS and measure any impairment in accordance with IAS 36 Impairment of Assets.

(c) disclosures that identify and explain the amounts in the entity's financial statements arising from the exploration for and evaluation of mineral resources and help users of those financial statements understand the amount, timing and certainty of future cash flows from any exploration and evaluation assets recognised.

Scope

An entity shall apply the IFRS to exploration and evaluation expenditures that it incurs.

The IFRS does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral resources.

An entity shall not apply the IFRS to expenditures incurred:

(a) before the exploration for and evaluation of mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area.

(b) after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

IFRS 7: FINANCIAL INSTRUMENTS-DISCLOSURES

The objective of this IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

The principles in this IFRS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement.

This IFRS shall be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* or IAS 31 *Interests in Joint Ventures*.

However, in some cases, IAS 27, IAS 28 or IAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using IAS 39; in those cases, entities shall apply the disclosure requirements in IAS 27, IAS 28 or IAS 31 in addition to those in this IFRS. Entities shall also apply this IFRS to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in IAS 32.

(b) employers' rights and obligations arising from employee benefit plans, to which IAS 19 *Employee Benefits* applies.

(c) [deleted]

(d) insurance contracts as defined in IFRS 4 *Insurance Contracts*. However, this IFRS applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately. Moreover, an issuer shall apply this IFRS to *financial guarantee contracts* if the issuer applies IAS 39 in recognising and measuring the contracts, but shall apply IFRS 4 if the issuer elects, in accordance with paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring them.

(e) financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2 *Share-based Payment* applies, except that this IFRS applies to contracts within the scope of paragraphs 5–7 of IAS 39.

This IFRS applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of IAS 39. Unrecognised financial instruments include some financial instruments that, although outside the scope of IAS 39, are within the scope of this IFRS (such as some loan commitments).

This IFRS applies to contracts to buy or sell a non-financial item that are within the scope of IAS 39 (see paragraphs 5–7 of IAS 39).

IFRS 8: OPERATING SEGMENT

The IFRS specifies how an entity should report information about its operating segments in annual financial statements and, as a consequential amendment to IAS 34 Interim Financial Reporting, requires an entity to report selected information about its operating segments in interim financial reports. It also sets out requirements for related disclosures about products and services, geographical areas and major customers. The IFRS requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate re sources to operating segments.

Identification of segments

The requirements of the IFRS are based on the information about the components of the entity that management uses to make decisions about operating matters.

The IFRS requires identification of operating segments on the basis of internal reports that are regularly reviewed by the entity’s chief operating decision maker in order to allocate resources to the segment and assess its performance. IAS 14 required identification of two sets of segments—one based on related products and services, and the other on geographical areas. IAS 14 regarded one set as primary segments and the other as secondary segments.

A component of an entity that sells primarily or exclusively to other operating segments of the entity is included in the IFRS’s definition of an operating segment if the entity is managed that way. IAS 14 limited reportable segments to those that earn a majority of their revenue from sales to external customers and therefore did not require the different stages of vertically integrated operations to be identified as separate segments.

IFRS 9: FINANCIAL INSTRUMENTS: Classification and Measurement

The IASB’s overarching intent was to reduce the complexity inherent in IAS 39. To achieve that, IFRS 9 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, rather than following the many different rules contained in IAS 39.

Applicability:

An entity shall apply this IFRS for annual periods beginning on or after 1 January, 2013.

Features:

- Debt instruments are subject to “Business Models” and “Characteristics of the financial asset” test to determine if they should be measured at amortized cost and fair value.
- Debt instruments must meet both tests both tests to be measured at amortized cost
- All equity investments are measured at fair value either through profit or loss or equity.

1.6 A COMPARISON IGAAP - US GAAP – IFRS

True & Fair View: Under IFRS and IGAAP framework, there is an assumption that adoption of IFRS / IGAAP leads to a true and fair presentation, there is no such assumption under US GAAP.

Prudence Vs Rules: US GAAP essentially takes the cook book approach to set detailed accounting rules as compared to IFRS approach of setting a broad accounting principles and guidelines. Accounting principles in UG on a particular subject is scattered across various pronouncements whereas in IFRS it is concentrated in one or few accounting standards.

Comparative Position: Under IGAAP and IFRS, comparative financial figures are to be provided for one previous years, whereas under USGAAP (SEC requirement for listed companies) comparatives are to be provided for two previous years except for Balance Sheet.

Over-riding of Standards – IFRS permits that a company may withhold application of IFRS in extremely rare situation, where it is felt that application of IFRS would defeat the very objective of Financial reporting. Disclosure must be made for reason for override. No such override is generally permitted under IGAAP and US GAAP.

Reporting Elements - IFRS prescribes the minimum structure and content of financial statement including Statement of Changes in equity (in addition to Balance sheet, Income statement, Cash flow statement , notes comprising significant accounting Policy and other explanatory notes). Under US GAAP in addition to statement of changes in Equity, Statement of Comprehensive Income is required.

Both of these statements are NOT required under IGAAP.

FINANCIAL STATEMENTS

Indian GAAP: Balance sheet, Profit and loss account and Cash flows statement* (*only in case of listed companies). Comparative financial statements of previous period necessary.

US GAAP: Balance sheet, Income statement, Statement of stockholders’ equity and statement of cash flows. Balance sheet for two years and Income statement, Statement of stockholders’ equity and Cash flows statement for three years* (*two years for non-listed companies).

IFRS: Balance sheet, Income statement, Statement of changes in equity, cash flows statement and accounting policies and notes. Comparative information for previous period necessary.

BALANCE SHEET

Basis of Difference	IFRS	USGAAP	IGAAP
Format	IFRS does not prescribe any format, but stipulates minimum line items like PPE, Investment property, Intangible assets, Financial assets, Biological assets, inventory, receivables, etc.	US GAAP also does not prescribe any format , but Rule S-X of SEC stipulates for listed companies minimum line items to be disclosed either on face of Balance sheet or Notes to Accounts.	IGAAP provides two format of Balance Sheet-Horizontal and Vertical format (Part I of schedule VI to the Companies Act, 1956).

Basis of Difference	**IFRS**	**USGAAP**	**IGAAP**
Order	Under IFRS, lineitems are presented in increasing order of liquidity.	Under US GAAP, items in assets and liabilities are presented in decreasing order of liquidity.	In IGAAP, line items are presented in increasing order of liquidity.
Consolidation	Consolidation of Financial statements of subsidiaries is not compulsory until it is required under some other law or regulation	Under US GAAP consolidation of results of Subsidiaries and Variable interest entity (FIN 46R) is compulsory	It is not mandatory for companies to prepare CFS under AS 21. However, listed enterprises are mandatorily required by listing agreement of SEBI to prepare and present CFS.
Current/Non-Current	An organisation has an option to adopt Current or Non current classification of assets and liabilities	Bifurcation into current & non-current items is cumpulsorily required.	No such requirement

Income Statement

Basis of Difference	**IFRS**	**USGAAP**	**IGAAP**
Format	IFRS does not prescribe any standard format for income statement but prescribes minimum disclosure includes revenue, finance costs, share of post tax results of JV and associates using equity method.	There is no prescribed format, SEC guidelines Rule S-X prescribe minimum line items to be shown on the face of income statement& suggest 2 alternatives a) a single step format where expenses are classified by function and b) a Multiple step format where Cost of sales is deducted from sales	Under Indian GAAP no format is prescribed , but minimum line items have been specified in Part II of schedule VI to Companies Act, 1956 including Aggregate Turnover, Gross Service revenue for Commission paid to Sole selling agent, Brokerage and discount on sales etc.
Prior Period Items	A prior period item/ error should be corrected by retrospective effect by restatement of opening balance of assets, liabilities or equities	Mandates retrospective application of error and requires restatement of comparative opening balance with suitable footnote disclosure.	Requires separate disclosure of prior period in the current financial statement & no restatement of retained earnings are required.

Basis of Difference	**IFRS**	**USGAAP**	**IGAAP**
Discounting	IFRS provides that where the inflow of cash is significantly deferred without interest, discounting is needed.	US GAAP also permits discounting in certain cases for instance discounting is done in case of loans, debentures, bonds and upfront fees	There is no concept of discounting under IGAAP.
Change in accounting policy	IFRS requires retroactive application for the earliest period practical and adjustment of opening retained earning.	Requires prospective application of change in accounting policy and proforma disclosure of effect on income before extraordinary items on the face of income statement as separate section. Only in specific case retrospective is applicable	Under IGAAP, effect for change in accounting policy is given with prospective effect , if the same is material.
Bifurcation of Cost	There is no specific provision in this regard	Total cost is required to be shown separately under: a) Cost of Sales b) Sellingand Administration c) R & D	There is no specific provision in this regard. There are certain disclosure requirements under varied AS which should be complied.
Extra ordinary Events	Disclosure is prohibited	Nature should be both: a) Infrequent b) Unusual Disclosed separately on the face of Income Statement net of Taxes after results from operations	Distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. The nature and the amount of each extraordinary item should be separately disclosed in the statement of P & L in a manner that its impact on current profit or loss can be perceived.

CASH FLOW STATEMENT

Basis of Difference	**IFRS**	**USGAAP**	**IGAAP**
Exemptions	No exemptions	Limited exemptions for certain investment entities	Unlisted enterprises, enterprises with a turnover less than Rs.500 million and those with borrowings less than Rs.100 million
Direct/Indirect Method	Both allowed	Both allowed	Both allowed. Listed companies- Indirect method Insurance companies- Direct Method
Periods to be presented	2 years	3 years	2 years
Interest paid	Operating and financing activity	Operating activity (to be disclosed by way of a note)	Financing. In case of a financial enterprise, operating activities
Interest received	Operating or investing activity	Operating activity	Investing. In the case of a financial enterprise, operating activity.
Dividends paid	Operating or financing	Financing	Financing
Tax payments	Operating	Operating(to be disclosed by way of a note)	Operating
Dividends received	Operating or investing	Operating	Investing. In the case of a financial enterprise, operating activity.

SHAREHOLDERS' EQUITY

Repurchase of own shares:

IGAAP

Entity may purchase its own shares provided it is in consonance with the complex legal requirements stipulated in the Companies Act and SEBI guidelines.

The excess of cost over par value may be adjusted against free reserves and securities premium.

Also, such shares are required to be cancelled, i.e. cannot be kept in treasury.

US GAAP

Repurchased for retiring stock, excess of cost over par value may be Charged entirely to retained earnings; or allocated between retained earnings and additional paid-in-capital (APIC); or charged entirely to APIC.

When stock repurchased for purposes other than retiring stock, the cost of acquired stock may be shown separately as a deduction from equity; or treated the same as retired stock.

IFRS

Similar to US GAAP. Repurchased stock is shown as a deduction from equity.

Statement of Changes in Shareholders' Equity

	Common Stock	Additional Paid in Capital	Retained Earnings	Treasury Stock(i.e. Buy Back)	Cumulative Translation adjustment	Accumulated other comprehensive income	Total
Balance at the beginning of the year							
Net income							
Other comprehensive income							
Dividend paid							
Cumulative translation adjustment							
Stock options							
Balance as at the end of the year							

Statement of changes in shareholders equity:

Indian GAAP – 2 years

Not Applicable. Share capital and reserves are disclosed by way of a schedule.

IFRS – 2 years

Primary statement Shows capital transactions with owners, movement in accumulated profits and reconciliation of equity. Other Comprehensive Income may be shown as a part of it.

US GAAP – 3 years

May be shown as a part of notes to accounts shows capital transactions with owners, movement in accumulated profits and reconciliation of equity.Other Comprehensive Income may be shown as a part of it.

Dividend on equity shares

IGAAP

Presented as a appropriation of profits.

Dividends are accounted in the year when Proposed.

US GAAP

Presented as a deduction in the statement of changes in shareholders' equity Cash Dividends are accounted in the year when Declared. Only in case of Stock dividend adjustments is done in accounts..

IFRS

Presented as a deduction in the statement of changes in shareholders' equity dividends are accounted in the year when Declared.

INVESTMENTS

IGAAP : AS 13

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

(A) Current Investments – Lower of Cost or Fair Value

(B) Long term Investments. – At cost. If Permanent decline then reduce the carrying value to declined FMV.

All changes in carrying value is taken to P&L

Reclassification – Long term to Current – at lower of cost and carrying amount.

Reclassification – Current to Long term – at lower of cost and Fair Value.

INVESTMENTS: US GAAP

(A) Held to Maturity – *At Cost*. (with discount or premium amortized over the effective yield basis). *Most Restrictive category*. securities can be so classified if there is positive intent and ability to hold (maintain the securities) till maturity.

(B) Available for Sale. – *At FMV*. Unrealized gain / loss due to Fair value are accounted under OCI. In case of Permanent decline, the reduction is taken to income statement.

(C) Trading Securities – *AT FMV*. Unrealized gains and losses are entirely taken to Income Statement.

Investment in unlisted securities is valued at cost .There are very stringent limitations on reclassification of Investments.

IF "HTM" securities are sold, use of this category is prohibited *Provision for diminution (in value of the long-term investment) created in earlier years cannot be reversed, whereas in Indian GAAP it can be reversed.*

INVESTMENTS: IFRS

(A) Held to Maturity – *At Cost*. (with discount or premium amortized over the effective yield basis). *Most Restrictive category*. securities can be so classified if there is positive intent and ability to hold (maintain the securities) till maturity.

(B) Available for Sale. – *At FMV*. Unrealized gain / loss due to Fair value are accounted under OCI. In case of Permanent decline, the reduction is taken to income statement.

(C) Trading Securities – *AT FMV*. Unrealized gains and losses are entirely taken to Income Statement.

Investment in unlisted securities can be valued at FMV.

There are very stringent limitations on reclassification of Investments.

IF "HTM" securities are sold, use of this category is prohibited for next two years.

CONSOLIDATION - SUBSIDIARIES

Indian GAAP

Based on controlling interest, control directly or indirectly through subsidiary (ies), by the virtue of holding the majority of voting shares or control over the board of directors.

IFRS

Based on voting control or power to govern.

The existence of currently exercisable *potential voting rights* is also taken into consideration. SPEs also need to be consolidated.

US GAAP

Controlling interest through majority ownership of voting shares or by contract.

Consolidate **variable interest entities (VIEs)** in which a parent does not have voting control but absorbs the majority of losses or returns.

CONSOLIDATION : VARIABLE INTEREST ENTITIES(VIE)

US GAAP – FIN 46(R)

VIE is an entity which satisfies any of the following conditions:

- The **equity investment** at risk is not sufficient to permit that entity to finance its activities without additional subordinated financial support.
- Equity investors **lack** either **(a) voting control**, or (b) an obligation to **absorb expected losses**, or (c) the right to receive expected residual returns.
- Equity investors have voting rights that are not proportionate to their economic interest, and activities of the entity involve or are conducted on behalf of an investor with disproportionately small voting interest.

A **VIE** is a thinly capitalized and is not self supportive entity.

The **primary beneficiary** (i.e one absorbing more than half of expected losses or receiving more than half of expected residual returns) needs to consolidate the VIE.

Exclusions from Consolidation – Subsidiaries – IFRS

Under IFRS, a parent may avoid consolidation if the parent is a wholly owned subsidiary or a partially owned subsidiary of another entity and its other owners, including those not entitled to vote, have been informed about and do not object to the parent not preparing consolidated financial statements the parent is neither listed nor it is in the process of listing the ultimate or any intermediate parent of the parent produces IFRS compliant consolidated financial statements.

Recent Changes

Temporary control (unless the intended period of holding is less than12 months) is not a justification for non consolidation.

Severe long term restrictions to transfer funds to the parent are not a justification for non-consolidation.

IMPAIRMENT OF ASSETS

Difference Criterion	**IFRS and IGAAP**	**US GAAP**
Timing of impairment review	Annually	Whenever events or changes in circumstances indicate that the carrying amount may not be recovered
Asset is impaired if	Recoverable amount < Carrying amount	Fair value < Carrying amount
Recoverable amount/Fair Value	Recoverable amount is higher of Net Selling Price Value in use	Fair Value is the amount at which an asset or liability could be bought or settled in a current transaction between willing parties
Cash flows for calculating value in use/fair value	Use discounted cash flows for calculating the value in use	Use discounted cash flows for calculating the fair value
Reversal of impairment loss	Whenever there is a change in the economic conditions	Prohibited

BUSINESS COMBINATION

Indian GAAP:

If the combination satisfies the specified conditions, it is an amalgamation in the form of a merger (Pooling of Interest Method), else an amalgamation in the nature or purchase.

Pooling of Interest Method and Purchase Method allowed

US GAAP:

Acquisition of net assets that constitute a business or controlling equity interests of entities.

Prohibits Pooling of Interest.

IFRS:

Bringing together of separate entities or operations into one reporting entity.

Prohibits Pooling of Interest.

Issues	IFRS	USGAAP	IGAAP
Date of acquisition	When control is transferred	When assets received or equity issued	Date specified by the court or the purchase agreement
Valuation of assets and liabilities	Fair value	Fair value	In pooling of interests method-book value In purchase method-book value or fair value
Treatment of goodwill	Capitalize and test for impairment	Capitalize and test for impairment	Estimate the useful life and amortize accordingly
Negative goodwill	Recognized in the income statement	Reduce fair value of non-monetary assets	Disclose as capital reserve
Reverse acquisition	Acquisition accounting is based on substance. Accordingly legal acquirer is treated as acquiree and legal acquiree is treated as acquirer	Similar to IFRS	Acquisition accounting is based on form. Legal Acquirer is treated as acquirer and legal acquiree is treated as acquiree for legal as well as accounting purpose.

INTERNALLY GENERATED INTANGIBLE ASSETS

Issues	IFRS	USGAAP	IGAAP
Research Cost	Charge off	Charge off	Charge off
Development Cost	Capitalize if criterion is met	Charge off	Capitalize if criterion is met

STUDY NOTE - 2

Preparation of Company Accounts under Various Circumstances

This Study Note includes:

- Merger and Acquisitions
- Accounting for Merger and Acquisitions
- External Reconstruction

2.1 Merger and Acquisitions

2.1.1 Introduction

In today's global business environment, companies may have to grow to survive, and one of the best ways to grow is by merging with another company or acquiring other companies. A merger occurs when one firm assumes all the assets and all the liabilities of another. The acquiring firm retains its identity, while the acquired firm ceases to exist.

The United Kingdom Financial Reporting Standard 6 defines the term 'merger' as: "Merger is a business combination which results in the creation of a new reporting entity formed from the combining parties, in which the shareholders come together in a substantially equal partnership for the mutual sharing of risks and benefits of the combined entity; and in which no party to the combination, in substance, obtains control over any other."

A majority vote of shareholders is generally required to approve a merger. A merger is just one type of acquisition. One company can acquire another in several other ways, including purchasing some or all of the company's assets or buying up its outstanding shares of stock.

In general, mergers and other types of acquisitions are performed in the hopes of realizing an economic gain. For such a transaction to be justified, the two firms involved must be worth more together than they were apart. Some of the potential advantages of mergers and acquisitions include achieving economies of scale, combining complementary resources, garnering tax advantages, and eliminating inefficiencies. Other reasons for considering growth through acquisitions include obtaining proprietary rights to products or services, increasing market power by purchasing competitors, shoring up weaknesses in key business areas, penetrating new geographic regions, or providing managers with new opportunities for career growth and advancement. Since mergers and acquisitions are so complex, however, it can be very difficult to evaluate the transaction, define the associated costs and benefits, and handle the resulting tax and legal issues.

2.1.2 What is Merger?

Merger or amalgamation contemplates joining two or more companies to form a new company, an altogether a new entity or absorbing of one or more companies by an existing company. The term"merger" and "amalgamation" are used synonymously.

Co. A + Co. B – New Co. C

Figure 1

Co. A and Co. B = Transferor/Amalgamating Company

New Co. C = Transferee/Amalgamated Company

Co. A + Co. B + Co.C – Existing Co.As

Figure 2

Co. B and Co. C = Transferor/Amalgamating Company

Co. A = Transferee/Amalgamated Company

In other words, merger involves consolidation of business of Company A and Company B into a new Company C on a going concern basis as shown in Figure 1 above or transfer of business of

Company B and Company C to Company A on a going concern basis as shown in Figure 2 above. The transaction involves arrangement with the shareholdeRs.

The consideration for transfer of business may be discharged either through issue of shares (equity or preference) or other instruments of the transferee company or by cash.

2.1.3 Varieties of Mergers

From the perspective of business structures, there are a whole host of different mergeRs. Here are a few types, distinguished by the relationship between the two companies that are merging:

- Horizontal merger Two companies that are in direct competition in the same product lines and markets.
- Vertical merger A customer and company or a supplier and company. Think of a cone supplier to an ice cream maker.
- Market-extension merger: Two companies that sell the same products in different markets.
- Product-extension merger: Two companies selling different but related products in the same market.
- Conglomeration: Two companies that have no common business areas.

  From the perspective of how the merge is financed, there are two types of mergers: purchase mergers and consolidation mergeRs. Each has certain implications for the companies involved and for investors:

  - Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt instrument, and the sale is taxable.

    Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be ''written-up'' to the actual purchase price, and the difference between book value and purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company (we discuss this further in part four of this tutorial).
  - Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

2.1.4 Acquisitions

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies, and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another – there is no exchanging of stock or consolidating as a new company. Acquisitions are often congenial, with all parties feeling satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discussed above, a company can buy another company with cash, with stock, or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on how well this synergy is achieved.

2.1.5 Types of Acquisitions

In general, acquisitions can be horizontal, vertical, or conglomerate. A horizontal acquisition takes place between two firms in the same line of business. For example, one tool and die company might purchase another. In contrast, a vertical merger entails expanding forward or backward in the chain of distribution, toward the source of raw materials or toward the ultimate consumer. For example, an auto parts manufacturer might purchase a retail auto parts store. A conglomerate is formed through the combination of unrelated businesses.

Another type of combination of two companies is a consolidation. In a consolidation, an entirely new firm is created, and the two previous entities cease to exist. Consolidated financial statements are prepared under the assumption that two or more corporate entities are in actuality only one. The consolidated statements are prepared by combining the account balances of the individual firms after certain adjusting and eliminating entries are made.

Another way to acquire a firm is to buy the voting stock. This can be done by agreement of management or by tender offer. In a tender offer, the acquiring firm makes the offer to buy stock directly to the shareholders, thereby bypassing management. In contrast to a merger, a stock acquisition requires no stockholder voting. Shareholders wishing to keep their stock can simply do so. Also, a minority of shareholders may hold out in a tender offer.

A bidding firm can also buy another simply by purchasing all its assets. This involves a costly legal transfer of title and must be approved by the shareholders of the selling firm. A takeover is the transfer of control from one group to another. Normally, the acquiring firm (the bidder) makes an offer for the target firm. In a proxy contest, a group of dissident shareholders will seek to obtain enough votes to gain control of the board of directoRs.

2.1.6 Distinction Between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms ''merger'' and "acquisition" mean slightly different things.

When a company takes over another one and clearly becomes the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist and the buyer "swallows" the business, and stock of the buyer continues to be traded.

In the pure sense of the term, a merger happens when two firms, often about the same size, agree to go forward as a new single company rather than remain separately owned and operated. This kind of action is more precisely referred to as a “merger of equals.” Both companies’ stocks are surrendered, and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don’t happen very often. Often, one company will buy another and, as part of the deal’s terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it’s technically an acquisition. Being bought out often carries negative connotations. By using the term “merger,” dealmakers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together in business is in the best interests of both their companies. But when the deal is unfriendly–that is, when the target company does not want to be purchased–it is always regarded as an acquisition.

So, whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company’s board of directors, employees and shareholdeRs.

Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- Staff reductions – As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- Economies of scale yes, size matters. Whether it’s purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies – when placing larger orders, companies have a greater ability to negotiate price with their supplieRs.
- Acquiring new technology – To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can keep or develop a competitive edge.
- Improved market reach and industry visibility – Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done – it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes it works in reverse. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the dealmake Rs. Where there is no value to be created, the CEO and investment bankers – who have much to gain from a successful M&A deal – will try to build up the image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price. We talk more about why M&A may fail in a later section of this tutorial.

Conclusion & Resources

One size does not fit all. Many companies find that the best route forward is expanding ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power.

By contrast, de-merged companies often enjoy improved operating performance thanks to redesigned management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.

M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

2.2 Accounting For Mergers And Acquisitions

The two principal accounting methods used in mergers and acquisitions are the pooling of interests method and the purchase method. The main difference between them is the value that the combined firm's balance sheet places on the assets of the acquired firm, as well as the depreciation allowances and charges against income following the merger.

The pooling of interests method assumes that the transaction is simply an exchange of equity securities. Therefore, the capital stock account of the target firm is eliminated, and the acquirer issues new stock to replace it. The two firms' assets and liabilities are combined at their historical book values as of the acquisition date. The end result of a pooling of interests transaction is that the total assets of the combined firm are equal to the sum of the assets of the individual firms. No goodwill is generated, and there are no charges against earnings. A tax-free acquisition would normally be reported as a pooling of interests.

Under the purchase method, assets and liabilities are shown on the merged firm's books at their market (not book) values as of the acquisition date. This method is based on the idea that the resulting values should reflect the market values established during the bargaining process. The total liabilities of the combined firm equal the sum of the two firms' individual liabilities. The equity of the acquiring firm is increased by the amount of the purchase price.

Accounting for the excess of cost over the aggregate of the fair market values of the identifiable net assets acquired applies only in purchase accounting. The excess is called goodwill, an asset which is charged against income and amortized over a period that cannot exceed 40 yeaRs. Although the amortization "expense" is deducted from reported income, it cannot be deducted for tax purposes.

Purchase accounting usually results in increased depreciation charges because the book value of most assets is usually less than fair value because of inflation. For tax purposes, however, depreciation does not increase because the tax basis of the assets remains the same. Since depreciation under pooling accounting is based on the old book values of the assets, accounting income is usually higher under the pooling method. The accounting treatment has no cash flow consequences. Thus, value should be unaffected by accounting procedure. However, some firms may dislike the purchase method because of the goodwill created. The reason for this is that goodwill is amortized over a period of yeaRs.

Accounting Standard (AS-14) as prescribed by the Institute of Chartered Accountants of India deals with accounting for amalgamation and treatment for resulting goodwill or reserves. AS-14 classifies amalgamation into two types, viz.:

Amalgamation in nature of merger; and

Amalgamation in nature of purchase.

Amalgamation in nature of merger is an amalgamation, which satisfies all the following conditions:

i. All the assets and liabilities of the transferor company become the assets and liabilities of the transferee company;

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than transferee company and its nominees) become equity shareholders of the transferee company after amalgamation;

iii. The consideration is to be discharged by way of issue of equity shares in the transferee company to the shareholders of the transferor company on the amalgamation;

iv. The business of the transferor company is to be carried on by the transferee company;

v. No adjustments are intended to be made to the book values of the assets and liabilities of the transferor company.

If any one or more of the aforesaid conditions are not satisfied then the amalgamation is in nature of purchase.

Amalgamation in the nature of merger is to be accounted as per the Pooling of Interest Method and in case of amalgamation in the nature of purchase accounting needs to be done as per the Purchase Method.

2.2.1 Methods of Accounting:

Pooling of Interest Method (In the nature of merger)

i. The assets, liabilities and reserves of the transferor company are to be recorded at their existing carrying amounts and in the same form as it was appearing in the books of the transferor company.

ii. The identity of the reserves of the transferor company is to be kept intact in the balance sheet of the transferee company.

iii. Difference between the amounts of share capital issued plus any other additional consideration paid by the transferee company and the amount of the share capital of the transferor company should be adjusted in Reserves.

Purchase Method:

i. The assets and the liabilities of the transferor company are to be recorded at their existing carrying amounts or, alternatively, the consideration should be allocated to individual assets and liabilities on the basis of fair values at the date of amalgamation while preparing the financial statements of the transferee company.

ii. The identity of the reserves of the transferor company other than the statutory reserves is not preserved. The identity of the statutory reserves is preserved in the same form and is recorded in the books of the transferee company by a corresponding debit to the amalgamation adjustment a/c.

iii. Excess or shortfall of consideration over the value of net assets acquired should be credited/ debited as capital reserve/goodwill, as the case may be.

iv. It is appropriate to amortize goodwill over a period of not exceeding 5 years unless a longer period is justified.

The accounting treatment as specified in AS-14 needs to be followed for accounting of reserves. In case the scheme of amalgamation sanctioned prescribes a separate treatment to be given to the reserves of the transferor company on amalgamation, it can be followed.

However the Institute of Chartered Accountants of India has issued a general clarification wherein the following disclosure is to be made in case the accounting treatment for reserves is different from that specified in AS-14:

i. Description of the accounting treatment given to reserves;

ii. Deviation in the Accounting Treatment and the reasons for following a treatment different from that prescribed in the AS-14;

iii. The financial effect, if any, arising due to such deviation is to be disclosed.

iv. Other Disclosure Requirements

  a. General

  - Names and general nature of business of the amalgamating companies
  - Effective date of amalgamation for accounting purposes
  - Method of accounting used to reflect the amalgamation and Exchange Ratio
  - Particulars of the scheme sanctioned by the Court

  b. **If Pooling of Interest Method is used**

  - Description and number of shares issued, together with the percentage of each company's equity shares exchanged.
  - The amount of any difference between the consideration and the value of net identifiable assets acquired and the treatment thereof.

c. **If Purchase Method is used**

- Consideration for the amalgamation and description of consideration paid/payable
- The amount of difference between the consideration and the value of net identifiable assets acquired and the treatment thereof including the period of amortization of any goodwill arising on amalgamation

ENTRIES IN BOOKS OF VENDOR COMPANY

1. **Transfer to Realisation A/c.**

Particulars		**Debit Rs.**	**Credit Rs.**
a. Assets taken over by purchasing Company at Book values.			
Realisation A/c	Dr.	XXX	
To Liquidator of A Ltd. A/c			XXX
b. Liabilities taken over by Purchasing Company			
at Balance Sheet value.			
Liabilities A/c	Dr	XXX	
To Realisation A/c			XXX

2. **Purchase Consideration**

Purchase consideration represents consideration paid by transferee company to shareholders (equity and preference) in any form viz., cash, shares, debentures etc.

Particulars		**Debit Rs.**	**Credit Rs.**
a. Due Entry for consideration			
Transfer company A/c	Dr.	XXX	
To Realisation A/c			XXX
b. Receipt of Considertion			
Shares/Securities of transferee company A/c	Dr.	XXX	
Bank A/c	Dr.	XXX	
To Transferee company A/c			XXX

3. **Sale of Assets not taken over (Assuming Profits)**

Particulars		**Debit Rs.**	**Credit Rs.**
Bank A/c (Sale proceeds)	Dr.	XXX	
To Assets A/c (Book value)			XXX
To Realisation A/c (Profits)			XXX

4. Settlement of liabilities not taken over (Assuming at a discount)

Particulars	Debit Rs.	Credit Rs.
Liabilities A/c (book value) Dr.	XXX	
To Bank A/c		XXX
To Realisation A/c (discount)		XXX

5. Realisation expenses

Particulars	Debit Rs.	Credit Rs.
a. Incurred by transferor company		
Realisation A/c Dr.	XXX	
To Bank A/c		XXX
b. Incurred by transferee company		
No Entry		
c. Incurred by transferor company reimbursed by transferee company		
i. On incurring the expenses		
Transferee company A/c Dr.	XXX	
To Bank		XXX
ii. On reimbursement		
Bank A/c Dr.	XXX	
To Transferee company A/c		XXX

6. Amount due to the euqity Share holders

Particulars	Debit Rs.	Credit Rs.
a. Transfer of share capital and reserves to shareholders account		
Equity Share Capital A/c Dr.	XXX	
Reserves A/c Dr.	XXX	
To Shareholders A/c		XXX

7. Settlement to Share holders by transfer of consideration received:

Particulars	Debit Rs.	Credit Rs.
Shareholders A/c Dr.	XXX	
To Shares/Securities of transferee company A/c		XXX
To Bank A/c		XXX

Entries in books of Transferee Company

a) Three basic entries

For purchase consideration due		
Business Purchase a/c	Dr.	
To Liquidator of Vendor Company		
For assets and liabilities taken over		
Sundry Assets A/c	Dr.	
Goodwill A/c	Dr.	(Bal. fig.)
To Sundry Liabilities		
To Business Purchase A/c		
To Capital Reserve A/c (Bal. fig.)		
For discharge of purchase consideration		
Liquidator of Vendor Company A/c	Dr.	
To Equity Share Capital A/c		
To Securities Premium A/c		
To Debentures A/c		
To Preference Share Capital A/c		
To Cash A/c		

b) For liquidation expenses paid by purchasing company

Goodwill/Capital Reserve A/c	Dr.
To Cash A/c	

c) For cancellation of mutual owings

Creditor/Bills payable A/c	Dr.
To Debtors/Bills receivable A/c	

d) For adjustment of unrealised profit

Goodwill/Capital reserve A/c	Dr.
To Stock A/c	

e) For carry forward of statutory reserves

Amalgamation Adjustment A/c	Dr.
To Statutory Reserve A/c	

f) If both capital reserve and goodwill appears in books

Capital Reserve A/c	Dr.
To Goodwill A/c	

2.2.2 How To Value An Acquisition

Valuing an acquisition is similar to valuing any investment. The analyst estimates the incremental cash flows, determines an appropriate risk-adjusted discount rate, and then computes the net present value (NPV). If firm A is acquiring firm B, for example, then the acquisition makes economic sense if the value of the combined firm is greater than the value of firm A plus the value of firm B. Synergy is said to exist when the cash flow of the combined firm is greater than the sum of the cash flows for the two firms as separate companies. The gain from the merger is the present value of this difference in cash flows.

2.2.3 Sources of Gains From Acquisitions

The gains from an acquisition may result from one or more of the following five categories: (1) revenue enhancement, (2) cost reductions, (3) lower taxes, (4) changing capital requirements, or (5) a lower cost of capital. Increased revenues may come from marketing gains, strategic benefits, and market power. Marketing gains arise from more effective advertising, economies of distribution, and a better mix of products. Strategic benefits represent opportunities to enter new lines of business. Finally, a merger may reduce competition, thereby increasing market power. Such mergers, of course, may run afoul of antitrust legislation.

A larger firm may be able to operate more efficiently than two smaller firms, thereby reducing costs. Horizontal mergers may generate economies of scale. This means that the average production cost will fall as production volume increases. A vertical merger may allow a firm to decrease costs by more closely coordinating production and distribution. Finally, economies may be achieved when firms have complementary resources — for example, when one firm has excess production capacity and another has insufficient capacity.

Tax gains in mergers may arise because of unused tax losses, unused debt capacity, surplus funds, and the write-up of depreciable assets. The tax losses of target corporations can be used to offset the acquiring corporation's future income. These tax losses can be used to offset income for a maximum of 15 years or until the tax loss is exhausted. Only tax losses for the previous three years can be used to offset future income.

Tax loss carry-forwards can motivate mergers and acquisitions. A company that has earned profits may find value in the tax losses of a target corporation that can be used to offset the income it plans to earn. A merger may not, however, be structured solely for tax purposes. In addition, the acquirer must continue to operate the pre-acquisition business of the company in a net loss position. The tax benefits may be less than their "face value," not only because of the time value of money, but also because the tax loss carry-forwards might expire without being fully utilized.

Tax advantages can also arise in an acquisition when a target firm carries assets on its books with basis, for tax purposes, below their market value. These assets could be more valuable, for tax purposes, if they were owned by another corporation that could increase their tax basis following the acquisition. The acquirer would then depreciate the assets based on the higher market values, in turn, gaining additional depreciation benefits.

Interest payments on debt are a tax-deductible expense, whereas dividend payments from equity ownership are not. The existence of a tax advantage for debt is an incentive to have greater use of debt, as opposed to equity, as the means of financing merger and acquisition transactions. Also, a firm that borrows much less than it could may be an acquisition target because of its unused debt capacity. While the use of financial leverage produces tax benefits, debt also increases the likelihood of financial distress in the event that the acquiring firm cannot meet its interest payments on the acquisition debt.

Finally, a firm with surplus funds may wish to acquire another firm. The reason is that distributing the money as a dividend or using it to repurchase shares will increase income taxes for shareholdeRs. With an acquisition, no income taxes are paid by shareholders.

Acquiring firms may be able to more efficiently utilize working capital and fixed assets in the target firm, thereby reducing capital requirements and enhancing profitability. This is particularly true if the target firm has redundant assets that may be divested.

The cost of debt can often be reduced when two firms merge. The combined firm will generally have reduced variability in its cash flows. Therefore, there may be circumstances under which one or the other of the firms would have defaulted on its debt, but the combined firm will not. This makes the debt safer, and the cost of borrowing may decline as a result. This is termed the coinsurance effect.

Diversification is often cited as a benefit in mergers. Diversification by itself, however, does not create any value because stockholders can accomplish the same thing as the merger by buying stock in both firms.

2.2.4 Valuation Procedures

The procedure for valuing an acquisition candidate depends on the source of the estimated gains. Different sources of synergy have different risks. Tax gains can be estimated fairly accurately and should be discounted at the cost of debt. Cost reductions through operating efficiencies can also be determined with some confidence. Such savings should be discounted at a normal weighted average cost of capital. Gains from strategic benefits are difficult to estimate and are often highly uncertain. A discount rate greater than the overall cost of capital would thus be appropriate.

The net present value (NPV) of the acquisition is equal to the gains less the cost of the acquisition. The cost depends on whether cash or stock is used as payment. The cost of an acquisition when cash is used is just the amount paid. The cost of the merger when common stock is used as the consideration (the payment) is equal to the percentage of the new firm that is owned by the previous shareholders in the acquired firm multiplied by the value of the new firm. In a cash merger the benefits go entirely to the acquiring firm, whereas in a stock-for-stock exchange the benefits are shared by the acquiring and acquired firms.

Whether to use cash or stock depends on three considerations. First, if the acquiring firm's management believes that its stock is overvalued, then a stock acquisition may be cheaper. Second, a cash acquisition is usually taxable, which may result in a higher price. Third, the use of stock means that the acquired firm will share in any gains from merger; if the merger has a negative NPV, however, then the acquired firm will share in the loss.

In valuing acquisitions, the following factors should be kept in mind. First, market values must not be ignored. Thus, there is no need to estimate the value of a publicly traded firm as a separate entity. Second, only those cash flows that are incremental are relevant to the analysis. Third, the discount rate used should reflect the risk associated with the incremental cash flows. Therefore, the acquiring firm should not use its own cost of capital to value the cash flows of another firm. Finally, acquisition may involve significant investment banking fees and costs.

Mergers and acquisitions and corporate restructuring – or M&A for short – are a big part of the corporate finance world. Everyday, Wall Street investment bankers arrange M&A transactions that bring together separate companies to make larger ones. When they are not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs, or tracking stocks.

Not surprisingly, these types of actions often make the news. Deals can be worth hundreds of millions or even billions of dollars, and they can dictate the fortunes of the companies involved for years to come. For CEOs, leading M&A can represent the pinnacle of their careeRs.

2.3 External Reconstruction

Reconstruction means reorganization of a company's financial structure. In reconstruction of a company, usually the assets and liabilities of the company are revalued, the losses suffered by the company are written off by a deduction of the paid-up value of shares and/or varying of the rights attached to different classes of shares and compounding with the creditoRs. It may be done without liquidating the company and forming a new company in which case the process is called internal reconstruction. However, there may be external reconstruction in which case the undertaking being carried on by the company is transferred to a newly started company consisting substantially of the same shareholders with a view to the business of the transferee company being continued by the transferee company. An attempt is made that the newly started company has a sound financial structure and a good set of assets and liabilities recorded in the books of the transferee company at their fair values.

From the point of view of an accountant, external reconstruction is similar to amalgamation in the nature of purchase; the books of the transferee company are closed and in the books of the transferee company, the purchase of the business is recorded. But otherwise external reconstruction and amalgamation differs as follows:

(i) In external reconstruction, only one company is involved whereas in amalgamation, there are at least two existing companies which amalgamate.

(ii) In external reconstruction, a new company is certainly formed whereas in amalgamation a new company may be formed or in the alternative one of the existing companies may take over the other amalgamating company or companies and no new company may be formed.

(iii) The objective of the external reconstruction is to reorganize the financial structure of the company, on the other hand, the objective of the amalgamation is to cut competition and reap the economies of larger scale.

Scheme of Reconstruction

The need for reconstruction arises when a company has accumulated losses or when a company finds itself overcapitalized which means either that the value placed on assets is too much as compared to their earning capacity or that the profits as a whole are insufficient to pay a proper dividend. Apart from clarity, wide acceptance and justice, the reconstruction scheme must take into account the following:-

The fundamental basis of any proposals is the earning power of the company. Even the interest to debenture holders cannot be paid unless the company's activities are profitable. A very careful estimate should, therefore, be made of the profits expected by the company in the future. Unless the profits are sufficient to meet all the expenses including adequate depreciation, interest to debenture holders and other creditors, preference dividend, and a reasonable return to the equity shareholder, it would be useless to process with any reconstruction scheme because, otherwise, the need for reconstruction will soon arise again.

Assuming that adequate profits can be expected, the reconstruction scheme should not adversely affect the rights of preference shareholders (not to speak of creditors and debenture holders) unless it is absolutely necessary. Suppose, the profits are such that after paying dividends to preference shareholders little remains for equity shareholders: the preference shareholder may be persuaded to accept a sacrifice either by reduction of capital or by reduction in the rate of dividend or both because the alternative to such acceptance of sacrifice may be the liquidation of the company (in which case, due to forced sale, the asset may not realize much and the preference shareholder may not be able to get back what they have invested). If the company is in very bad position, even the debenture holders may be prevailed upon to accept a reduction of their claims. But, so far as is possible, contractual and legal rights and priorities should be maintained.

The equity shareholder will naturally have to bear the brunt of the losses and sacrifice. This is not as bade as it sounds because (a) the equity shareholders realize from the very beginning that if losses occur they have to bear them before anybody else can be called upon to do so, and (b) they must have already known that the value of their holding is small due to absence of dividend. The market price of share is related to dividend and not to the face or nominal value of the share. It really does not matter, therefore, whether the nominal value of an equity share is Rs. 1 or Rs. 100 or Rs. 1,000 as long as it is not 0. (This does matter in case of preference shareholders and debenture holders whose earnings depend on the nominal value). In fact, a reconstruction scheme may be beneficial to the equity shareholders by enabling the payment of a dividend on such shares. On this ground, it would be unjust to ask the preference shareholders to accept a sacrifice when the equity shareholders improve their position.

There is, however, one important right which the equity shareholders enjoy. This is control over the affairs of the company. The equity shareholders will not easily give up this rite, and hence the reconstruction scheme should keep this in mind. The equity shareholder may not agree to the conversion of preference share or debenture into equity share even if the holders of preference shares or debenture are willing to accept lower security for their holdings. The equity share holders may agree to this only if there is a threat of the company being wound up (in which case they will lose almost all). It should also be noted that without the consent of the parties their liability cannot be increased. For instances, fully paid shares cannot be converted into partly paid shares without the consent of the shareholdeRs.

The requirements of the working capital must not be overlooked. Cash may require to pay certain dissenting creditor or even to pay arrears of preference dividend. Generally, therefore, a company under reconstruction will have to raise funds to enable it to pay off such dissenters and to carry on its work smoothly. Which of the various parties are willing to subscribe more shares will have to be seen. The equity shareholders will like to consolidate their position by buying more shares. Sometimes, outsiders are willing to subscribe to the shares but they will generally prefer to do so if they are given a controlling share.

Steps:

(1) First of all the total amounts to be written off should be ascertained. This would mean totaling up the debit balance of the Profit and Loss account, all fictitious assets like goodwill, preliminary expenses, discount on shares or debentures, any fall in value of assets, any increase in liabilities and arrears of dividends on cumulative preference shares. If the value of any share can be legitimately increased the amount of loss would then be reduced accordingly. The other way to get at the same figure would be to add up the present value as a going concern, of all the assets and deduct there from the amount of liabilities and also the arrears of dividend on cumulative preference shares. What is left is "net assets". The share capital compared with net assets will show how much amount is to be written off.

(2) The question now arises has to who is to bear the loss. If the net assets are more than the preference share capital, it is obvious the whole of the loss will have to be borne by the equity shareholdeRs. The nominal value of the equity shares should be reduced by a sufficient margin to cover the loss. If the net assets are not sufficient to cover the preference share capital (or if the net assets are just sufficient), the preference share holder will have to accept a sacrifice, although their sacrifice will be smaller than that of the equity share holdeRs. (Equity share holders should not be completely wiped off). If the future earning power of the company permits, the dividend rate should be increased so that, in terms of rupees, the dividend remains unchanged. Thus if 10.5% preference share of Rs. 100 are converted into preference share of Rs. 75 each, rate of dividend should be raised to 14%, if possible. In both cases, then the dividend will be Rs. 10.5 per share.

(3) Payment of arrears of dividend (question arises only in case of cumulative preference shares) in cash immediately may present difficulties. In such a case a good method is to issue deposit certificates. This is preferable to issuing shares because (a) it will not upset the voting power and (b) the certificate can be redeemed as soon as opportunity arises. The rate of interest need not be heavy, but of course, it will depend on the future earning capacity of the company.

(4) Debenture holders and other creditors are affected by the reconstruction scheme only if the total assets in the company are insufficient to cover even the liabilities (although they are concerned is necessary to any scheme that may be formulated). In such an eventuality, the creditors (including debenture holders) will have to accept sacrifice unless they think that by sending the company into liquidation we will be able to realize substantial portion of their claims. The share holders, both preference and equity will have to accept a heavy reduction in the value of share but they cannot be expected to agree to complete wiping of the shares, in which case they will have no interest in keeping the company going. Generally, the sacrifice to be borne by the creditors will be as follows:

Preferential creditors (According to law)	Nil

Depending upon the value of the security Heaviest.

In short, the whole scheme should broadly depend upon the expected earning power and upon the position as it likely to obtain if the company is sent to liquidation.

Internal vs. External Reconstruction: Having decided who is to bear how much sacrifice of loss and having settled the broad details of the scheme, and important question remains to be decided. Will the reconstruction be internal or external? Internal reconstruction means that the scheme will be carried out by liquidating the existing company and incorporating immediately another company (with the name only slightly changed such as A B Ltd. , to take over the business of the outgoing company. There are advantages in both, but generally internal reconstruction is preferred. The advantages in its favour are:-

(a) Creditors, specially bank overdraft and debenture holders, may continue whereas they may not if the company is formally liquidated which will involve payment of claims to outsiders, If they do not continue, the company may suffer from want of financial assistance. This is, however, only academic since no reconstruction scheme, even internal, will be really formulated without the consent of the bank, debenture holdeRs. Etc.

(b) The company will be able to set off its past losses against future profits for income-tax purposes. This will materially reduce the income-tax liability depending on the losses suffered during the preceding eight yeaRs. Losses can be carried forward for eight years provided the business is carried on. The business will technically end when the company is liquidated. Hence, in case of external reconstruction, losses cannot be carried forward for income tax purposes.

The arguments in favour of external reconstruction are as under:-

(a) External reconstruction may be the only way to bring about speedy reconstruction because sometimes a few people hold up the scheme by delaying tactics by means of legal objections.

(b) It may help in raising more finance by issuing to the existing shareholders partly paid shares in the new company. It should be remembered that in internal reconstruction fully paid up shares unless every shareholder gives his assent in writing. This may prove cumbersome. However, if shareholders are willing to accept partly paid shares in the new company, there is not much reason why they should refuse to buy new shares under a scheme of internal reconstruction.

Legal position as regards external reconstruction:

Sec 494 of the Companies Act permits the liquidator of a company to transfer the whole or any part of the company's business or property to another company and receive from the transferee company for distribution among the share holders of the company under liquidation. The liquidator must obtain the sanction of the company by a special resolution. Any sale of arrangement in pursuance of this section is binding on the members of the transferor company.

But a shareholder who has not voted for the special resolution may, within seven days of the resolution, serve a notice on the liquidator expressing his dissent and requiring the liquidator either, (a) to abstain from carrying the resolution into effect, or (b) to purchase his interest at a price to be determined by agreement or by arbitration.

Illustrations :

I. Computation and Discharge of Purchase Consideration

Illustration - 1

The Oil Shell Ltd. was incorporated on 1st April 2008 for the purpose of acquiring P Ltd., Q. Ltd., and R Ltd.

The Balance sheet of these companies as on 31st March 2009 are as follows :

(Rs.)

Particulars	**P Ltd.**	**Q Ltd.**	**R Ltd.**
Assets			
Tangible Fixed assets - at cost less depreciation	50,00,000	40,00,000	30,00,000
Goodwill		6,00,000	
Other assets	20,00,000	28,00,000	8,50,000
Total	**70,00,000**	**74,00,000**	**38,50,000**
Liabilities			
Issued Equity Share Capital (shares of Rs. 10 each)	40,00,000	50,00,000	25,00,000
Profit and Loss A/c	15,00,000	11,00,000	6,00,000
10% Debentures	7,00,000		4,00,000
Sundry Creditors	8,00,000	13,00,000	3,50,000
Total	**70,00,000**	**74,00,000**	**38,50,000**
Average annual profits before debentures interest (April 2008 to March 2009 inclusive)	9,00,000	12,00,000	5,00,000
Professional valuation of tangible assets on 31st March 2009	62,00,000	48,00,000	36,00,000

1. The directors in their negotiations agreed that : (i) the recorded goodwill of Q Ltd. is valueless ; (ii) the "Other assets" of P Ltd. are worth Rs. 3,00,000; (iii) the valuation of 31st March 2009 in respect of tangible Fixed assets should be accepted. (iv) these adjustments are to be made by the individual companyt before the completion of the acquitition.
2. The acquisition agreement provided for the issue of 12% unsecured Debentures to the value of the net assets of companies P Ltd. Q Ltd and R Ltd., and for the issuance of Rs. 100 nominal value equity shares for the capitalized average profit of each acquired company in excess of net assets contributed. The capitalisation rate is established at 10%.

You are required to:

i. Compute Purchase consideration.

ii. Dicscharge of Purchase consideration.

Solution :

Computation of Purchase Consideration

WN # 1 : ***Consideration in the form of 12% Debentures***

Particulars	P Ltd.		Q Ltd.		R Ltd.	
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
a. Asset						
i. Tangilbe Fixed assets (as valuation)	62,00,000		48,00,000		36,00,000	
ii. Other Assets (as per directors negotiation)	3,00,000	65,00,000	28,00,000	76,00,000	8,50,000	44,50,000
b. Liabilities						
i. Sundry Creditors	8,00,000		13,00,000		3,50,000	
ii. 10% Debentures	7,00,000	(15,00,000)	—	(13,00,000)	4,00,000	(7,50,000)
c. NET ASSETS (a-b)		50,00,000		63,00,000		37,00,000
d. 12% Debentures to be issued.		50,00,000		63,00,000		37,00,000

WN # 2 : ***Consideration in the form of Equity Shares***

Particulars	**P Ltd.** **Rs.**	**Q Ltd.** **Rs.**	**R Ltd.** **Rs.**
a. Average annual profit before debenture interest (given)	9,00,000	12,00,000	5,00,000
b. Debenture interest (on 10% Debentures)	70,000	—	40,000
c. Profit after debentures interest (a-b)	8,30,000	12,00,000	4,60,000
d. Capitalisation rate	10%	10%	10%
e. Capitalised average profit (c/d)	83,00,000	1,20,00,000	46,00,000
f. Net Assets takeover (WN # 1(c))	50,00,000	63,00,000	37,00,000
g. Excess of capitalised average profit over net assets take over (e-f)	33,00,000	57,00,000	9,00,000

WN # 3 : Summary of Purchase Consideration

Particulars	**P Ltd.** **Rs.**	**Q Ltd.** **Rs.**	**R Ltd.** **Rs.**
a. 12% Debentures of Oil Shell Ltd. each @ Rs. 100/- [WN # 1(d)]	50,00,000	63,00,000	37,00,000
b. Equity shares of Rs. 100 each of Oil Shell Ltd. [WN # 2(g)]	33,00,000	57,00,000	9,00,000
c. Total Consideration	**83,00,000**	**1,20,00,000**	**46,00,000**

Illustration - 2

Zee Ltd. agreed to absorb Gulf Ltd. on 31st March, 2009, whose Balance sheet stood as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital		Fixed assets	70,00,000
80,000 shares of Rs. 100 each		Investments	
fully paid	80,00,000	Current assets	
Reserves and surplus		Loans and Advances	
General Reserve	10,00,000	Stock in trade	10,00,000
Secured Loan	—	Sundry Debtors	20,00,000
Unsecured Loan	—		
Current Liabilities and Provisions			
Sundry creditors	10,00,000		
	1,00,00,000		**1,00,00,000**

The consideration was agreed to be paid as follows :

a. A payment in cash of Rs. 50 per share in Gulf Ltd. and

b. The issue of shares of Rs. 100 each in Zee Ltd., on the basis of 2 Equity Shars (valued at Rs. 150) and one 10% cumulative preference share (valued at Rs. 100) for every five shares held in Gulf Ltd.

It was agreed that Zee Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in Gulf Ltd. i.e. Rs. 650 for five shares of Rs. 500 paid.

The whole of the Share capital consists of shareholdings in exact multiple of five except the following holding.

Bharati	116	
Sonu	76	
Hitesh	72	
Jagat	28	
Other individuals	8	(eight members holding one share each)
	300	

Prepare a statement showing the purchase consideration receivable by above shareholders in shares and cash.

Solution :

WN # 1 : ***Statement of consideration paid for fraction shares***

	Particulars	Bharti	Sonu	Hitesh	Jagat	Others	Total
a.	Holding of shares	116	76	72	28	8	300
b.	Non-exchangeable shares (Payable in Cash)	1	1	2	3	8	15
c.	Exchangeable Shares [(a) - (b)]	115	75	70	25	—	285
d.	Above shares						
	i. in Equity shares (2:5)	46	30	28	10	—	14
	ii. in Preference shares (1:5)	23	15	14	5	—	57

WN # 2 : Number of shares to be issued

a. Exchangeable shares :

= Total shares – Non Exchangeable shares

= 80,000 – 15 = 79,985

b. Equity shares to be issued :

= $\frac{79,985}{5}$ x 2 = 31,994 Shares (i.e. 2 shares for every 5 shares)

c. Preference shares to be issued

= $\frac{79,985}{5}$ x 1 = 15,997 Shares (i.e. 1 shares for every 5 shares)

WN # 3 : ***Cash to be paid***

	Particulars	***Rs.***
a.	79,985 shares @ Rs. 50 each	39,99,250
b.	Consideration for non-exchangeable [15×100]× $\frac{650}{500}$ (i.e. Rs. 650 for five shares of Rs. 500 paid)	1,950
c.	Total	40,01,200

Statement of Purchase Consideration :

	Particulars		***Rs.***
a.	In Shares :		
	i. 31,994 Equity shares @ Rs. 150 each	47,99,100	
	ii. 15,997 Preference shares @ Rs. 100 each	15,99,700	63,98,800
b.	In Cash (WN # 3)		40,01,200
c.	Total (a+b)		1,04,00,000

Illustration - 3

The summarized Balance Sheets of P Ltd. and R Ltd. for the year ended 31.3.2009 are as under :

	P Ltd. Rs.	**R Ltd. Rs.**		**P Ltd. Rs.**	**R Ltd. Rs.**
Equity Share capital (in shares of Rs. 100 each)	24,00,000	12,00,000	Fixed Assets	55,00,000	27,00,000
8% Preference Share capital (in share of Rs. 100 each)	8,00,000	—	Current Assets	25,00,000	23,00,000
10% Preference Share capital (in shares of Rs. 100 each)	—	4,00,000			
Reserves	30,00,000	24,00,000			
Current liabilities	18,00,000	10,00,000			
	80,00,000	**50,00,000**		**80,00,000**	**50,00,000**

1. The following information is provided :

		P Ltd. Rs.	R Ltd. Rs.
a)	Profit before tax	10,64,000	4,80,000
b)	Taxation	4,00,000	2,00,000
c)	Preference dividend	64,000	40,000
d)	Equity dividend	2,88,000	1,92,000

2. The Equity shares of both the companies are quoted in the market. Both the companies are carrying on similar manufacturing operations.

3. P. Ltd. proposes to absorb R Ltd. as on 31.3.2009. The terms of absorption are as under :

   a. Preference shareholders of R Ltd. will receive 8% preference shares of P. Ltd. sufficient to increase the income of preference shareholders of R Ltd. by 10%

   b. The equity shareholders of R Ltd. will receive equity shares of P Ltd. on the following basis :

      i. The equity shares of R Ltd. will be valued by applying to the earnings per share of R Ltd. 75% of price earnings ratio of P Ltd. based on the results of 2008-2009 of both the companies.

      ii. The market price of equity shares of P Ltd. is Rs. 400 per share.

      iii. The number of shares to be issued to the equity shareholders of R Ltd. will be based on the above market value.

      iv. In addition to equity shares, 8% preference share of P Ltd. will be issued to the equity shareholders of R Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2008-2009.

4. The assets and liabilities of R Ltd. as on 31.3.2009 are revalued by professional valuer as under :

	Increased by *Rs.*	*Decreased by* *Rs.*
Fixed assets	1,60,000	—
Current assets	—	2,00,000
Current liabilities		40,000

5. For the next two years, no increase in the rate of equity dividend is expected.

   You are required to :

   i) Calculate purchase consideration.

   ii) Give the Balance Sheet as on 31.3.2009 after absorption.

Note : Journal entires are not required.

Solution :

I. Purchase Consideration

A. Preference Shareholders

8% preference shares of P Ltd. sufficient to increase income by 10%.

Particulars	*Rs.*
Current income from Preference shares of R Ltd. (Rs. 4,00,000 × 10%)	40,000
Add : 10% increase	4,000
Income from Preference Shares of P Ltd.	44,000
Value of 8% Preference Shares of R Ltd. to be issued [44,000×100/8]	**5,50,000**

B. Equity Shareholders

i. Consideration by way of Equity shares

Valuation of shares of P Ltd.

(12,000 shares × Rs. 240 [WN # 3]

Rs. 28,80,000

Share Capital	Share Premium
[7,200 shares* ×Rs. 100]	[7,200 shares* × Rs. 300]
Rs. 7,20,000	Rs. 21,60,000

* No. of shares to be issued = Rs. 28,80,000 ÷ Rs. 400

= 7,200 Shares

ii. Consideration by way of Preference Shares

	Particulars	*Rs.*
i.	Current equity dividend from R Ltd.	1,92,000
ii.	Expected Equity dividend from P Ltd.	86,400
iii.	Loss in income	1,05,600
iv.	Value of 8% Preference Shares to be issued (1,05,600 ÷ 8%)	**13,20,000**

C. Total Purchase Consideration

[5,50,000 + 28,80,000 + 13,20,000] Rs. 47,50,000

WN # 1 : ***Computation of EPS***

Rs.

Particulars	*P Ltd.*	*R Ltd*
Profit before tax (PBT)	10,64,000	4,80,000
Less : Tax (given)	(4,00,000)	(2,00,000)
Profit after tax (PAT)	6,64,000	2,80,000
Less : Preference dividend	(64,000)	(40,000)
Profit available to equity shareholders	6,00,000	2,40,000
Earnings per share (Profit for Equity Shareholders ÷ No of Shares)	25	20

WN # 2 : P/E ratio of R Ltd.

P/E ratio = $\frac{\text{Market Price}}{\text{EPS}} = \frac{400}{25}$ = Rs. 16

75% of P/E ratio = (16×0.75) = Rs. 12

WN # 3 : Value per share of P Ltd.

= EPS × P/E ratio

= Rs. 20 × Rs. 12

= Rs. 240

WN # 4 : ***Adjustment with Reserves***

Total Purchase Consideration paid to R Ltd.	47,50,000
Less : Share Capital of R Ltd. (Equity + Preference)	16,00,000
To be adjusted with Reserves	31,50,000

∴ Reserves = 30,00,000 + 24,00,000 – 31,50,000 = 22,50,000

P Ltd.

Balance Sheet as at on 31.03.2009 (after absorption)

Liabilities	*Amount Rs.*	*Amount Rs.*	*Assets*	*Amount Rs.*	*Amount Rs.*
Equity Share Capital (@ Rs. 100 each) (24,000 + 7,200 Eq. Shares)		31,20,000	Fixed Assets	55,00,000	
			(+) R Ltd. (27,00,000 + 1,60,000)	28,60,000	83,60,000
8% Preference Shares of Rs. 100 each (8,000+5,500+13,200) = 26,700 shares)		26,70,000	Current Assets	25,00,000	
			(+)R Ltd. (23,00,000 – 2,00,000)	21,00,000	46,00,000
Reserves (WN # 4)		22,50,000			
Securities Premium		21,60,000			
Current Liabilities (18,00,000 + 10,00,000 – 40,000)		27,60,000			
		1,29,60,000			1,29,60,000

II Basics of Amalgamation and Absorption

Illustration - 4

A Ltd. and B Ltd. amalgamated on and from 1st April 2009. A new Company C Ltd. was formed to take over the businesses of the existing companies.

Balance Sheet as on 31.02.2003

Rs. in ′000

Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity Shares of R. 100 each	60,000	70,000	Sundry Fixed Assets	85,000	75,000
General reserve	15,000	20,000	Investments	10,500	5,500
Profit and Loss A/c	10,000	5,000	Stock	12,500	27,500
Investment allowance			Debtors	18,000	40,000
Reserve	5,000	1,000	Cash and Bank	4,500	4,000
Export profit reserve	500	1,000			
12% Debentures	30,000	40,000			
Sundry creditors	10,000	15,000			
	1,30,500	**1,52,000**		**1,30,500**	**1,52,000**

C Ltd. issued requisite number of equity shares to discharge the claims of the equity shareholders of the transferor companies; The total shares issued as consideration is to be aggregate of paid up capital of A Ltd. and B Ltd.

Compute the Purchase Consideration and mode of discharge thereof and draft the Balance Sheet of C Ltd. after amalgamation on the following assumptions.

a. Amalgamation is the nature of MERGER

b. Amalgamation is the nature of PURCHASE

***Solution*:**

i. Amalgamation in the nature of MERGER

- Nature of Amalgamation → MERGER
- Method of Accounting → POOLING OF INTEREST METHOD

ii. Computation of Purchase Consideration

Rs. in '000)

Particulars	A Ltd.		B Ltd.	
A. Assets				
i. Sundry Fixed assets	85,000		75,000	
ii. Investments	10,500		5,500	
iii. Stock	12,500		27,500	
iv. Debtors	18,000		40,000	
v. Cash and Bank	4,500		4,000	
		1,30,500		1,52,000
B. Liabilities				
i. 12% Debentures	30,000		40,000	
ii. Sundry creditors	10,000		15,000	
		(40,000)		(55,000)
C. NET ASSETS taken over [A-B]		**90,500**		**97,000**

Journal Entries in the Books of X Ltd. (in the case of Amalgamation in the nature of Merger)

Purchase consideration for amalgamation in the nature of merger.

Total consideration payable = Aggregate of paid-up capital of A Ltd. and B Ltd.

= Rs. 60,000 + Rs. 70,000

= Rs. 1,30,000

Total net assets taken over = Rs. 90,050 + Rs. 97,000

= Rs. 1,87,500

The total consideration payable to A Ltd. and B Ltd. is apportioned based on the net assets of the companies.

A Ltd. : Rs. 1,30,000 x $\frac{90,500}{1,87,500}$ = Rs. 62,750

B Ltd. : Rs. 1,30,000 x $\frac{97,000}{1,87,500}$ = Rs. 67,250

(Rs. in '000)

Particulars	*Debit*	*Credit*
I. Take over a A Ltd:		
a. For Business Purchase		
Business Purchase A/c Dr.	62,750	
To Liquidator of A Ltd. A/c		62,750
b. For Assets and Liabilities taken over:		
i. Purchase consideration paid - 62,750		
ii. Less: Paid up Share capital - 60,000		
iii. Excess consideration paid - 2,750		

	Particulars		Debit	Credit
	As per AS-14 consideration will be adjusted against for reserves of A Ltd.			
	The General reserves of A Ltd. to be incorporated = Rs. 15,000 - Rs. 2,750 = Rs. 12,250			
	Sundry Fixed Assets A/c	Dr.	85,000	
	Investments A/c	Dr.	10,500	
	Stock A/c	Dr.	12,500	
	Debtors A/c	Dr.	18,000	
	Cash and Bank A/c	Dr.	4,500	
	To General Reserve A/c			12,250
	To Profit and Loss A/c			10,000
	To Investment Allowance Reserve A/c			5,000
	To Export Profit Reserve A/c			500
	To 12% Debentures A/c			30,000
	To Sundry creditors A/c			10,000
	To Business Purchase A/c			62,750
	c. For Discharge of Purchase Consideration:			
	Liquidator of A Ltd. A/c	Dr.	62,750	
	To Equity Share capital A/c			62,750

	Particulars		Debit	Credit
II.	Take over of B Ltd:			
	a. For Business Purchase			
	Business Purchase A/c	Dr.	67,250	
	To Liquidator of B Ltd. A/c			67,250
	b. For Assets and Liabilities Taken over: i. Purchase Consideration Paid : 67,250 ii. Paid up Share capital : 70,000 iii. Short fall to Purchase Consideration : 2,750			
	The above short payment is to be credited to "Capital reserve A/c" as per ICAI - Expert Advisory Committee Opinion on AS-14			
	Sundry Fixed Assets A/c	Dr.	75,000	
	Investments A/c	Dr.	5,500	
	Stock A/c	Dr.	27,500	
	Debtors A/c	Dr.	40,000	
	Cash and Bank A/c	Dr.	4,000	
	To General Reserve A/c			20,000
	To Profit and Loss A/c			5,000
	To Investment Allowance Reserve A/c			1,000

Particulars	*Debit*	*Credit*
To Export Profit Reserve A/c		1,000
To 12% Debentures A/c		40,000
To Sundry Creditors A/c		15,000
To Business Purchase A/c		67,250
To Capital Reserve A/c*		2,750
c. For Discharge purchase consideration:		
Liquidator of B Ltd. A/c Dr.	67,250	
To Equity Share capital A/c		67,250

Balance Sheet of C Ltd. as on 1.04.2009

Rs. in ’000

Liabilities	*Amount*	*Assets*	*Amount*
Share Capital:		Sundry Fixed assets	1,60,000
Equity Shares of		(85,000 + 75,000)	
Rs. 100/- each (60,000+70,000)	1,30,000	Investments (10,500 + 5,500)	16,000
Reserves and surplus:		<u>Current assets</u>:	
Capital Reserve	2,750	Stock (12,500 + 27,500)	40,000
General Reserve (12,250 + 20,000)	32,250	Debtors (18,000 + 40,000)	58,000
Profit and Loss A/c (10,000 + 5,000)	15,000	Cash and Bank (4,500 + 4,000)	8,500
Investment Allowance Reserve			
(5,000 + 1,000)	6,000		
Export Profit Reserve (500 + 1,000)	1,500		
12% Debentures (Note 2)	70,000		
(30,000 + 40,000)			
Current liabilities and Provisions:			
Sundry creditors (10,000 + 15,000)	25,000		
	2,82,500		**2,82,500**

Journal Entries in the Books of C Ltd. (in the case of Amalgamation in the nature of Purchase)

In the case of Amalgamation in the nature of purchase consideration will be paid on the bais of “Net Assets” and hence the purchase consideration is for A - Rs. 90,500 and for B - Rs. 97,500.

Particulars	*Debit*	*Credit*
	Rs.	*Rs.*
I. Take over of A Ltd:		
a. For Business Purchase:		
Business Purchase A/c Dr.	90,500	
To Liquidator of A Ltd. A/c		90,500
b. For Assets and Liabilities taken over:		
Sundry Fixed Assets A/c Dr.	85,000	

Particulars	*Debit*	*Credit*
Investments A/c Dr.	10,500	
Stock A/c Dr.	12,500	
Debtors A/c Dr.	18,000	
Cash and Bank A/c Dr.	4,500	
To Business Purchase A/c		90,500
To 12% Debentures A/c		30,000
To Sundry Creditors A/c		10,000
c. For Discharge of Purchase Consideration:		
Liquidator of A Ltd. A/c Dr.	90,500	
To Equity Share capital A/c		90,500
II. Take over of B Ltd:		
a. For Business Purchase		
Business Purchase A/c Dr.	97,000	
To Liquidator of B Ltd. A/c		97,000
b. For Assets and Liabilities taken over:		
Sundry Fixed Assets A/c Dr.	75,000	
Investments A/c Dr.	5,500	
Stock A/c Dr.	27,500	
Debtors A/c Dr.	40,000	
Cash and Bank A/c Dr.	4,000	
To Business Purchase A/c		97,000
To 12% Debentures A/c		40,000
To Sundry creditors A/c		15,000
c. Discharge of Purchase Consideration:		
Liquidator of A Ltd. A/c Dr.	97,000	
To Equity Share capital A/c		97,000

Note: Assumed that new debetures were issued in exchange of the old debentures.

Amalgamation Adjustment A/c Dr.	7,500	
To Statutory Reserve A/c		7,500

Note: The "Amalgamation Adjustment A/c" should be disclosed as a part of "Miscellaneous Expenditure" to the extent not written off or other similar category in the Balance Sheet of the TRANSFEREE Company.

Balance Sheet of C Ltd. as on 1.4.09 after Amalgamation

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital:		Sundry Fixed assets	1,60,000
Equity Shares of		(85,000 + 75,000)	
Rs. 100/- each (90,500+97,000)	1,87,500	Investments (10,500 + 5,500)	16,000
Reserves and Surplus:		**Current Asset, and Loan Advances:**	
Investment Allowance Reserve		Current Assets:	
(5,000 + 1,000)	6,000	Stock (12,500 + 27,500)	40,000
Export Profit Reserve (500 + 1,000)	1,500	Debtors (18,000 + 40,000)	58,000
12% Debentures (30,000 + 40,000)	70,000	Cash and Bank (4,500 + 4,000)	8,500
Current liabilities and Provisions:		**Miscellaneous Expenditure to**	
Sundry creditors (10,000 + 15,000)	25,000	**the extent not written off:**	
		Amalgamation	7,500
		Adjustment A/c	
	2,90,000		**2,90,000**

Illustration - 5

A Ltd. and B Ltd. were amalgamation on and from 1st April, 2009. A new company X Ltd. was formed to take over the business of the existing companies. The Balance sheet of A Ltd and B Ltd as on 31st March, 2009 are given below:

(Rs. in lakhs)

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Share capital:			Fixed assets:		
Equity Shares of Rs. 100/-	850	725	Land and Building	460	275
each			Plant and Machinery	325	210
10% Preference Share of			Investments	75	50
Rs. 100 each	320	175	Current Asset and		
Reserves and surplus:			Loans and Advances:		
Revaluation Reserve	125	80	Stock	325	269
General reserve	240	160	Sundry Debtors	305	270
Investment Allowance	50	30	Bills receivable	25	—
Reserve			Cash and Bank	385	251
Profit and Loss Account	75	52			
Secured Loans:					
13% Debentures (Rs.100 each)	50	28			
Unsecured Loan:					
Public Deposits	25	—			
Current liabilities and					
Provision:					
Sundry creditors	145	75			
Bills Payable	20	—			
	1,900	**1,325**		**1,900**	**1,325**

Other Information:

i. 13% debentures of A Ltd and B Ltd are discharged by X Ltd. by issuing such number of its 15% debentures of Rs. 100 each so as to maintain the same amount to interest.

ii. Preference shareholders of the two companies are issued equivalent number of 15% preference shares of X Ltd. at a price of Rs. 125 per share (face value Rs. 100)

iii. X Ltd. will issue 4 equity shares for each equity share of A Ltd. and 3 equity shares for each equity share of B Ltd. The shares are to be issued @ Rs. 35 each, having a face value of Rs. 10 per share.

iv. Investment allowance reserve is to be maintained for two more years.

Prepare the Balance sheet of X Ltd. as on 1st April, 2009 after the amalgamation.

Solution:

Method 1: Amalgamation in the Nature of Merger

WN # 1 : ***Calculation of Purchase Consideration***

	Particulars	*A Ltd.*	*B Ltd.*
a.	Equity Shares:		
	i. No. of Shares outstanding	8.50	7.25
	ii. Exchange Ratio	4:1	3:1
	iii. No. of Shares to be issued	34	21.75
	iv. Issue price per share (Rs.)	35	35
	v. Purchase Consideration	1190	761.25
	• Share capital	340	217.50
	• Securities Premium	850	543.75
b.	Preference Shares:		
	i. No. of Shares outstanding	3.2	1.75
	ii. Exchange Ratio	1:1	1:1
	iii. No. of Shares to be issued	3.2	1.75
	iv. Issue price per share (Rs.)	125	125
	v. Purchase Consideration	400	218.75
	• Share capital	320	175.00
	• Securities Premium	80	43.75
c.	Total Considertion {a(iv) + b(iv)}	1590	980.00
		Rs. 2,570 Lakhs	

WN # 2 : ***Computation of Debenture to be issued***

	Particulars	*A Ltd.*	*B Ltd.*
a.	Value of 13% Debentures takes over	50,00,000	28,00,000
b.	13% Interest on above value	6,50,000	3,64,000
c.	15% Debentures to be issued to keep same interest amount	43,33,333.33	24,26,666.66
		$\left[6,50,000 \times \frac{100}{15}\right]$	$\left[3,64,000 \times \frac{100}{15}\right]$
d.	Total amont of debenture issued		Rs. 67,60,000

Note: Normally fractions of Debentures is settled in Cash.

Balance Sheet of A Ltd. as at 31st March 2009 (after amalgamation)

(Rs. in Lakhs)

Liabilities	*Amount*	*Assets*	*Amount*
Share Capital:		**Fixed Assets:**	
Equity Share capital:		Land and Building	
Authorized, issued and		(460 + 275)	735.00
Subscribed		Plant and Machinery	
Capital (340 Lakhs + 217.50	557.50	(325 + 210)	535.00
Lakhs) of Rs. 10 each -		Investment (75+50)	
[out of the above all the		Current Asset and	125.00
shares were issued for		Loans and Advances:	
consideration other than cash]		Stock (325+269)	594.00
15% Preference Share capital		Debtors (305+270)	575.00
or Rs. 100 each (320000+175000)	495.00	Bills Receivable (25+ –)	25.00
[of the above all the shares were		Cash and Bank	636.00
issued for consideration other		(385+251)	
than cash]			
Reserves and surplus			
Share Premium	1,517.50		
[850+543.75+80+43.75]			
Profit and Loss (WN # 3)	37.40		
Revaluation Reserve	205.00		
Investment allowance reserve	80.00		
Secured Loans:			
15% Debentures	67.60		
(Rs. 100 each) (WN # 2)			
Unsecured Liabilities :			
Public deposits	25.00		
Current liabilities and Provisions:			
Sundry Creditors (145+75)	220.00		
Bills Payable	20.00		
	3,225.00		**3,225.00**

WN # 3: ***Calculation of reserves to be incorporated in Balance Sheet.***

Particulars	*A Ltd.*	*B Ltd.*
a. Aggregated Purchase Consideration		2,570
b. Aggregate paid-up capial		
i. Equity Share capital	1,575	
ii. Preference Share capital	495	2,070
c. Excess		500
d. The above excess to be adjusted against:		
i. General reserves	400	
ii. P and L Account	100	500
e. Balance of Reserves available		
i. Profit and Loss A/c	27	
ii. Investment allowance reserve	80	
iii. Revaluation reserve	205	312
f. Settlement to debenture holders		
i. Debenure capital of transferee companies	78.00	
ii. Less : Amount of A Ltd.'s debenture issued	(67.60)	
iii. Profit to be credited to Profit and Loss A/c		10.40
g. Balance of reserves to be incorporated		
i. P and L Account		37.40
ii. Investment allowance reserve		80.00
iii. Revaluation reserve		205.00

Method 2: Amalgamation in Nature of Purchase

Balance Sheet of A Ltd. as on 31.03.09 (after amalgamation)

Liabilities	*Rs. in Lakhs*	*Assets*	*Rs. in Lakhs*
Share capital:		Fixed assets: (WN1)	
Equity Share capital of Rs. 100 each (of		Land and Building	735.00
the above all he shares were issued for		Plant and Machinery	535.00
consideration other than cash)	557.50	Investments	125.00
15% Preference Share capital of Rs. 100		Current assets and	
each (of the above all the share were issued		Loans and Advances	
for consideration other than for cash)	495.00	Stock	594.00
Reserves and surplus:		Debtors	575.00
Securities Premium (WN#1)	1517.50	Bills Receivable	25.00
Capital reserve (312+10.40)	322.40	Cash and Bank	636.00
Investment allowance	80.00	Misc. Exp. to be	
Secured Loans		extent not written off	
15% Debentures of Rs. 100 each	67.60	Amalgamation	
Unsecured Liabilities		Adjustment amount	80.00
Public deposits	25.00		
Current liabilities and Provisions:			
Creditors	220.00		
Bills Payable	20.00		
	3,305.00		**3,305.00**

Illustration - 6

A Limited and B Limited were amalgamated on and from 1st April, 2009. A new company D Limited was formed to takeover the business of the existing companies. The Balance Sheet of A Limited and B Limited and as on 31st March, 2009 are given below:

(Rs. in lakhs)

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Share capital:			Fixed assets	1,200	1,000
Equity Shares of Rs. 100 each	1,000	800	Current assets, Loans and Advances	880	565
15% Preference Share Capital of Rs. 100 each	400	300			
Reserve and Surplus:					
Revaluation Reserve	100	80			
General Reserve	200	150			
P & L Account	80	60			
Secured Loan:					
12% Debentures of Rs. 100 each	96	80			
Current Liabilities and Provisions	204	95			
	2,080	**1,565**		**2,080**	**1,565**

Other Information :

1. 12% Debenture holders of A Ltd. and B Ltd. are discharged by D Limited by issuing adequate number of 16% Debentures of Rs. 100 each to ensure that they continue to receive the same amount of interest.
2. Preference shareholders of A Ltd. and B Ltd. have received same number of 15% Preference share of Rs. 100 each of D Limited.
3. D Ltd. has issued 1.5 equity shares for each equity share of A Ltd. and 1 equity share each equity share of B Ltd. The face value of shares issued by D Ltd. is Rs. 100 each.

Required:

Prepare the Balance sheet of D Ltd. as on 1st April, 2009 after the amalgamation has been carried out using pooling of interest method.

Solution:

WN # 1 : ***Calculation of purchase consideration:***

	Purchase consideration	*A Ltd.*	*B Ltd.*
i.	No. of equity shares	10,00,000	8,00,000
	Exchange Ratio	1:1.5	1:1
	No. of equity shares to be issued	15,00,000	8,00,000
	Equity Shares capital	Rs. 15,000 Lakhs	Rs. 800 Lakhs
ii.	No. of preference shares	4,00,000	3,00,000
	Exchange Ratio	1:1	1:1
	No. of preference share to be issued	4,00,000	3,00,000
	Preference Share Capital	Rs. 400 Lakhs	Rs. 300 Lakhs

Journal Entries in the books of D Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars		**A Ltd.**		**B Ltd.**	
			Debit Rs.	**Credit Rs.**	**Debit Rs.**	**Credit Rs.**
a.	For Business Purchase					
	Business Purchase A/c	Dr.	1,900		1,100	
	To Liquidator of Selling Co. A/c			1,900		1,100
b.	Incorporation of Assets and Liabilities taken over:					
	Fixed Assets A/c	Dr.	1,200		1,000	
	Current Assets A/c	Dr.	880		565	
	Profit and Loss A/c	Dr.	120			
	To Current Liabilities A/c			204		95
	To 12% Debentures A/c			96		80
	To Revaluation Reserve A/c			—		80
	To General Reserve A/c	WN#2		—		150
	To Pofit and Loss A/c			—		60
	To Business Purchase A/c			1,900		1,100
c.	Discharge of Purchase Consideration					
	Liquidator of Selling Co. A/c	Dr.	1,900		1,100	
	To Equity Share Capital A/c			1,500		800
	To Preference Share Capital A/c			400		300
d.	Discharge of Debentures:					
	12% Debentures A/c	Dr.	96		80	
	To 16% Debentures A/c			72		60
	To Profit & Loss A/c (WN # 3)			74		20

WN # 2 : ***Reserves to be incorporated on the Amalgamation:***

(in Lakhs)

	Particulars		*A Ltd.* *Rs.*	*B Ltd.* *Rs.*
(i)	Purchase consideration payable		1,900	1,100
(ii)	Total paid up Share capital			
	(a) Equity Share capital	1,000		
	(b) Preference Share capital	400	1,400	1,100
(iii)	Excess purchase consideration		500	Nil
(iv)	Adjustment against reserves of transferee company:			
	(a) General reserve		(200)	
	(b) Profit & Loss A/c Balance		(80)	
	(c) Revaluation resrve		(100)	
	(d) Profit & Loss A/c debit balance		(120)	
(v)	Reserves of transferor company to be incorporated			
	(a) Revaluation Reserve		—	80
	(b) General Reserve		—	150
	(c) Profit & Loss A/c		—	60

WN # 3 : ***Settlement of Debentures:***

(in Lakhs)

	Particulars	*A Ltd.* *Rs.*	*B Ltd.* *Rs.*
(i)	Value of 12% Debentures	96	80
(ii)	Interest Payable	11.52	9.6
(iii)	16% Debentures to be issued $\left[\frac{11.52}{16} \text{ x } 100\right]\left[\frac{9.6}{16} \text{ x } 100\right]$	72	60
(iv)	Amount to be credited to Profit & Loss A/c (i)-(iii)	24	20

Balance Sheet D Ltd. as on 31.03.2009

Liabilities		*Amount*	*Assets*	*Amount*
Share capital:			Fixed assets	2,200
Equity Share capital		2,300	(1,200 + 1,000)	
Preference Share capital		700	Current assets, Loans and	1,445
Reserves and Surplus:			Advances (880+665)	
General Reserve	150			
Profit & Loss A/c	(116)			
[(220)+60+20+24)				
Revaluation Reserve	180			
16% Debentures		132		
Current Liabilities		299		
		3,645		**3,645**

Illustration - - 7

Given below Balance Sheets of M Ltd. and N Ltd. as on 31st March, 2009.

Balance Sheets

(in 000's)

	M Ltd. **Rs.**	**NLtd.** **Rs.**
Share Capital	1,00,000	1,20,000
General Reserve	50,000	40,000
Export Profit Reserve	20,000	30,000
(Statutory Reserve as per Income Tax Law)		
14% Debentures	50,000	50,000
Sundry Creditors	20,000	10,000
Provisions	20,000	20,000
Proposed Dividend	25,000	30,000
	2,85,000	**3,00,000**

Assets	**M Ltd.** **Rs.**	**N Ltd.** **Rs.**
Fixed Assets	1,65,000	1,80,000
Investments	50,000	—
Stock	50,000	50,000
Debtors	15,000	65,000
Cash and Bank Balances	5,000	5,000
	2,85,000	**3,00,000**

Shares of M Ltd. and N Ltd. are Rs. 100/- each. M Ltd. held 15% shares of N Ltd. Z Ltd. has been formed for the purpose of amalgamation which took over M Ltd. and N Ltd. and in exchange, shares of Z Ltd. were issued. Expenses for amalgamation were Rs. 100 thousand. You are required to prepare post amalgamation balance sheet of Z Ltd. Show also the purchase consideration and exchange ratio. Calculate the number of shares to be issued to the shareholders of the amalgamated company without increasing the issued capital.

Solution:

(I) ***Calculation of Purchase Consideration***

(Rs. in '000's)

	Particulars	M Ltd. Rs.	N Ltd. Rs.
a.	Sundry Assets	2,85,000	3,00,000
b.	Outside Liabilities:		
	i. Debentures	50,000	50,000
	ii. Creditors	20,000	10,000
	iii. Provisions	20,000	20,000
	iv. Proposed Dividend	25,000	30,000
		1,15,000	1,10,000
c.	Net Assets (a-b)	1,70,000	1,90,000
d.	Consideration restricted to Rs. 2,20,000 in the ratio 17:19 as the problem required not to increase the Share capital.	1,03,900	1,16,100

(II) ***In the books of Z Ltd.***

Section A : Amalgamation of M Ltd and N Ltd.

- Nature of Amalgamation - Merger
- Method of Amalgamation - Pooling of Interest

(Rs. in '000)

Particulars		M Ltd.		N Ltd.	
		Debit	Credit	Debit	Credit
1. For Business Purchase :					
Business Purchase A/c	Dr.	1,03,900		1,16,100	
To Liquidator of M Ltd.			1,03,900		1,16,100
2. For Assets and Liabilities Taken over:					
a. Purchase consideration		1,03,900		1,16,100	
b. Less: Paid up capital		(1,00,000)		(1,20,000)	
c. Excess consideration paid (Short fall)		3,900		(3,900)	
d. Above excess to be adjusted against General Reserve of M Ltd.					
e. Balance reserve to be taken from M Ltd. to incorporate in Z Ltd.					

Particulars	A Ltd.		B Ltd.	
	Debit	Credit	Debit	Credit
• General Reserve (50,000 - 3900)	46,100		43,900	
• Export Profit Reserve	20,000		30,000	
Fixed Assets A/c Dr.	1,65,000		1,80,000	
Investments A/c Dr.	50,000		—	
Stock A/c Dr.	50,000		50,000	
Debtors A/c Dr.	15,000		65,000	
Cash and Bank Balances A/c Dr.	5,000		5,000	
To Debenture holders A/c		50,000		50,000
To Creditors A/c		20,000		10,000
To Provisions A/c		20,000		20,000
To Proposed Dividend A/c		25,000		30,000
To General Reserve A/c (WN # 1 and 2)		46,100		43,900
To Export Profit Reserve A/c		20,000		30,000
To Business Purchase A/c		1,03,900		1,16,100
3. For Discharge of Purchase Consideration:				
Liquidator of M Ltd. A/c Dr.	1,03,900		1,16,100	
To Equity Share Capital A/c		1,03,900		1,16,100

(B) : Other transactions

(Rs. in '000)

Particulars	*Debit*	*Credit*
1. Issue of debentures to debenture holders of M Ltd. and N Ltd.		
Debenture holders of M Ltd. Dr.	50,000	
Debenture holders of N Ltd. Dr.	50,000	
To 14% Debentures A/c		1,00,000
2. Expenses of amalgamation		
Profit and Loss A/c Dr.	1,000	
To Bank A/c		1,000

Balance Sheet of Z Ltd. as at 31st March 2009

Liabilities	*Amount (Rs. '000)*	*Assets*	*Amount (Rs. '000)*
Share capital:		Fixed Assets (1,65,000 + 1,80,000)	3,45,000
Authorized, Issued and Subscribed		Investments (50,000 + Nil)	50,000
(of the above, all shares are issued		Curent assets and Loans	
for consideration other than cash to		and Advances	

Liabilities		*Amount (Rs. '000)*	*Assets*		*Amount (Rs. '000)*
M Ltd. and N Ltd. pursuant to		2,20,000	Stock (50,000 + 50,000)		1,00,000
Amalgamation approved by			Cash at Bank	10,000	
Honorable court)			Less : Preliminary	(1,000)	
Reserves and surplus :			Expenses		9,000
General Reserve					
(43,900 + 46,100)	90,000		Debtors (15,000 + 65,000)		80,000
Less: Profit and Loss a/c	(1,000)				
(Debit Balance)		89,000			
Export Profit Reserve (20,000 + 30,000)		50,000			
Secured Loan					
14% Debentures		1,00,000			
Current liabilities to the Provisions					
Creditors		30,000			
Provisions		40,000			
Proposed Dividend		55,000			
		5,84,000			**5,84,000**

Illustration - 8

D Ltd. and F Ltd. were amalgamated on and from 1st April, 2009. A new Company P Ltd. was formed to takeover the business of the existing companies. The Balance Sheets of D Ltd. and F Ltd. as on 31st March, 2009 are given below:

Liabilities	**D Ltd.**	**F Ltd.**	**Assets**	**D Ltd.**	**F Ltd.**
Share capital			**Fixed assets:**		
Equity Shar of Rs. 10 each	85,000	72,500	Land and Building	79,500	43,300
9% Preference	32,000	17,500	Investments	7,500	5,000
Shares of Rs. 100 each			**Current assets:**		
Reserve and Surplus:			Stock	32,500	26,900
Revaluation Reserve	12,500	8,000	Debtors	30,500	27,000
General Reserve	24,000	16,000	Bills Receivable	2,500	—
Export Profit Reserve	7,500	3,000	Cash and Bank	30,000	25,100
Secured Loan:					
13% Debentures of	5,000	2,800			
Rs. 100 each					
Current liabilities					
and Provisions					
Bills Payable	2,000	–			
Sundry creditors	14,500	7,500			
	1,82,500	**1,27,300**		**1,82,500**	**1,27,300**

Other informations :

1. 13% Debenture holders of D Ltd. and F Ltd. are discharged by P Ltd. by issuing such number of its 15% Debentures of Rs. 100 each so as to maintain the same amount of interest.
2. Preference Shareholders of the two companies are issued equivalent number of 12% Preference Shares of P Ltd. at a price of Rs. 12.50 per share (face value Rs.10).
3. P Ltd. will issue 2 equity shares for each equity share of D Ltd. and 2 equity shares for each equity share of F Ltd. at Rs. 15 per share having a face value Rs. 10.
4. Export Profit Reserve is to be maintained for two more years.

Prepare Journal Entries and prepare the Balance Sheet of P Ltd. after the amalgamation is carried out using under Merger Method.

Solution :

WN # 1 : ***Calculation of Purchase Consideration***

Particulars			*D Ltd.* *Rs.*	*F Ltd.* *Rs.*
a.	In Preference shares :			
	i.	No. of Preference shares outstanding	3,200	1,750
	ii.	Exchange ratio	1:1	1:1
	iii.	No. of shares to be issued	3,200	1,750
	iv.	Issue Price	Rs. 12.5	Rs. 12.5
	v.	Value of Shares to be issued	Rs. 40,000	Rs. 21,875
b.	In Equity shares :			
	i.	No. of Preference shares outstanding	8,500	7,250
	ii.	Exchange ratio	2:1	2:1
	iii.	No. of shares to be issued	17,000	14,500
	iv.	Issue Price	Rs. 15	Rs. 15
	v.	Value of Shares to be issued	Rs. 2,55,000	Rs. 2,17,500
c.	**Total Purchase Consideration (a+b)**		**Rs. 2,95,000**	**Rs. 2,39,375**

In the books of P Ltd.

1. Amalgamation of D Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars			Debit	Credit
a.	For Busines Purchase				
	Business Purchase A/c		Dr.	2,95,000	
	To Liquidator of D Ltd.				2,95,000
b.	Incorporated of assets and liabilities				
	Consideration	2,95,000			
	Less: Paid up share capital	(1,17,000)			
	Amount to be adjusted against reserves	1,78,000			
	Less : General reserve	(24,000)			
	Profit and Loss balance (Dr.)	1,54,000			
	Land and Building A/c		Dr.	79,500	
	Investments A/c		Dr.	7,500	
	Stock A/c		Dr.	32,500	
	Debtors A/c		Dr.	30,500	
	Bill Receivable A/c		Dr.	2,500	
	Profit and Loss A/c		Dr.	1,54,000	
	Cash and bank A/c		Dr.	30,000	
	To Revaluation Reserve A/c				12,500
	To Bills Payable A/c				2,000
	To Sundry Creditors A/c				14,500
	To Debenture A/c				5,000
	To Business Purchase A/c				2,95,000
	To Export Profit Reserve A/c				7,500
c.	For Discharge of Consideration				
	Liquidator of D Ltd. A/c		Dr.	2,95,000	
	To Equity Share Capital A/c				1,70,000
	To Preference Share Capital A/c				32,000
	To Securities Premium A/c				93,000

*Note: Securities Premium includes both Equity & Preference shares Premium

II. Amalgamation of F Ltd.

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

Particulars			*Debit* *Rs.*	*Credit* *Rs.*
a. For Business Purchase:				
Business Purchase A/c		Dr.	2,39,375	
To Liquidator of F Ltd.				2,39,375
b. For of Assets and Liabilities taken over:				
Amount of Reserves to be incorporated.				
Consideration	2,39,375			
Less: Paid up Share capital	(90,000)			
Amount to be adjusted against Reserves	1,49,375			
Less : General Reserve	(16,000)			
Profit and Loss Balance (Dr.)	1,33,375			
Land and Building A/c		Dr.	3,300	
Investments A/c		Dr.	5,000	
Stock A/c		Dr.	26,900	
Debtors A/c		Dr.	27,000	
Cash and Bank A/c		Dr.	25,100	
Profit and Loss A/c		Dr.	1,33,375	
To Revaluation Reserve A/c				80,000
To Export Profit Reserve A/c				3,000
To 13% Debentures A/c				2,800
To Sundry Creditors A/c				7,500
To Business Purchase A/c				2,39,375
c. For Discharge of consideration				
Liquidator of F Ltd. A/c		Dr.	2,39,375	
To Equity Share Capital A/c				1,45,000
To Preference Share Capital A/c				17,500
To Securities Premium A/c				76,875

III. Others :

Particulars		*Debit*	*Credit*
For Discharge of Debenture Liability			
13% Debenture A/c	Dr.	7,800	
To 15% Debentures A/c			6,760
To Profit and Loss A/c			1,040

WN # 2 : Discharge of Debentures :

Rs.

a. 13% Debenture Outstanding = 5,000 + 2,800 = 7,800

b. Interest Payable = 650 + 364 = 1,014

c. 15% Debenture to be issued = 4,333 + 2,427 = 6,760

$$\left[\frac{650}{15\%}\right]+\left[\frac{364}{15\%}\right]$$

d. Amount to be credited to profit and loss account [(a)-(c)] =667 + 373 1,040

Note:

In "Amalgamation in the nature of Merger" all the assets and liabilities are to be taken at Book values. Change in the rate of interest will amount to violation of the above condition i.e. it is in the nature of purchase. But as the problem specifically require to solve "in the nature of merger", the problem is solved accordingly.

Balance sheet of P Ltd.as on 01.04.09

Liabilities	*Amount*	*Assets*	*Amount*
Share capital:		Fixed Assets:	
Equity shares of Rs. 10 each	3,15,000	Land and Building	1,22,800
9% Preference Shares of Rs. 10 each	49,500	Investments	12,500
Reserve and Surplus :		Current Assets :	
Securities Premium :		Stock	59,400
(85,000 + 72,500 + 8,000 + 4,375)	1,69,875	Debtors	57,500
Revaluation Reserve	20,500	Cash and Bank	55,100
Export Profit Reserve	10,500	Bills Receivable	2,500
Secured Loans :		Profit / Loss	2,86,335
15% Debentures of Rs. 100 each	6,760	(1,54,000 + 1,33,375 -	
Current liabilities and Provisions :		1,040)	
Bills Payable	2,000		
Sundry creditors	22,000		
	5,96,135		**5,96,135**

Illustration - 9

Given below Balance Sheets of Ram Ltd and Rahim Ltd. as on 31.3.2009. Rahim Ltd. was merged with Ram Ltd. with effect from 01.04.2009.

Balance Sheets as on 31.3.2009

(Rs.)

Liabilities	**Ram Ltd.**	**Rahim Ltd.**	**Assets**	**Ram Ltd.**	**Rahim Ltd.**
Share Capital :			Sundry Fixed Assets	9,50,000	4,00,000
Equity Shares of			Investments (Non-	2,00,000	50,000
Rs. 10 each	7,00,000	2,50,000	trade)		
General Reserve	3,50,000	1,20,000	Stock	1,20,000	50,000
Profit and Loss A/c	2,10,000	65,000	Debtors	75,000	80,000
Export Profit Reserve	70,000	40,000	Advance Tax	80,000	20,000
12% Debentures	1,00,000	1,00,000	Cash and Bank	2,75,000	1,30,000
Sundry Creditors	40,000	45,000	balances		
Provision for Taxation	1,00,000	60,000	Preliminary Expenses	10,000	—
Proposed Dividend	1,40,000	50,000			
	17,10,000	**7,30,000**		**17,10,000**	**7,30,000**

Ram Ltd. would issue 12% Debentures to discharge the claims of the debenture holders of Rahim Ltd. at par. Non-trade investments of Ram Ltd. fetched @ 25% while those of Rahim Ltd. fetched @ 18%. Profit (pre-tax) by Ram Ltd and Rahim Ltd. during 2006-07, 2007-08 and 2008-09 and were as follows :

Year	Ram Ltd. Rs.	Rahim Ltd. Rs.
2006-07	5,00,000	1,50,000
2007-08	6,50,000	2,10,000
2008-09	5,75,000	1,80,000

Goodwill may be calculated on the basis of capitalisation method taking 20% as the pretax normal rate of return. Purchase consideration is discharged by Ram Ltd. on the basis of intrinsic value per share. Both companies decided to cancel the proposed dividend.

Required Balance Sheet of Ram Ltd. after merger.

Solution:

WN # 1: ***Purchase Consideration**:*

(i)	Shares outstanding in Rahim Ltd.	25,000
(ii)	Intrinsic Value per Share of Rahim Ltd. [WN # 2]	Rs. 36.20
(iii)	Value of Shares (a×b)	Rs. 9,05,000

(iv) Intrinsic value per share of Ram Ltd. [WN # 2] Rs. 40.40

(v) No. of shares to be issued by Ram Ltd.

Rs. 905000 / Rs. 40.40 = 22400.99

Shares	Cash for fractions
22400	0.99 × 40.40 = 40

(iv) Purchase consideration

(a) 22400 shares @ 40.40

Capital [Rs.10 / Share]	2,24,000		
Premium [Rs. 30.40 / Share]	6,80,960	=	9,04,960
(b) Cash for fractional shares		=	40
(c) Total purchase consideration payable		=	9,05,000

WH # 2 : ***Intrinsic Value per share :***

(Rs.)

			Ram Ltd.		**Rahim Ltd.**	
(i)	**Assets**					
	(a)	Goodwill	13,65,000		3,80,000	
	(b)	Sundry Fixed assets	9,50,000		4,00,000	
	(c)	Investments	2,00,000		50,000	
	(d)	Stock	1,20,000		50,000	
	(e)	Debtors	75,000		80,000	
	(f)	Advance Tax	80,000		20,000	
	(g)	Cash and Bank Balance	2,75,000	30,65,000	1,30,000	11,10,000
(ii)	**Liabilities**					
	(a)	12% Debentures	1,00,000		1,00,000	
	(b)	Sundry creditors	40,000		45,000	
	(c)	Provision for tax	1.00,000	(2,40.000)	60.000	(2,05.000)
(iii)	Net Assets (i-ii)			28,25,000		9,05,000
(iv)	No. of Outstanding Shares			70,000		25,000
(v)	Intrinsic Value per share (iii)/(iv)			**40.40**		**36.20**

W # 3 : Valuation of Goodwill

A. Capital Employed

	Ram Ltd.		*Rahim Ltd.*	
(i) Assets :				
(a) Sundry Fixed assets	9,50,000		4,00,000	
(b) Investment (Non-trade)	-		-	
(c) Stock	1,20,000		50,000	
(d) Debtors	75,000		80,000	
(e) Advance tax	80,000		20,000	
(f) Cash and Bank balance	2,75,000	15,00,000	1.30.000	6,80,000
(ii) Liabilities:				
(a) 12% Debentures	1,00,000		1,00,000	
(b) Sundry creditors	40,000		45,000	
(c) Provision for tax	1,00,000	2,40,000	60,000	2,05,000
(iii) Capital Employed : (i) - (ii)		**12,60,000**		**4,75,000**

B. Average Pre-tax Profit :

	Particulars	*Ram Ltd.*	*Rahim Ltd.*
(i)	2006-07	5,00,000	1,50,000
(ii)	2000-08	6,50,000	2,10,000
(iii)	2008-09	5,75,000	1,80,000
(iv)	Total (a+b+c)	17,25,000	5,40,000
(v)	Simple Average [(iv)/3]	5,75,000	1,80,000
(vi)	Less: Non-trading income	(50,000)	(9,000)
(vii)	**Average pre-tax profit**	**5,25,000**	**1,71,000**

C. Computation of Goodwill :

	Particulars	*Ram Ltd.* *Rs.*	*Rahim Ltd.* *Rs.*
a.	Capitalised value of average profits $\left[\frac{5,25,000}{0.20};\frac{1,71,000}{0.20}\right]$	26,25,000	8,55,000
b.	Capital Employed	12,60,000	4,75,000
c.	**Goodwill (a-b)**	**13,65,000**	**3,80,000**

Journal Entries - Books of Ram Ltd.

- Nature of Amalgamation – PURCHASE
- Method of Accounting – PURCHASE METHOD

Particulars		*Debit*	*Credit*
a. For Business Purchase:			
Business Purchase A/c	Dr.	9,05,000	
To Liquidator of Rahim Ltd. A/c			9,05,000
b. For Assets and Liabilities taken over			
Goodwill A/c	Dr.	3,80,000	
Fixed Assets A/c	Dr.	4,00,000	
Investments A/c	Dr.	50,000	
Stock A/c	Dr.	50,000	
Debtors A/c	Dr.	80,000	
Advance tax A/c	Dr.	20,000	
Cash and Bank A/c	Dr.	1,30,000	
To 12% Debenture holders A/c			1,00,000
To Creditors A/c			45,000
To Provision for Taxation A/c			60,000
To Business Purchase A/c			9,05,000
c. For Discharge of Purchase Consideration:			
Liquidator of Rahim Ltd.	Dr.	9,05,000	
To Equity Share capital A/c			2,24,000
To Securities premium A/c			6,80,000
To Cash A/c			40
d. Contra Entry			
Amalgamation Adjustment A/c	Dr.	40,000	
To Export Profit Reserve A/c			40,000

Balance Sheet Ram Ltd as at 01.04.09 (after Merger)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital:		Fixed assets:	
Issued, Subscribed Paid up	9,24,000	Goodwill (WN # 3C)	3,80,000
Share capital		Sundry Fixed assets	13,50,000
92,400 Equity Shares of Rs. 10 each.		(9,50,000 + 4,00,000)	
(Of which 22,400 shares were		Investment	2,50,000
issued for consideration other		Current assets, Loans	
than cash)		and Advances:	
Reserves and surplus		Stock (1,20,000 + 50,000)	1,70,000
Share Premium	6,80,960	Debtors (75,000 + 80,000)	1,55,000
General Reserve	3,50,000	Advance tax (80,000+20,000)	1,00,000

Liabilities	*Rs.*	*Assets*	*Rs.*
Profit and Loss A/c 2,10,000		Cash and Bank Balances	
Add: Proposed		(2,75,000 + 1,30,000 - 40)	4,04,960
Dividend cancelled 1,40,000	3,50,000	Miscellaneous Expenses:	
Export Profit Reserve	1,10,000	Preliminary Expenses	10,000
(70,000 + 40,000)		Amalgamation	
Secured Loans		Adjustment A/c	40,000
12% Debenture	2,00,000		
(1,00,000 + 1,00,000)			
Current liabilities and provisions:			
Sundry creditors			
(40,000 + 45,000)	85,000		
Provision for tax			
(1,00,000 + 60,000)	1,60,000		
	28,59,960		**28,59,960**

Illustration - 10

The following are the Balance sheets of Fat Ltd. and Thin Ltd. for the year ending on 31st March, 2009.

(Figures in Crores)

	Fat Ltd.	**Thin Ltd.**
Equity Share capital. @ Rs. 10 each	50	40
Preference Share capital - in 12% preference shares of Rs. 100 each	–	60
Reserves and surplus	200	150
	250	250
Loan - Secured	100	100
Total	**350**	**350**
Fixed assets (at cost less depreciation)	150	150
Current assets less Current liabilities	200	200
Total	**350**	**350**

The present worth of Fixed assets of Fat Ltd. is Rs. 200 crores and that of Thin Ltd. is Rs. 429 crores. Goodwill of Fat Ltd. is Rs. 40 crores and of Thin Ltd. is 75 crores.

Thin Ltd. absorbs Fat Ltd. by issuing equity shares at par in such a way that intrinsic networth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

(a) Show the Balance Sheet after absorption.

(b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

Solution :

Part-I : ***Purchase consideration***

WN # 1 : Intrinsic Value of Equity Shares

(Rs. in Crores)

Particulars		*Fat Ltd.*	*Thin Ltd.*
a)	**Assets :**		
	i. Goodwill	40	75
	ii. Fixed assets	200	429
	iii. Current asset less Current liabilities	200	200
		440	704
b)	**Liabilities**		
	i. Secured Loans	(100)	(100)
	ii. 12% Preference Share capital	-	(60)
c)	Net Assets attributable to Equity shareholders	340	544
d)	Number of Shares (in Crores)	5	4
e)	Value per share of Rs. 10 each	Rs. 68	Rs. 136

WN # 2 : ***Determination of Exchange Ratio and the number of shares to be issued***

Exchange Ratio is based on intrinsic value per share of the companies

		Fat Ltd.	:	Thin Ltd.
i.	Intrinsic value	Rs. 68	:	Rs. 136
ii.	Exchange ratio	1	:	2

1 share of Small Ltd. for 2 shares of Fat Ltd.

Therefore, Number of shares to be issued = Number of shares of Thin Ltd. × %

= 5 crores × 50% (i.e. ratio is 1:2 =50%)

= 2.5 crores

Journal Entries in the books of Thin Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

(Rs. in Crores)

Particulars		*Debit Rs.*	*Credit Rs.*
1. For Business Purchase			
Business Purchase A/c	Dr.	25	
To Liquidator of Fat Ltd.			25
2. For assets and liabilities taken over :			
Fixed Assets A/c	Dr.	150	
Net Current Assets A/c	Dr.	200	
To Secured Loans A/c			100
To Capital Reserve A/c			225
To Business Purchase A/c			25
3. For Discahrge of Purchase Consideration :			
Liquidator of Fat Ltd. A/c	Dr.	25	
To Equity Share Capital A/c			25

Balance Sheet of Thin Ltd. as at 1st April, 2009

Liabilities		*Rs.*	*Assets*	*Rs.*
Share capital 6.5 crore equity shares of Rs.10 each (of the above shares, 2.5 crores equity shares are allotted as fully paid up for consideration other than cash)		65	Fixed assets (150 + 150)	300
			Net Current assets (200 + 200)	400
12% Preference Share capital (60 lakhs shares of Rs. 100 each)		60		
Reserves and surplus :				
Capital Reserve	225			
Other Reserve	150	375		
Secured Loans (100+100)		200		
		700		**700**

WN 3 : ***Statement to prove the accuracy of workings.***

(Rs. in Crores)

(i)	Equity Share capital (after absorption)	65
	Add: Reserves Surplus (after absorption)	375
	Add: Unrecorded value of goodwill (40+75)	115
	Add: Unrecorded incremental value of Fixed assets (50+279)	329
	Value of the Business	884
(ii)	Number of Equity shares (4 + 2.5)	6.5 Crores
(iii)	Intrinsic value of an equity share (884/6.5)	Rs. 136

Illustration - 11

Divya Ltd. agreed to take over the Swati Ltd. as a going concern-both companies being engaged in the same trade.

Divya Ltd. was to pay the debentures and liabilities of Swati Ltd. and take over the assets, the consideration being the issue by Divya Ltd. of 4,00,000 fully paid shares of Rs. 10 each and the payment of Rs. 3,00,000 in cash to the Swati Ltd. Divya Ltd. was to pay the liquidation expenses, which amounted to Rs. 1,40,000.

The Balances in the books of the respective companies, as on the date of absorption are given hereunder.

Particulars	Assets Divya Ltd. Rs.	Assets Swati Ltd. Rs.	Liabilities Divya Ltd. Rs.	Liabilities Swati Ltd. Rs.
Authorised Capital :				
Divya Ltd. 20,00,000 shares of Rs.10 each.			<u>2,00,00,000</u>	<u>75,00,000</u>
Swati Ltd. 7,50,000 shares of Rs.10 each				
Issued Capital	–	–	1,50,00,000	50,00,000
Unpaid Calls	50,000	10,000	–	–
10% Debentures	–	–	50,00,000	10,00,000
Land and Buildings	1,03,33,000	35,68,200	–	–
Goodwill	30,00,000	5,00,000	–	–
Sundry Debtors and Creditors	7,24,000	3,98,400	834,200	4,36,200
Bank Balances	16,84,200	–	–	2,00,000
Stock	17,92,600	7,85,200	–	–
Plant and Machinery	38,76,800	16,43,900	–	–
Bills Receivable	3,62,100	–	–	–
Profit and Loss Account balances	–	–	9,88,500	2,69,500
	2,18,22,700	***69,05,700***	***2,18,22,700***	***69,05,700***

Assume that the absorption was duly effected but that the unpaid calls and a book debt of Rs.40,000 due to Swati Ltd. proved irrecoverable.

Prepare the Realisation Account and Members Account in the books of Swati Ltd. and the Balance Sheet of Divya Ltd. after the absorption. Your working should form part of the answer.

Solution :

Part I - *Calculation of Purchase* consideration - *Payments* Method

Divya Ltd to take over Swati Ltd by :

			Rs.
a.	Issuing 4,00,000 equity shares of Rs.10 each fully paid	:	40,00,000
b.	Cash	:	3,00,000
c.	***Total Purchase consideration***		**43,00,000**

Part II - *In* the *books of transferor company Swati Ltd.*

Realisation Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Goodwill	5,00,000	By 10% Debentures	10,00,000
To Land	35,68,200	By Sundry Creditors	4,36,200
To Sundry debtors	3,98,400	By Bank Overdraft	2,00,000
To Stock	7,85,200	By Bad debts	40,000
To Plant and Machinery	16,43,900	By Shareholders A/c Loss on Realisation (balancing figure)	9,19,500
To Cash (Realisation Exp.)	1,40,000	By Divya Ltd.	
		Purchase consideration	43,00,000
		Realisation Expenses	1,40,000
	70,35,700		**70,35,700**

Shareholders Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Unpaid capital	10,000	By Equity Share capital	50,00,000
To Realisation A/c (Loss)	9,19,500	By Profit and Loss A/c	2,29,500
To Divya Ltd. (purchase consideration)	43,00,000	(2,69,500 – 40,000)	
	52,29,500		**52,29,500**

Note:

a. Realisation loss includes the irrecoverable amount of debtors considered as bad debt in Realisation amount.

b. For Realisation expenses reimbursed by Divya Ltd.

Particulars		*Debit*	*Credit*
i. Realisation A/c	Dr.	1,40,000	
To Cash A/c			1,40,000
ii. Divya Ltd A/c	Dr.	1,40,000	
To Realisation A/c			1,40,000

Part III - *In the Books of Divya Ltd :*

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

Particulars		*Debit Rs.*	*Credit Rs.*
a. For Business Purchase :			
Business Purchase A/c	Dr.	43,00,000	
To Liquidator of Swati Ltd.			43,00,000
b. For takeover of Assets and Liabilities :			
Goodwill A/c	Dr.	5,00,000	
Land and Building A/c	Dr.	35,68,200	
Sundry Debtors A/c (3,98,400 – 40,000)	Dr.	3,58,400	
Stock A/c	Dr.	7,85,200	
Plant and Machinery A/c	Dr.	16,43,900	
To Capital Reserve A/c			9,19,500
To Creditors A/c			4,36,200
To Bank Overdraft A/c			2,00,000
To Business Purchase A/c			43,00,000
To Debentures A/c			10,00,000
c. Discharge of consideration			
Liquidator of Swati Ltd. A/c	Dr.	43,00,000	
To Equity Share capital A/c			40,00,000
To Cash A/c			3,00,000
d. Reimbursement of realisation expenses :			
Capital Reserve A/c	Dr.	1,40,000	
To Cash A/c			1,40,000
[Being Reimbursement of realisation expenses adjusted against Capital reserve]			

Balance Sheet of Divya Ltd. (After Amalgamation)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital :		**Fixed Assets :**	
Authorised capital	2,00,00,000	Goodwill	35,00,000
20 lakhs shares of Rs. 10 each		Land and Building	1,39,01,200
		Plant and Machinery	55,20,700
Issued capital	1,90,00,000	**Current Assets and Loans**	
19 lakhs share of Rs. 10 each		**and Advances :**	
[of the above, 4 lakh shares		Sundry Debtors	10,82,400
were issued to Swati Ltd for		Stock	25,77,800
consideration other than		Bills Receivable	3,62,100
cash]		Bank Balance (16,84,200 - 3,00,000 - 1,40,000)	12,44,200
Less : Unpaid calls	(50,000)		
	1,89,50,000		

Liabilities	Rs.	Assets	Rs.
Reserves and Surplus :			
Capital Reserve	7,79,500		
Profit & Loss	9,88,500		
Secured Loans :			
10% Debentures (50+10)	60,00,000		
Current Liabilities and Provision :			
Creditors	12,70,400		
Bank Overdraft	2,00,000		
	2,81,88,400		**2,81,88,400**

Illustration - 12

A Ltd. agreed to take over B Ltd. as on 1st October, 2008. No Balance Sheet of B Ltd. was prepared on that date.

Balance Sheets of A Ltd. and B Ltd. as at 31st March, 2008 were as follows :

	A Ltd. Rs.	*B Ltd. Rs.*		*A Ltd. Rs.*	*B Ltd. Rs.*
Share capital:	15,00,000	10,00,000	Fixed Assets	12,50,000	8,75,000
In equity shares			Current Assets :		
of Rs. 10 each			Stock	2,37,500	1,87,500
fully paid up			Debtors	3,90,000	2,93,750
Reserves and			Bank	2,56,000	1,50,000
surplus:			Miscellaneous		
Reserve	4,15,000	2,56,000	Expenditure		
Profit and Loss	1,87,500	1,50,000	Preliminary		
Creditors	93,750	75,000	Expenses	25,000	12,500
	21,96,250	**14,81,000**		**21,96,250**	**14,81,000**

Additional information available:

i) For the six months period from 1st April, 2008, A Ltd. made a profit of Rs. 4,20,000 after writing off depreciation at 10% per annum on its Fixed assets.

ii) For the same period, B Ltd. made a net profit of Rs. 2,04,000 after writing off depreciation at 10% p.a. on its Fixed assets.

iii) Both the companies paid on 1st August, 2008 equity dividends of 15%. Tax at 10% on such payments was also paid by each of them.

iv) Goodwill of B Ltd. was valued at Rs. 1,20,000, on the date of take-over, stock of B, subject to an abnormal item of Rs. 7,500 to be fully written off, would be appreciated by 25% (or purpose of take-over).

v) A Ltd. to issue to B's shareholders fully paid equity share of Rs.10 each, on the basis of the comparative intrinsic value of the shares on the take-over date.

Draft the Balance sheet of A Ltd. after absorption of B Ltd.

Solution :

- Nature of Amalgamation - Purchase Method
- Method of Accounting - Purchase Method

Part - 1 Purchase consideration

WN # 1 : ***Balance sheet of A Ltd. and B Ltd. as on 1st October 2008 [Before absorption]***

(Rs.)

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Share capital	15,00,000	10,00,000	Fixed Assets	11,87,500	8,31,250
Reserves and			[WN # 1 (a)]		
Surplus			Current Assets :		
Reserves	4,15,000	2,56,000	Stock [WN # 1 (d)]	2,37,500	1,87,500
Profit and Loss A/c	3,60,000	1,89,000	Debtors	3,90,000	2,56,000
			[WN # 1 (d)]		
[WN # 1 (c)]			Bank [WN # 1 (b)]	5,28,750	2,32,750
Creditors	93,750	75,000	Miscellaneous Exp.		
[WN # 1 (d)]			Preliminary expenditure	25,000	12,500
	23,68,750	**15,20,000**		**23,68,750**	**15,20,000**

(Rs.)

Particulars		***A Ltd.***	***B Ltd.***
WN # 1(a)	Fixed assets :		
	As on 1.4.08	12,50,000	8,75,000
	Less: Depreciation for 6 months		
	[1-4-08 to 30-9-08]	62,500	43,750
	Balance carried to balance sheet	11,87,500	8,31,250
WN # 1(b)	Bank Balance :		
	As on 31.3.08	2,93,750	1,50,000
	Add : Net profit after depreciation	4,20,000	2,04,000
	Add : Depreciation	62,500	43,750
		7,76,250	3,97,750
	Less : Dividend @ 15%	(2,25,000)	(1,50,000)
	Less : Dividend tax @ 10%	(22,500)	(15,000)
	Balance carried to balance sheet	**5,28,750**	**2,32,750**
WN # 1(c)	Profit and Loss A/c.		
	Balance as on 31.3.08	1,87,500	1,50,000
	Add : Profit after depreciation for 6 months	4,20,000	2,04,000
		6,07,500	3,54,000
	Dividend	(2,25,000)	(1,50,000)
	Dividend tax	(22,500)	(15,000)
		3,60,000	**1,89,000**

WN # 1(d) Stock and debtors :
It is assumed that in the absence of any other information, the amount of stock and debtors as on 1st October 2008 and 1st April 2008 is same.

WN # 2 : Intrinsic value per share :

(Rs.)

		A Ltd.	*B Ltd.*
A.	Assets :		
	(i) Goodwill	–	1,20,000
	(ii) Fixed assets	11,87,500	8,31,250
	(iii) Stock	2,37,500	2,25,000
	(iv) Debtors	3,90,000	2,56,000
	(v) Bank	5,28,750	2,32,750
		23,43,750	**16,65,000**
B.	Liabilities		
	Creditors	(93,750)	(75,000)
C.	Net asset (A - B)	22,50,000	15,90,000
D.	Number of shares	1,50,000	1,00,000
E.	Intrinsic value per share (C÷D)	**15**	**15.90**

WN #** 3 : **Purchase consideration.

a. No. of shares of B Ltd. 1,00,000
b. Value of shares of B Ltd. (1,00,000 × 15.9) = Rs. 15,90,000
c. Intrinsic value per share of A Ltd. Rs. 15
d. No. of share to be issued by A Ltd. to B Ltd. = 1,06,000

$\frac{15,90,000}{15}$

∴ Purchase consideration = Rs. 15,90,000

Share capital
Rs. 10,60,000

Securities premium
Rs. 5,30,000

Part II - *Balance sheet of A Ltd. (after absorption of B Ltd.)*

Liabilities	**Amount Rs.**	**Assets**	**Amount Rs.**
Share capital		**Fixed assets :**	
(1,50,000 + 1,06,000)		Goodwill	1,20,000
2,56,000 Equity shares of Rs. 10/-		Other Fixed assets	20,18,750
each fully paid [1,06,000 shares		Current assets, Loans and	
alloted for consideration other	25,60,000	**Advances :**	
than cash]		Stock	4,62,500
Reserves and surplus:		Debtors	6,46,000
Securities premium	5,30,000	Bank	7,61,500

Liabilities	**Amount Rs.**	**Assets**	**Amount Rs.**
Reserves	4,15,700	Miscellaneous Expenditure :	
Profit and Loss A/c	3,60,000	Preliminary expenses	25,000
Current liabilities and Provisions :			
Creditors	1,68,000		
	40,33,750		**40,33,750**

Illustration - 13

S and M had been carrying on business independently, agree to amalgamate and form a company N Ltd. with an authorised Share capital of Rs. 2,00,000 divided into 40,000 equity shares of Rs. 5 each.

On 31st December, 2008, the respective Balance Sheets of S and M were as follows :

Particulars	***S Rs.***	***M Rs.***
Fixed Assets	3,17,500	1,82,500
Current Assets	1,63,500	83,875
	4,81,000	**2,66,375**
Less : Current liabilities	2,98,500	90,125
	1,82,500	**1,76,250**

Additional Information :

Revalued figures of Fixed and Current assets were as follows :

Particulars	**S**	**M**
Fixed Assets	6,55,000	2,95,000
Current Assets	1,49,750	78,875

The debtors and creditors include Rs. 21,675 owed by S to M.

The purchase consideration is satisfied by issue of the following shares and debentures:

i. 30,000 equity shares of N Ltd. to S and M in the proportion to the profitability of their respective business based on the average net profit during the last three years which were as follows :

Particulars	*S*	*M*
2006 Profit	2,24,788	1,36,950
2007 (Loss) / Profit	(1,250)	1,71,050
2008 Profit	1,88,962	1,79,500

ii. 15% debentures in N Ltd. at par to provide an income equivalent to 10% return on capital employed in their respective business as on 31st December 2008 after revaluation of assets.

You are required to :

1. Compute the amount of debentures and shares to be issued to S and M.
2. A Balance sheet of N Ltd. showing the position immediately after amalgamation.

Solution :

Part I : Calculation of shares to be issued and No. of debentures to be issued :

WN # 1 : ***Calculation of average profit for the past 3 years.***

$$S = \frac{2,24,788 - 1,250 + 1,88,962}{3} = \text{Rs. } 1,37,500/-$$

$$M = \frac{1,36,950 + 1,71,050 + 1,79,500}{3} = \text{Rs. } 1,62,500/-$$

WN # 2 : ***Determination of shares to be distributed to each company***

Distribution : 30,000 Equity Shares of N Ltd. are to be distributed between the S Ltd. and M Ltd. in their profitability ratio. i.e. 1375 : 1625

$$\text{Shares to be Issued to S Ltd.} = \frac{1,375}{3,000} \times 30,000 = 13,750 \text{ Shares.}$$

$$\text{Shares to be Issued to M Ltd.} = \frac{1,625}{3,000} \times 30,000 = 16,250 \text{ Shares.}$$

WN # 2 : ***Calculation of the number of debentures to be issued :***

i. Calculation of 10% return of capital employed :- (at revalued figures)

Particulars	S	M
a. Fixed Assets	6,55,000	2,95,000
b. Current Assets	1,49,750	78,875
	8,04,750	3,73,875
c. Current liabilities	(2,98,500)	(90,125)
d. Capital employed	5,06,250	2,83,750
e. Return on capital employed @ 10%	50,625	28,375
f. Number of 15% debenture to be issued in order to get same return of Rs. 50,625/- and Rs. 28,375/- respectively. $\left(\frac{50,625}{15\%}, \frac{28,375}{15\%}\right)$	3,37,500	1,89,167 = 1,89,200 (rounded of in nearest Multiples of Rs.100

WN # 3 : Calculation of Purchase consideration and Goodwill* or *Capital reserve from the amalgamation:

(Rs.)

Particulars	S	M	Total
I. Purchase Consideration:			
a. Value *of* Equity Shares (WN # 1) (13,750 x 5; 16,250 x 5)	68,750	81,250	1,50,000
b. 15% Debentures (WN # 2)	3,37,500	1,89,200	5,26,700
c. *Total*	**4,06,250**	**2,70,450**	**6,76,700**
II. Net Assets taken over:			
a. Fixed assets (Revalued Figures)	6,55,000	2,95,000	9,50,000
b. Add: Current assets (*78,875 - 21,675 Inter Co. Owings)	1,49,750	57,200*	2,06,950
c. Less: Current liabilities (**2,98,500 - 21,675 Inter Co. Owings)	(2,76,825)**	(90,125)	(3,66,950)
d. **Total (a+b+c)**	**5,27,925**	**2,62,075**	**7,90,000**
III. Goodwill / (Capital reserve) (I - II)	(1,21,675)	8,375	(1,13,300)

Balance Sheet of N Ltd. as on 31st Dec. 2008

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Share *ca*pital :		Fixed Assets	9,50,000
Authorised :		Current Assets	2,06,950
40,000 Equity Shares of Rs. 5 each	2,00,000		
Issued and Subscribed :			
30,000 Equity Shares of Rs. 5 each fully paid up	1,50,000		
(All the above shares are issued for a consideration other than cash persuant to contract of Amalgamation)			
Reserves and surplus :			
Capital reserve (WN # 3)	1,13,300		
Secured Loans :			
15% Debentures (WN # 2)	5,26,700		
Current liabilities and Provision :			
Current liabilities	3,66,950		
Provisions	—		
	11,56,950		**11,56,950**

Illustration - 14

The following are the summarised Balance sheets of three undertakings as on 31st March, 2009.

Particulars	*B Ltd.* *Rs.*	*E Ltd.* *Rs.*	*D Ltd.* *Rs.*
Freehold premises at cost	5,00,000	1,80,000	1,20,000
Other Fixed assets at cost less depreciation	15,80,000	3,70,000	2,00,000
Stock in trade	13,50,000	1,80,000	1,10,000
Sundry Debtors	12,30,000	4,30,000	2,10,000
Cash at Bank.	2,10,000	1,20,000	55,000
	48,70,000	12,80,000	6,95,000
Equity Shares of Rs. 10 each	30,00,000	5,00,000	
Capital: D Ltd.			4,15,000
Reserves	12,20,000	2,60,000	
Creditors	6,50,000	5,20,000	2,80,000
	48,70,000	12,80,000	6,95,000

It was decided that on 31st March 2009 would acquire the whole of the Share capital of E Ltd. and the goodwill, Fixed assets and stocks of D, the purchase consideration in both cases being discharged by the issue of equity shares in B Ltd., valued at Rs. 12.50 per share. The terms agreed upon were the following:

1. The Fixed assets were to be taken at the value placed on them by an independent valuer.
2. The stocks of D were to be reduced by Rs. 10,000 because of obsolete items. Stocks of E Ltd. were to be taken at their book value.
3. In the case of E Ltd. debtors and creditors to be taken at book value less Rs. 30,000 for debtor and Rs. 15,000 for creditor.
4. Goodwill was to be valued at two years' purchase of the average profits of the last three years subject only to the following adjustments.

In the case of E Ltd.

i. The Director's remuneration charged in each year was to be reduced by Rs. 25,000; and

ii. The depreciation charged in each year on Other Fixed assets was to be substituted with depreciation on those assets calculated at 10% of cost on straight line basis.

In the case of D:

i. Notional expenses of Rs. 50,000 p.a. in total, are to be provided; and

ii. Rs. 20,000 being exceptional items of expense was to be added back to the profits in 2007.

Other Information :

	Particulars	B Ltd. Rs.	E Ltd. Rs.	D Ltd. Rs.
i.	Depreciation on Other Fixed assets till date	6,20,000	2,50,000	1,00,000
ii.	Independent valuation as on 31st March 2009;			
	Freehold premises		6,00,000	2,50,000
	Other Fixed assets		3,30,000	2,10,000
iii.	Profits for the last three years;			
	2006-07		90,000	90,000
	2007-08		1,21,000	65,000
	2008-09		1,31,060	95,000

Depreciation charged on other Fixed assets of E Ltd. was Rs. 54,500 in 2006-07, Rs. 44,580 in 2007-08 and Rs. 45,360 in 2008-09.

iv. Particulars of other Fixed assets at 31 st March. 2009 at cost were :

Before 31 st March 2007	6,00,000
Purchase on 1st April, 2007	1,10,000
Disposed of on 1 st April 2008 (acquired on 1 April 1996)	80,000

You are required to prepare:

i. a statement showing the shares to be issued for the acquisition; and

ii. the Balance sheet of B Ltd. at on April 2009.

ignore taxation.

Solution:

Part - (i) ***Purchase consideration***

WN # 1 : ***Calculation of goodwill***

Particulars	E Ltd. Rs.	D Ltd. Rs.
Total Profits for three years		
2006-07	90,000	90,000
2007-08	1,21,000	65,000
2008-09	1,31,060	95,000
	3,42,060	2,50,000
Add: Directors fees	75,000	
Less: Additional Depreciation*	(49,560)	–
Add: Exceptional item for Exp.		20,000
Less : Notional salaries for partners each Rs.50,000/p.a.		(1,50,000)
Total	**3,67,500**	**1,20,000**
No. of years	3	3
Average Profits	1,22,500	40,000
Goodwill (2 years purchase) [(h) × 2]	2,45,000	80,000

* Calculation of Additional Depreciation :

Year	**2006**	**2007**	**2008**	**Total**
Depreciation to be charged	60,000	71,000	63,000	
Less: Depreciation already charged	(54,500)	(44,580)	(45,360)	
Additional depreciation to be charged	**5,500**	**26,420**	**17,640**	**49,560**

Statement showing shares to be issued to E Ltd. and D Ltd.

	Particulars	*E Ltd.* *Rs.*	*D Ltd.* *Rs.*
a.	Fixed assets :		
	i. Freehold premises	6,00,000	2,50,000
	ii. Others	3,30,000	2,10,000
	iii. Goodwill (WN # 1)	2,45,000	80,000
b.	Current assets :		
	i. Stock in trade	1,80,000	1,00,000
	ii. Sundry Debtors	4,00,000	–
	iii. Cash at Bank	1,20,000	–
		18,75,000	6,40,000
c.	Less: Sundry creditors	(5,05,000)	–
d.	Net asset value	13,70,000	6,40,000
e.	Share Price	12.50	12.50
f.	No. of Shares to be issued (d × e)	1,09,600	51,200
		13,70,000 (12.50)	6,40,000 (12.50)

Balance Sheet of B Ltd. as at 31st March 2009

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital :		Fixed assets :	
4,60,800 shares of Rs. 10 each		Goodwill	80,000
fully paid		Freehold Premises	7,50,000
(of the above, 1,60,800 shares are	46,08,000	Other Fixed assets	17,90,000
being issued for consideration		Investments	13,70,000
other than cash)			
Reserves and surplus :		(Fully paid shares in	
General reserves	12,20,000	Subsidiary Co.)	
Securities Premium	4,02,000	Current assets:	
Current liabilities and Provisions :		Stock in trade	14,50,000
Creditors	6,50,000	Sundry Debtors	12,15,000
		Cash at Bank	2,25,000
	68,80,000		**68,80,000**

Illustration - 15

On 1st April, 2008 Hero Ltd. was incorporated with an authorised capital of Rs. 1,000 lakhs. It issued to its promoters equity capital of Rs. 50 lakhs which was paid for in full. On that day it purchased the running business of Vijay Ltd. for Rs. 200 lakhs and allotted at par equity capital of Rs. 200 lakhs in discharge of the consideration. The net assets taken over from Vijay Ltd. were valued as follows : Fixed assets Rs. 150 lakhs, inventory Rs. 10 lakhs, customers' dues Rs. 70 lakhs and Creditors Rs. 30 lakhs.

Hero Ltd. carried on business and the following information is furnished to you:

a. Summary of cash/bank transactions for year ended 31 st March, 2009.

Rs. in lakhs

Equity capital raised :		
Promotors (as shown above)	50	
Others	250	300
Collections from customers		4,000
Sale proceeds of Fixed assets (cost Rs.18 crores)		20
Less :		4,320
Payment to suppliers	2,000	
Payment for employees	700	
Payment for expenses	500	3,200
Investments in Upkar Ltd.		100
Payments to suppliers of Fixed assets :		
Instalment due	600	
Interest	50	3,200
Tax payment		270
Dividend		50
Closing cash/bank balance		50
		1,320

b. On *31st March,* 2009 *Hero Ltd.'s assets and liabilities were.*

	Rs. in lakhs
Inventory at cost	15
Customers' dues	400
Prepaid expenses	10
Advances to suppliers	40
Amounts due to suppliers of goods	260
Amounts due to suppliers of Fixed assets	750
Outstanding expenses	30

c. Depreciation for the year under :

i. Companies Act, 1956	Rs. 180 lakhs
ii. Income tax Act, 1961	Rs. 200 lakhs

d. Provide for tax at 35% of "total income". There are no disallowables for the purpose of income taxation, provision for tax is to be rounded off.
   i. Revenue statement for the year ended 31st March, 2009 and
   ii. Balance Sheet as on 31st March, 2009 from the above information.

Solution :

WN # 1 : ***Computation of purchase consideration***

	Rs. in lakhs
Fixed Assets	150
Inventory	10
Customer's Dues	70
Less: Creditors	(30)
Purchase consideration	**200**

IN THE BOOKS OF HERO LTD.

- Nature of Amalgamation - Purchase Method
- Method of Accounting - Purchase Method

Rs. in lakhs

	Particulars		*Debit*	*Credit*
1.	For Business Purchase :			
	Business Purchase A/c	Dr.	200	
	To Liquidator of Vijay Ltd. A/c			200
2.	**Incorporation of assets and liabilities taken over :**			
	Fixed Assets A/c	Dr.	150	
	Inventory A/c	Dr.	10	
	Customer's dues A/c	Dr.	70	
	To Creditors A/c			30
	To Business Purchase A/c			200
	Note : There is no goodwill or Capital reserve arising.			
3.	**Discharge of Consideration :**			
	Liquidator of Vijay Ltd. A/c	Dr.	200	
	To Equity Share Capital A/c			200

Debtors / Customers Account

Dr. Cr.

Particulars	**Amount**	**Particulars**	**Amount**
To Business Purchase	70	By Bank	4,000
To Sales [balance c/d]	4,330	By Balance c/d	400
	4,400		**4,400**

Suppliers Account

Dr. Cr.

Particulars	Amount	Particulars	Amount
To Bank *	1,960	By Business Purchase	30
To Balance c/d	260	By Purchase [balance c/d]	2,190
	2,220		**2,220**

Amount	2,000
Less : Advances	40
	1,960

Rs. in lakhs

Fixed assets Accounts (Suppliers)

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Bank A/c	650	By Fixed assets A/c (Bal. fig.)	1,350
To Balance c/d	750	By Interest A/c	50
	1,400		**1,400**

Rs. in lakhs

Fixed assets Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Business Purchase A/c	150	By Bank A/c	20
To Profit and Loss A/c	2	By Balance c/d	1,482
To Suppliers A/c	1,350		
	1,502		**1,502**

Rs. in lakhs

Expenses Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Bank A/c	500	By Profit and Loss a/c (Balancing Figure)	520
To Outstanding expenses A/c	30	By Balance c/d (prepaid)	10
	530		**530**

Revenue Statement for the year ended 31.3.09

Rs. in *lakhs*

Particulars	*Amount*	*Amount*
a) Sales		4,330
b) Less: Expenditure		
Stock taken over	10	
Add: Purchases	2,190	
	2,200	
Less : Closing Stock	15	
Inventory consumed	2,185	
Employee cost	520	

Expenses	700	(3,405)
Profit before Interest depreciation and Tax		925
Less: Interest		(50)
Profit before depreciation and Tax		875
Less: Depreciation as per Companies Act, 1956		(180)
		695
Add: Profit on sale of Fixed assets		2
Profit before tax		697
Less: Provision for tax *		236.25
Profit After Tax		460.75
Less: Dividend		(50)
Balance Carried forward to Balance Sheet.		**410.75**

* Calculation of Tax provision

Particulars	***Rs. in lakhs***
Profit before Tax.	697
Less: Profit and Loss on sale of Fixed assets	(2)
Add: Depreciation as per Companies Act	180
Less: Depreciation as per IT Account	(200)
Adjusted Profit before tax	675
Less: Tax @ 35%	236.25
	438.75

Balance sheet of Hero Ltd. as on 31.3.09

Liabilities		***Rs. in Lakhs***	***Assets***		***Rs. in Lakhs***
Equity Share capital:			Fixed assets	1,482	
Authrised Share capital		1,000	Less: Depreciation	(180)	1,302
Issued, subscribed and fully			Investments in Upkar Ltd.		
paid-up capital			Current assets, Loans and		
Existing 300 + Issued 200			Advances:		
(of the above, shares worth		500	Inventories	15	
Rs.200 crores were issued			Customers Dues	400	
for a consideration other			Cash and Bank	50	
than cash)			Advances to Suppliers	40	
Reserves and surplus :			Prepaid Expenses	10	
Profit and Loss A/c		410.75	Advance tax	270	785
Amount due to suppliers of Fixed assets		750			
Current liabilities and Provisions :					
Creditors	260				
Outstanding expenses	30				
Provision for tax	236.25	526.25			
		2,187			**2,187**

Illustration - 16

AX Ltd. and BX Ltd. decided to amalgamate their business with a view to a public share issue. A holding company, MX Ltd. is to be incorporated on 1st May 2009 with an authorised capital of Rs. 60,00,000 in Rs. 10 ordinary shares. The company will acquire the entire ordinary Share capital of AX Ltd. and BX Ltd. in exchange for an issue of its own shares.

The consideration for the acquisition is to be ascertained by multiplying the estimated profits available to the ordinary shareholders by agreed price earnings ratio. The following relevant figures are given :

	AX Ltd. *Rs.*	*BX Ltd.* *Rs.*
Issued Share capital		
Ordinary shares of Rs. 10 each	30,00,000	12,00,000
6% Cumulative Preference shares of Rs. 100 each	–	10,00,000
5% Debentures, redeemable in 2013		8,00,000
Estimated annual maintainable profits, before deduction of debenture interest and taxation	6,00,000	2,40,000
Price / Earning Ratio	15	10

The shares in the holding company are to be issued to members of the subsidiaries on 1st June 2009, at a premium of Rs. 2.50 per share and thereafter these shares will be marketable on the Stock Exchange.

It is anticipated that the merger will achieve significant economics but will necessitate additional working capital. Accordingly, it is planned that on 31st December, 2009, MX Ltd. will make a further issue of 60,000 ordinary shares the public for cash at the premium of Rs. 3.75 a share. These shares will not rank for dividends until 31st December, 2009.

In the period ended 31st December, 2009, bank overdraft facilities will provide funds for the payment of MX Ltd. of preliminary expenses estimated at Rs. 50,000 and management etc. expenses estimated at Rs. 6,000.

It is further assumed that interim dividends on ordinary shares, relating to the period from 1st June to 31st December, 2009 will be paid on 31st December 2009 by MX Ltd. at 3% by AX Ltd. at 5% and by BX Ltd. at 2%.

You are required to project, as on 31st December 2009 for MX Ltd., (a) the Balance Sheet as it would appear immediately after fully subscribed share issue, and (b) the Profit and Loss Account for the period ending 31st December, 2009.

Assume the rate of corporation tax to be 40% you can make any other assumption you consider relevant.

Solution :

WN # 1 : ***Computation of Purchase Consideration***

		AX Ltd.		***BX Ltd.***
a.	Earnings before Interest and Tax (EBIT)	6,00,000		2,40,000
b.	Less: Interest	–		(40,000)
c.	Earnings before tax (EBT)	6,00,000		2,00,000
d.	Less: Tax @ 40%	(2,40,000)		(80,000)
e.	Earnings after tax (EAT or PAT)	3,60,000		1,20,000
f.	Less: Preference Dividend	–		(60,000)
g.	Profit for Equity Shareholders	3,60,000		60,000
h.	P/E Ratio	15		10
i.	Total Consideration (Profit × P/E ratio)	54,00,000		6,00,000
j.	Share capital (432000 × 10)	43,20,000	48000 × 10	4,80,000
k.	Share Premium (432000 × 2.5)	10,80,000	48000 × 2.5	1,20,000

Projected Profit and Loss Account for the period ending on 31st Dec. 2009

a.	Dividend Received from Subsidiaries		
	AX Ltd.	30,00,000 × 5%	1,50,000
	BX Ltd.	12,00,000 × 2%	24,000
			1,74,000
b.	Less: Management Expense		(6,000)
	Less: Dividend @ 3.5% on 48,00,000		1,68,000
	(43,20,000 + 4,80,000)		(1,68,000)
c.	Projected profit		Nil

WN # 2 :

Bank Account

Dr. Cr.

Particulars	**Amount**	**Particulars**	**Amount**
To Shares issued	8,25,000	By Preliminary expenses	50,000
(60,000 @ 13.75)		By Management expenses	6,000
To Dividend Received - AX Ltd.	1,50,000	By Dividend paid	1,68,000
- BX Ltd.	24,000	By Balancec/d	7,75,000
	9,99,000		**9,99,000**

Projected Balance Sheet of MX Ltd. as on 31.12.09

Liabilities		**Rs.**	**Assets**	**Rs.**
Share capital			Investments:	
[Authorised 6,00,000 Equity			Subsidiaries	
Share of Rs. 10 each]		60,00,000	Shares at Cost	60,00,000
Issued Capital			Bank	7,75,000
4,80,000 x 10	48,00,000			
60,000 x 10	6,00,000	54,00,000		
Share Premium				
RX Ltd.	10,80,000			
PX Ltd.	1,20,000			
Others (60,000 x 3.75)	2,25,000			
	14,25,000			
Less : Preliminary Expenses	(50,000)	13,75,000		
		67,75,000		**67,75,000**

Note: The preliminary expenses are to be written off against securities premium A/c.

III. Purchasing Company holding shares in Selling Company

Illustration - 17

It has been decided that P Ltd. will absorb the entire undertaking of S Ltd. and T Ltd. as on 1.4.2009. The outside shareholders in the latter companies are to be issued equity shares in P Ltd. on the basis of an agreed issue price of Rs.200 per share. For this purpose, the interests of such shareholders are to be determined according to the intrinsic values of the shares of the respective companies. N Ltd. is a subsidiary of T Ltd. and is also to be merged into P Ltd. appropriately.

The Balance Sheets of the companies as at 31.3.2009, stood as under :

(Rs. Lakhs)

	P	**S**	**T**	**N**
Sources of Funds:				
Share capital				
Equity shares Rs. 100 each	1,500	1,000	800	400
Reserves	2,000	540	702	400
Loans	1,600	900	1,000	700
Total	**5,100**	**2,440**	**2,502**	**1,500**

(Rs. Lakhs)

	P	S	T	N
Application of Funds :				
Land	200	100	50	10
Buildings	500	400	100	200
Machinery	1,500	800	500	500
Other Fixed Assets	400	100	200	50
Investments				
4 lakhs shares of S	500			
2 lakhs shares of T	300			
4 lakhs shares of N	-	-	400	
Others	100	-	-	
Net Current Assets	1,600	1,040	1,252	740
Total	**5,100**	**2,440**	**2,502**	**1,500**

For the purpose of the scheme, it is agreed to give effect to the following value appreciations of the assets of the companies to be absorbed.

Land - 100%
Buildings - 50%
Machinery - 20%

In order to obtain the consent of the creditors of T Ltd., it becomes necessary to accept a claim of Rs.20 lakhs hitherto classified as contingent. 60% of the claim is accepted by T Ltd. and the balance is to be settled by P Ltd.

You are required to :

i. Compute the number of shares to be issued by P Ltd. to eligible outsiders
ii. Show journal entries.
iii. Draft the Balance sheet of P Ltd. after the absorption.

Solution :

Part 1. *Calculation of Purchase consideration.*

WN # 1 : *Calculation of Intrinsic value of shares.*

Rs. in Lakhs.

		S	T	N
a.	Land (↑100%)	200	100	20
b.	Building (↑50%)	600	150	300
c.	Machinery (↑20%)	960	600	600
d.	Others Fixed Assets	100	200	50
e.	Net current Asset	1040	1252	740

		S	T	N
f.	Investment in N Ltd. (100% subsidiary company)	—	1010	—
	[4 Lakhs shares × Rs. 252.50]	2900	3312	1710
g.	Loans	(900)	(1000)	(700)
h.	Contingent loan (60% of 20)	—	(12)	—
i.	Value of Net Assets	2,000	2,300	1010
j.	No. of shares Outstanding	10	8	4
k.	Intrinsic value per share (i/j)	200	287.50	252.50

WN # 2 : Purchase consideration

Lakhs.

	Particulars	*S*	*T*
a.	No. of shares outstanding	10	8
b.	Less: Already held by P Ltd.	(4)	(2)
c.	No. of shares held by outsiders	6	6
d.	Value payable at intrinsic value [WN # 2(c)xWN # 1 (k)]	Rs. 1,200	Rs. 1,725
e.	No. of shares to be issued at value of Rs. 200	6	8.625
f.	Payment to be made for T Ltd. is : Shares	–	8
	Cash (for fractional shares)		0.625 x 200 = Rs. 125/-

Part II - In the books of purchasing Co. P Ltd.

A. Take over of S Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

(Rs. in Lakhs)

	Particulars		*Debit*	*Credit*
a.	For Purchase Consideration Due:			
	Business Purchase A/c (6×200)	Dr.	1,200	
	To Liquidator of S Ltd's. A/c			1,200
b.	For Assets and liabilities takeover :			
	Land A/c	Dr.	200	
	Building A/c	Dr.	600	
	Machinery A/c	Dr.	960	
	Other Fixed Assets A/c	Dr.	100	

Particulars		Debit	Credit
Net Current Assets A/c	Dr.	1040	
To Capital Reserve A/c (balancing figure)			300
To Loans A/c			900
To Business purchase A/c			1,200
To Investments in S Ltd			500
c. Discharge of consideration			
Liquidator of S Ltd. A/c	Dr.	1,200	
To Equity Share Capital A/c (6 x 100)			600
To Securities Premium A/c (6 x 100)			600

B. Take over of T Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

Rs. in *Lakhs*

Particulars		Debit	Credit
a. For Purchase Consideration Due:			
Business Purchase A/c	Dr.	1,725	
To Liquidator of T Ltd. A/c			1,725
b. For takeover of assets and liabilities:			
Land A/c	Dr.	120	
Building A/c	Dr.	450	
Machinery A/c	Dr.	1200	
Other Fixed Assets A/c	Dr.	250	
Net Current Assets A/c	Dr.	1992	
To Capital Reserve A/c (balancing figure)			267
To Loans A/c			1712
To Contingent loan payable A/c			8
To Business purchase A/c			1725
To Investments in T Ltd. A/c			300
c. Settlement of contingent liability:			
Contingent liability payable A/c	Dr.	8	
To Net current asset (cash)			8

Rs. in *Lakhs*

Particulars		*Debit*	*Credit*
d. For discharge of consideration:			
Liquidator of T Ltd. A/c	Dr.	1,725	
To Equity Share Capital A/c (8 × 100)			800
To Securities Premium A/c (8 × 100)			800
To Cash A/c			125

Amalgamated Balance Sheet of P Ltd. as at 1st April 2009

Rs. in lakhs

Particulars	*Amount*
Source of Funds:	
Authorised, issued subscribed and fully paid up equity shares of Rs. 10 each	
Equity Share capital (1,500 + 600 + 800.00)	2,900
[Out of the above 6 lakhs shares to S Ltd. and 8 Lakhs shares to T Ltd. were issued for consideration other than cash]	
Reserves and surplus:	
Capital Reserve (300 + 267)	567
Securities premium (600 + 800)	1400
Other Reserves	2,000
Loans (1600 + 900 + 1012 + 700)	4,212
Total	**11,079**
Application of Funds :	
Fixed assets :	
Land (200 + 200 + 100 + 20)	520
Building (500 + 600 + 150 + 300)	1,550
Machinery (1,500 + 960 + 600 + 600)	3,660
Other Fixed assets (400 + 100 + 200 + 50)	750
Investments	100
Net Current assets (1,600 + 1,040 + 1,252 + 740 – 8 – 125)	4,499
Total	**11,079**

Illustration - 18

The Balance Sheets of Sweet Ltd. and Salt Ltd. as on 31.03.08 were as follows:

Balance Sheet as on 31.03.08

Liabilities	*Sweet Ltd. (Rs.)*	*Salt Ltd. (Rs.)*	*Assets*	*Sweet Ltd. (Rs.)*	*Salt Ltd. (Rs.)*
Equity Share capital (Rs. 100)	8,00,000	3,00,000	Building	2,00,000	1,00,000
			Machinery	5,00,000	3,00,000

Liabilities	*Sweet Ltd.* *(Rs.)*	*Salt Ltd.* *(Rs.)*	*Assets*	*Sweet Ltd.* *(Rs.)*	*Salt Ltd.* *(Rs.)*
10% Preference Share capital (Rs. 100)	-	2,00,000	Furniture	1,00,000	60,000
			Investment: 600 shares of Small Ltd.	60,000	—
General Reserve	3,00,000	1,00,000	Stock	1,50,000	1,90,000
Profit and Loss A/c	2,00,000	1,00,000	Debtors	3,50,000	2,50,000
Creditors	2,00,000	3,00,000	Cash and Bank	90,000	70,000
			Preliminary Expenses	50,000	30,000
	15,00,000	**10,00,000**		**15,00,000**	**10,00,000**

Sweet Ltd. has taken over the entire undertaking of Salt Ltd. on 30.09.08, on which date, the position of Current assets except cash and bank balances and Current liabilities were as follows:

	Sweet Ltd (Rs.)	Salt Ltd (Rs.)
Stock	1,20,000	1,50,000
Debtors	3,80,000	2,50,000
Creditors	1,80,000	2,10,000

Profits earned for the half year ended on 30.09.08 after charging depreciation as 5% on building, 15% on machinery and 10% on furniture, are:

Sweet Ltd.	Rs. 1,02,500
Salt Ltd.	Rs. 54,000

On 30.08.08 both companies have declared 15% dividend for 2007-08.

Goodwill of Salt Ltd. has been valued at Rs. 50,000 and other Fixed assets at 10% above Sweet their book values on 31.03.08. Preference shares of Salt Ltd. are to be allotted 10%. Preference Shares of Sweet Ltd. and Equity shareholders of Salt Ltd. are to receive requisite number of equity shares of Sweet Ltd. valued at Rs. 150 per share on satisfaction of their claims.

Show the Balance Sheet as of 30.09.08 assuming absorption is through by that date.

Solution :

Part. I

Balance **Sheet** *of Sweet Ltd. & Salt Ltd. as* **on September 30, 2008**

Liabilities	*Sweet Ltd.* *(Rs.)*	*Salt Ltd.* *(Rs.)*	*Assets*	*Sweet Ltd.* *(Rs.)*	*Salt Ltd.* *(Rs.)*
Equity Share capital Rs. 100 each	8,00,000	3,00,000	**Fixed Assets :**		
			Building	1,90,000	95,000
			Machinery	4,25,000	2,55,000
10% Preference Share capital	—	2,00,000	Furniture	90,000	54,000
			Investment	60,000	—

Liabilities	*Sweet Ltd. (Rs.)*	*Salt Ltd. (Rs.)*	*Assets*	*Sweet Ltd. (Rs.)*	*Salt Ltd. (Rs.)*
Reserves and surplus			Current assets Loans and **Advances:**		
General Reserve	3,00,000	1,00,000			
Profit and Loss A/c	1,91,500*	1,09,000*			
Current liabilities and Provisions			Stock	1,20,000	1,50,000
			Debtors	3,80,000	2,50,000
Creditors	1,80,000	2,10,000	Cash (bal. fig)	1,56,500	85,000
			Miscellaneous Expense not written off:		
			Preliminary Exp.	50,000	30,000
	14,71,500	**9,19,000**		**14,71,500**	**9,19,000**

* **Calculation of Profit & Loss Account Balances**

Particulars	*Sweet Ltd.*	*Salt Ltd.*
Opening balance	2,00,000	1,00,000
Add.Profit for half year	1,02,500	54,000
Less: Equity dividend	(1,20,000)	(45,000)
Add: Dividend income on 600 Equity Shares	9,000	–
Total	**1,91,500**	**1,09,000**

Assumptions:

a) Preference dividend has already been paid

b) Half year profit given is "Trading Profit" and does not include dividend income.

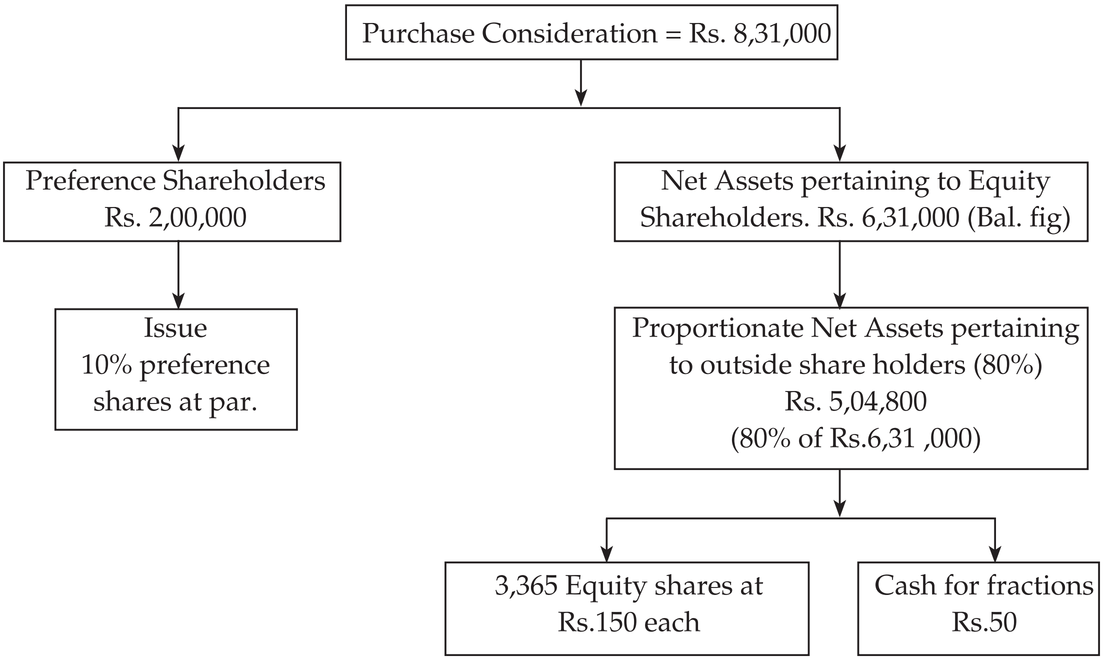
c) The entire dividend income is post-acquisition (ie. investment has been acquired prior to 1.4.08)

Part II

Purchase Consideration - Net Assets Method

Particulars	*Amount Rs.*	*Amount Rs.*
Goodwill	50,000	
Building	1,10,000	
Machinery	3,30,000	
Furniture	66,000	
Stock	1,50,000	
Debtors	2,50,000	
Cash	851000	10,41,000
Less: Creditors		(2,10,000)
Purchase Consideration		8,31,000

Analysis of Purchase Consideration:



***Total consideration summary* :**

	Particulars	*Amount Rs.*
i)	Preference Share capital at par	2,00,000
ii)	3,365 Equity shares @ Rs. 150 per share	5,04,750
iii)	Cash	50
	Total	**7,04,800**

Part - III : *In* the *books of Sweet Ltd.*

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

Journ entries

	Particulars		*Debit*	*Credit*
a.	For Purchase Consideration Due:			
	Business Purchase A/c	Dr.	7,04,800	
	To Liquidator of Salt Ltd.			7,04,800
2.	For Assets of Libilties taken over:			
	Building A/c	Dr.	1,10,000	
	Machinery A/c	Dr.	3,30,000	
	Furniture A/c	Dr.	66,000	

Particulars		*Debit*	*Credit*
Stock A/c	Dr.	1,50,000	
Debtors A/c	Dr.	2,50,000	
Cash A/c	Dr.	85,000	
To Creditors A/c			2,10,000
To Business Purchase A/c			7,04,800
To Investment in Salt Ltd. A/c			60,000
To Capital Reserve A/c			16,200
3. Discharge of Purchase Consideration			
Liquidator of Salt Ltd. A/c	Dr.	7,04,800	
To 10% Preference Share Capital A/c			2,00,000
To Equity Share Capital A/c			3,36,500
To Securities Premium A/c			1,68,250
To Bank/Cash A/c			50

Amalgamated Balance Sheet of Sweet Ltd. as on 30.09.2008

Liabilities	*Amount* *Rs.*	*Assets*	*Rs.*	*Amount* *Rs.*
Share Capital:	11,36,500	**Fixed Assets:**		
113650 Equity Shares of		Building	2,00,000	
Rs.10 each		Less: Depreciation	10,000	
(Out of which 33650 share are			1,90,000	
allotted for consideration		Add: Taken over	1,10,000	3,00,000
other than cash)				
10% Preference Share	2,00,000	Machinery	5,00,000	
capital of Rs. 100 each		Less: Depreciation	75,000	
(The above shares are		Add: Taken Over	3,30,000	7,55,000
alloted for consideration				
other than cash)		Furniture	1,00,000	
Reserves and surplus		Less: Depreciation	10,000	
Capital Reserve	16,200	Add: Taken over	66,000	1,56,000
Securities Premium	1,68,250	**Current assets,**		
General Reserve	3,00,000	**Loans and Advances:**		
Profit and Loss A/c	1,91,500	Stock		2,70,000
Current liabilities and		Sundry Debtors		6,30,000
Provisions		Cash and Bank		2,41,450
Sundry creditors	3,90,000	**Miscellaneous Expenditure**		
		Preliminary Exp.		50,000
	24,02,450			**24,02,450**

Illustration - 19

The Balance Sheets of S Ltd. and H Ltd. as on 31.3.09 were as follows.

(Rs. in Lakhs)

Liabilities			*S Ltd.*	*H Ltd.*
Equity Share capital			80	25
Reserves and surplus			400	75
10% 25,000 Debentures of Rs. 100 each			–	25
Other Liabilities			120	–
			600	**125**
Assets				
Fixed assets at cost	200		75	
Less: Depreciation	100	100	50	25
Investments in H Ltd.				
2 Lakhs Equity shares of Rs. 10 each at cost	32			
10% 25,000 debentures of Rs. 100 each at cost	24	56		
Current assets	800		300	
Less: Current liabilities	(356)	444	(200)	100
		600		**125**

In a scheme of absorption duly approved by the Court, the assets of 'H' Ltd. were taken over at an agreed value of Rs. 130 lakhs. The liabilities were taken over at par. Outside shareholders of 'H' Ltd. were allotted equity shares in S Ltd. at a premium of Rs. 90 per share in satisfaction of other claims in 'H' Ltd. for purposes of recording in the books of 'S' Ltd. Fixed assets taken over from 'H' Ltd. were revalued at Rs. 40 lakhs.

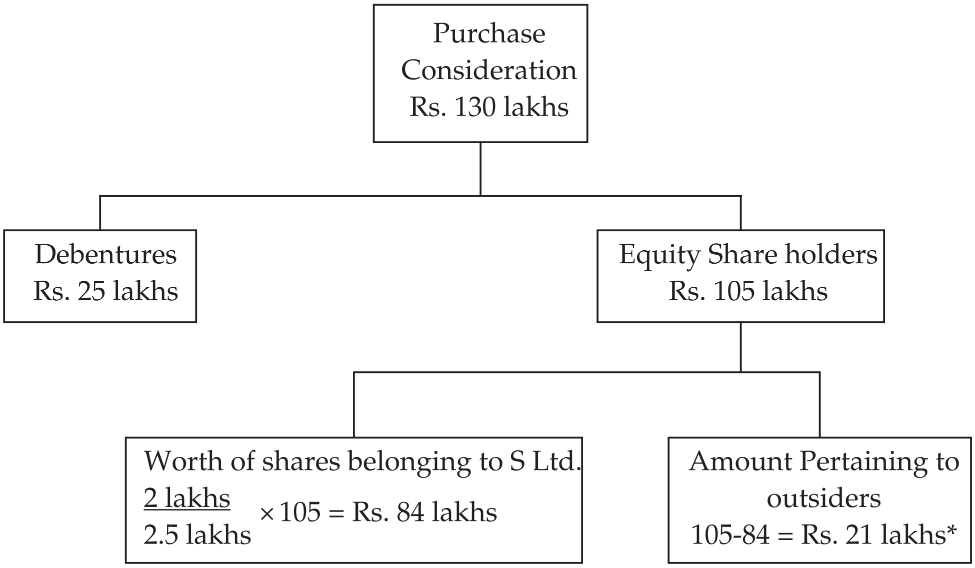
The scheme was put through on 1st April, 2009.

a. Journal Entries in the books of 'S' Ltd.

b. Show the balance of 'S' Ltd. after absorption of 'H' Ltd.

Solution :

WN # 1 : ***Purchase consideration of shares to be issued***



'Number of shares to be issued to outside shareholders @ 10/ each at a premium of Rs. 90/- $= \frac{\text{Rs. } 21,00,000}{100}$

$= 21,000$ Shares.

a) Part - II Journals in Books of S Ltd.

- Nature of Amlagamation - Purchase Method
- Method of Accounting - Purchase Method

(Rs. in lakhs)

Particulars		Debit	Credit
i. For Purchase Consideration Due :			
Business Purchase A/c	Dr.	21	
To Liquidator for H Ltd." A/c			21
(Being the purchase consideration payable to liquidator of H Ltd. for business purchase)			
ii. For assets and liabilities taken over :			
Fixed Assets A/c	Dr.	40	
Current Assets A/c	Dr.	300	
To Current Liabilities A/c			200

Particulars	*Debit*	*Credit*
To Liability for 10% Debentures A/c		25
To Business Purchase A/c		21
To Investment in H Ltd. A/c		32
To Capital Reserve (balancing figure)		62
(Being the assets and liabilities taken over from H Ltd)		
iii. Discharge of purchase consideration:		
Liquidator of H Ltd. A/c Dr.	21	
To Equity Share Capital A/c		2.10
To Securities Premium A/c		18.90
(Being the allotment of 21 lakhs equity shares of Rs. 10 each to outside shareholders of H Ltd. at a premium of Rs.90 per share.)		
iv. Cancellation of Liability of Debentures:		
10% Debenetures A/c Dr.	25	
To Investments in Debentures A/c		24
To Capital Reserve A/c		1
(Being the cancellation of debentures of H Ltd.)		

b)

Balance Sheet of S *Ltd. as on* 1st *April,* 2009

(Rs. in lakhs)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital:		Fixed assets	
(8.21 lakhs equity shares of	82.10	(100+40)	140.00
Rs. 10 each)		Current assets and	
(Of the above shares, 21,000		Loan and advances	
equity share are allotted as fully		Current assets	
paid up for consideration other		(800+300)	1100.00
than cash)			
Reserves and Surplus:			
As per last Balance Sheet	400.00		
Capital Reserve (62+1)	63.00		
Securities Premium A/c	18.90		
Other liabilities	120.00		
Current liabiltiies and provisions :			
Current liabilities			
(356 + 200)	556.00		
	1,240.00		**1,240.00**

Note: It has been assumed that Current assets have been taken over by S Ltd. at their book value.

Illustration - 20

The Balance sheet of H Ltd. as on 31.3.08 :

(Figures in Rs. lakhs)

Liabilities	*Amount*	*Assets*	*Amount*
Equity Share Capital	4.00	Fixed Assets less depreciation	6.00
(in equity shares of Rs. 10 each)		to date	
10% Preference Share Capital	3.00	Stock and debtors	5.30
General Reserve	1.00	Cash and Bank	0.70
Profit & Loss Account	1.00		
Creditors	3.00		
	12.00		**12.00**

M Ltd. another existing company holds 25% of equity Share capital of H Ltd. purchased at Rs.10 per share.

It was agreed that M. Ltd. should take over the entire undertaking of H Ltd. on 30.9.08 on which date the position of Current assets (except cash and bank balances) and creditors was as follows.

Stock and debtors	4 lakhs
Creditors	2 lakhs

Profits earned for half year ended 30.9.08 by H Ltd. was Rs. 70,500 after charging depreciation of Rs. 32,500 on fixed assets. H Ltd. declared 10% dividend for 2007-08 on 30.8.08 and the same was paid within a week.

Goodwill of H Ltd. was valued at Rs. 80,000 and block assets were valued at 10% over their book value as on 31.3.08 for purposes of take over. Preference shareholders of H Ltd. will be allotted 10% preference shares of Rs. 10 each by M Ltd. Equity share holders of H Ltd. will receive requisite number of equity shares of Rs. 10 each from M Ltd. valued at Rs. 10 per share.

i. Compute the purchase consideration.

b. Explain, how the Capital reserve or goodwill, if any, will appear in the balance sheet of M Ltd. after absorption.

Solution :

WN # 1 : ***Calculation of Cash and Bank Balances as on 30th September 2008***

Balance Sheet of H Ltd. as at 30.09.08

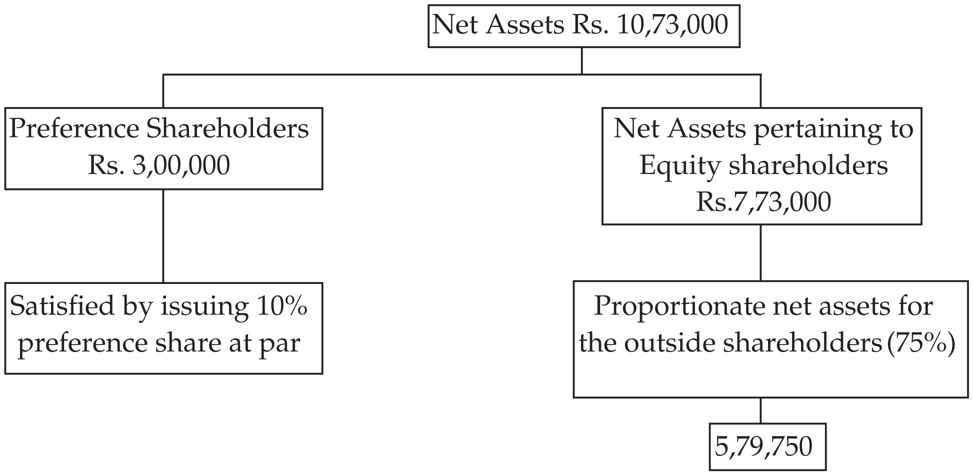
Liabilities	*Amount*	*Assets*	*Amount*
Equity Share capital	Rs	Block Assets 6,00,000	Rs.
(40,000 equity shares of Rs. 10 each)	4,00,000	Less: Depreciation (32,500)	5,67,500
10% Preference Share capital	3,00,000	Stock and Debtors	4,00,000
Reserves and surplus		Cash and Bank (balancing figure)	1,33,000
General Reserve	1,00,000		
Profit and Loss A/c*	1,00,500		
Creditors	2,00,000		
	11,00,500		**11,00,500**

Profit & Loss Account

Particulars	***Amount***
Opening Balance	1,00,000
Add: Half year profit	70,500
Less: Preference dividend @ 10%	(30,000)
Less: Equity dividend @ 10%	(40,000)
Closing balance	1,00,500

a. Purchase Consideration - Net Assets Method

Particulars	***Amount***	***Amount***
Fixed assets	6,60,000	
Stock and Debtors	4,00,000	
Cash and Bank	1,33,000	
Goodwill	80,000	12,73,000
Less: Creditors		(2,00,000)
Net Assets Taken over		**10,73,000**



Total Purchase Consideration

	Particulars	*Amount Rs.*
a.	10% Preference Share Capital	3,00,000
b.	Equity Share Capital (Outsiders)	5,79,750
c.	***Total***	**8,79,750**

Calculation of Capital Reserve

	Particulars		*Amount Rs.*
a.	Net Assets takenover		10,73,000
b.	Less:		
	i) Preference shares to be alloted	3,00,000	
	ii) Equity shares to be allotted	5,79,750	
	iii) Cost of Investments	1,00,000	(9,79,750)
c.	***Capital Reserve***		**93,250**

Balance sheet of M Ltd. as on 30th September 2008 (Extracts)

Liabilities		*Rs.*	*Assets*	*Rs.*
Reserves and Surplus:				
Capital Reserve	93,250			
Less: Goodwill	80,000	13,250		

Illustration - 21

The summarised Balance sheets of A Ltd. and its subsidiary B Ltd. as on 31.3.2009 are as follows:

	A Ltd. *Rs.*	*B Ltd.* *Rs.*
Equity Share Capital (Rs. 10 each)	1,00,00,000	20,00,000
Reserves and Surplus	1,40,00,000	60,00,000
Secured Loans	40,00,000	–
Current liabilities	60,00,000	20,00,000
	3,40,00,000	**1,00,00,000**
Fixed Assets	1,20,00,000	35,00,000
Investment in B Ltd.	7,40,000	–
Sundry Debtors	70,00,000	10,00,000
Inventories	60,00,000	50,00,000
Cash and Bank	82,60,000	5,00,000
	3,40,00,000	**1,00,00,000**

A Ltd. holds 76% of the paid up capital of B Ltd. The balance shares in B Ltd. are held by a foreign Collaborating Company. A memorandum of understanding has been entered into with the foreign company providing for the following.

a. The shares held by the foreign company will be sold to A Ltd. The price per share will be calculated by capitalising the yield at 16%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were Rs. 35 lakhs, Rs.44 lakhs and Rs.65 lakhs.

b. The actual cost of shares to the foreign company was Rs. 2,40,000 only. The profit that would accrue to them would be taxable at an average rate of 20%. The tax payable be deducted from the proceeds and A Ltd. will pay it to the Government.

c. Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after one year. It was also decided that A Ltd. would absorb B Ltd. simulataneously by writing down the Fixed assets of B Ltd. by 5%. The Balance sheet figures included. a sum of Rs.1 ,50,000 due by B Ltd. to A Ltd.

The entire arrangement was approved by all concerned for giving effect to on 1.4.2009. You are required to show the Balance Sheet of A Ltd. as it would appear after rrangement is put through on 1.4.2009.

Solution :

- Nature of Amalgamation - Purchase Method
- Method of Accounting - Purchase Method

WN # 1 : *Computation of Purchase consideration* :

a. Yield of B Ltd.

$$= \frac{\underline{(35+44+65)}}{3} \times 40\% = \text{Rs. } 19.20 \text{ Lakhs}$$

b. Price per share of B Ltd.

(Figures in Lakhs)

Particulars	*Amount*
Yield of B Ltd. (Rs. in lakhs)	19.20
Capitalisation rate	16%
Value of B Ltd. (Rs. in lakhs)	120.00
No. of Shares Outstanding (lakhs)	2.00
Price per share (Rs.) (120.00/20.00) (Rs. 120 lakhs /2.00 lakh shares)	60

c. Purchase Consideration :

(Rs. in Lakhs)

Particulars	*Amount*
Shares held by Foreign Collaborator (2,00,000 x 24%)	48,000 shares
Price per share	Rs. 60/-
Purchase Consideration	***Rs. 28,80,000***

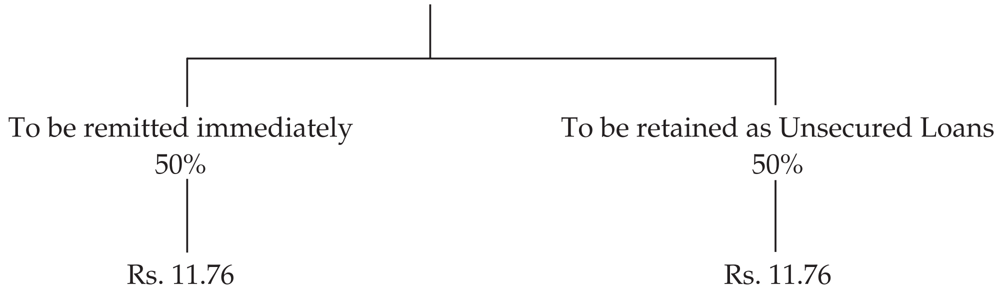
WN # 2 : *Discharge of Purchase Consideration* :

a. Tax Payable:

	(Rs. in Lakhs)
Purchase Consideration	28.80
Less: Cost of Acquisition	(2.40)
Capital Gains	26.40
Tax payable @ 20%	5.28

b. Mode of payment of purchase consideration

Purchase Consideration	28.80
Less: Income Tax payable	(5.28)
	23.52



WN # 3 : *Calculation of Goodwill / Capital Reserve on Absorption*

A. Calculation of Net Assets:

	Particulars	*Amount*	*Amount*
a.	Assets taken over :		
	i. Fixed assets	35	
	Less: 5% reduction in value	(1.75)	33.25
	ii. Sundry Debtors		10.00
	iii. Inventories		50.00
	iv. Cash and Bank balances		5.00
			98.25
b.	Current liabilities		20.00
c.	**Net Assets taken over (a-b)**		**78.25**

B. Goodwill / Capital Reserve :

Particulars	*Amount*	*Rs. in Lakhs*
Net Assets taken over		78.25
Less: Purchase Consideration		(28.80)
Less: Investments in B Ltd.		(7.40)
Capital Reserve		**42.05**

WN # 4 : ***Computation of Cash and Bank Balances after absorption***

Particulars	*Rs. in Lakhs*
Balance in A Ltd.	82.60
Cash and Bank Balance of B. Ltd.	5.00
Less : Remittance to Foreign Collaborating Company	(11.76)
Less : TDS paid	(5.28)
Cash and Bank balance	**70.56**

Balance Sheet of A Ltd. as* on *1st April, 2009

Liabilities	*Rs.*	*Amount*	*Assets*	*Rs.*	*Amount*
Equity Share Capital		100.00	Fixed assets		
of Rs. 10 each			(120 + 33.25)		153.25
Reserves and Surplus:			Current assets,		
Capital Reserve	42.05		Loans and Advances:		
Other Reserve	140.00	182.05	Sundry Debtors	80	
Secured Loans		40.00	(70+10)		
Unsecured Loans (WN # 2)		11.76	Less: Inter Company		
Current liabilities :-			owings	(1.5)	78.50
A Ltd.	60.00		Inventories (60+50)		110.00
B Ltd.	20.00		Cash & Bank		70.56
Less: Inter Co. Owings	(1.50)	78.50	(WN #4)		
		412.31			**412.31**

Illustration - 22

The Balance Sheets of S Ltd. and P Ltd. as on 31.03.09 are as under:

(Rs. in Lakhs)

Liabilities	*S*	*P*	*Assets*	*S*	*P*
Equity Shares of Rs. 100 each	25.00	50.00	Fixed Assets	110.00	50.00
Reserves	131.00	29.25	Investments	16.25	25.00
12% Debentures	11.00	5.50	Current Assets	40.25	3.25
Creditors	8.00	2.75	Miscellaneous Expenditure	8.50	9.25
	175.00	**87.50**		**175.00**	**87.50**

Investments of S Ltd. represents 12,500 shares of P Ltd. investments of P Ltd. are considered worth Rs. 30 lakhs.

P Ltd. is taken over by S Ltd. on the basis of the intrinsic value of shares in their respective books of accounts.

Prepare a statement showing the number of shares to be allotted by S Ltd. to P Ltd. and the balance sheet of S Ltd. after absorpotion of P Ltd.

Solution :

Part.* I : *Purchase consideration

WN* # 1 *Net Assets

			(Rs. in lakhs)
		S Ltd.	**P Ltd.**
A.	Assets		
	i) Fixed Assets	110.00	50.00
	ii) Investments	18.75*	30.00
	iii) Current Assets	40.25	3.25
		169.00	83.25
B.	Liabilities		
	i) 12% Debentures	11.00	5.50
	ii) Creditors	8.00	2.75
		19.00	7.75
		150.00	75
C.	Net Assets [A-B]		

* Investments of 'S' Ltd = 12,500 × Rs. 150 [WN # 2]
= Rs. 18.75 Lakhs.

WN* # 2 : *Intrinsic Value

	S Ltd.	P. Ltd.
Net assets	150.00 Lakhs	75.00 Lakhs
No. of equity shares	25,000	50,000
Intrinsic value	Rs. 600	Rs. 150.00

WN # 3 : *Purchase consideration (No. of shares alloted)*

No. of equity shares outstanding in P Ltd	50,000
Less: Already held by S Ltd.	12,500
No. of equity shares of outsiders	37,500
Intrinsic value of P Ltd.	Rs. 150
Purchase consideration (37,5000 × 150)	56,25,000
Instrinsic value per share of S Ltd.	Rs. 600
No. of shares to be allotted	56,25,000/600
	9,375 shares

Equity Share Capital = 9,375 × 100 = 9,37,500

Securities Premium = 9,375 × 500 = 46,87,500

Part - II : ***In the books of S Ltd.***

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due :			
Business Purchase A/c	Dr.	56,25,000	
To Liquidator of P Ltd. A/c			56,25,000
2. For assets and liabilities taken over :			
Fixed Assets A/c	Dr.	50,00,000	
Investments A/c	Dr.	30,00,000	
Current Assets A/c	Dr.	3,25,000	
To 12% Debentures A/c			5,50,000
To Creditors A/c			2,75,000
To Business Purchase A/c			56,25,000
To Investment in shares of P Ltd. A/c			16,25,000
To Capital Reserve (Balancing Figure)			2,50,000
3. Discharge of purchase consideration :			
Liquidator of P Ltd. A/c	Dr.	56,25,000	
To Share Capital A/c			9,37,500
To Securities Premium A/c			46,87,500

Balance sheet of S Ltd. (after absorption)

(Rs. in lakhs)

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Share capital :	34.38	Fixed assets :	160.00
34,375 equity shares of		(110+50)	
Rs. 100/ - each		Investments	30.00
[of the above shares 9,375		Current assets, loans and	
equity shares are allotted as		advances :	
fully paid up for consideration		Current assets	43.50
other than cash]		Miscellaneous expenditure	8.50
Reserves and surplus			
Capital reserve	131.00		
Securities premium	2.50		
Secured loans	46.87		
12% Debenture	16.50		
Current liabilities and provisions			
Creditors	10.75		
	242.00		**242.00**

Illustration - 23

Given below Balance sheets of X Limited and Y Limited as at 31.3.2009.

		X Ltd. *Rs. in Lakhs*		*YLtd.* *Rs. in Lakhs*
Sources of Funds				
Shareholders' funds		500		300
Equity Shares of Rs. 100 each				
Reserves and surplus				
General Reserve		200		100
Profit and Loss A/c		100		100
Loan Funds				
Secured Loans		300		200
Unsecured Loans		100		100
		1,200		**800**
Applications of Funds:				
Fixed Assets				
Gross block		800		600
Less: Depreciation		(200)		(150)
Net block		600		450
Investments - in 2.4 lakhs shares of Y Ltd.		300		–
Others		–		100
Current assets, Loans and Advances				
Less: Current liabilities	400		400	
Net Current assets	(100)		(150)	
		300		250
		1,200		**800**

X Ltd. agreed to take over all the assets and liabilities of Y Ltd. at book value and discharge the claims of minority shareholders by issuing its one share for every two shares held. Minorities claims are to be discharged on the basis of intrinsic value per share. For computing intrinsic value per share net Fixed assets of Y Ltd are to be valued at Rs. 850 Lakhs. Prepare post merger Balance Sheet of X Ltd. Show all your workings.

Solution :

Part I : ***Calculation of Purchase Consideration***

WN # 1 : ***Computation* of *Intrinsic Value***

Rs. in Lakhs

	X Ltd	*Y Ltd*
Fixed assets	600	850
Investments: In Y Ltd. (24 x 30)	720	–
Other investments	–	100
Current assets, Loans and Advances	400	400
Less: Current liabilities	(100)	(150)
Less: Unsecured Loans	(100)	(100)
Less: Secured Loans	(300)	(200)
Net Assets	1220	900
Intrinsic Value (Net Assets ÷ No. of shares outstanding)	1220/5	900/3
	= 244	= 300

WN # 2 : ***Purchase Consideration***

Particulars	
Total number of shares outstanding (lakhs)	3,00,000
Less: Shares held by X Ltd. (lakhs)	2,40,000
Shares held by Outsiders (lakhs)	60,000
Exchange Ratio (lakhs)	1:2
No. of shares to be issued (lakhs)	30,000
Intrinsic Value Per share	244
Purchase Consideration (30,000 × Rs. 244)	Rs. 73.2 Lakhs

Part II - ***In* the *Books of Purchasing Co.* X *Ltd***

- *Nature of Amalgamation* : Merger
- *Method of Accounting* : Pooling of interest

(Rs. in *Lakhs)*

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due :			
Business Purchase A/c	Dr.	73.20	
To Liquidator of Y Ltd A/c			73.20
2. For Assets and Liabilities Takeover :			
a. Aggregate Consideration			
i. Already Paid	300.00		
ii. Balance Payable	(73.20)		
	373.20		
b. Less: Paidup Capital of Vendor Co.	(300.00)		
c. Excess			
(The above excess to be adjusted against:			
*General Reserves of Y Ltd.			73.20

Particulars	Debit	Credit
d. Balance of General Reserves of Y Ltd. to be incorporated (100 – 73.20) 26.80		
Fixed Assets A/c Dr.	600.00	
Investments A/c Dr.	100.00	
Current Assets A/c Dr.	400.00	
To Provision for depreciation A/c		150.00
To Current liabilities and Provisions A/c		150.00
To Secured Loans A/c		200.00
To Unsecured Loans A/c		100.00
To Business Purchase A/c		73.20
To Investments in Y Ltd A/c		300.00
To General Reserve A/c		26.8
To Profit and Loss A/c		100.00
3. For Discharge of Purchase Consideration		
Liquidator of Y Ltd A/c Dr.	73.2	
To Equity Share Capital A/c		30.0
To Securities Premium A/c		43.2

Balance Sheet of X Ltd as at 31 st March 2009

Liabilities	*Rs. in Lakhs*	*Assets*		*Rs. in Lakhs*
Authorised, Issued, Subscribed and paid up Share capital of Rs. 100 each (out of the above 30,000 shares were issued for consideration other than for cash)	530	Fixed assets Less : Accumulated Depreciation	1400 350	1050
Reserves and surplus		Investments		100
General Reserve	226.80	Current assets		800
Profit and Loss A/c	200			
Securities Premium	43.20			
Secured Loans	500			
Unsecured Loans	200			
Current liabilities and Provisions	250			
	1950			**1950**

IV. Selling Company holding shares in Purchasing Company

Illustration - 24

Following are the Balance sheets of two companies, B Ltd. and D Ltd. as at December 31, 2008.

Liabilities	*B Ltd.* *Rs.*	*D Ltd.* *Rs.*	*Assets*	*B Ltd.* *Rs.*	*D Ltd.* *Rs.*
Equity Share Capital:			Sundry Assets	7,50,000	3,50,000
(Shares of Rs. 10 each)	5,00,000	30,00,000	10,000 Shares in		
Reserve	1,00,000	55,000	B Ltd.	—	1,00,000
Creditors	1,50,000	95,000			
Total	**7,50,000**	**4,50,000**	**Total**	**7,50,000**	**4,50,000**

B Ltd. was to absorb D Ltd. on the basis of intrinsic value of the shares, the purchase consideration was to be discharged in the form of fully paid shares, entries to be made at par value only. A sum of Rs. 20,000 is owed by B Ltd. to D Ltd. Also included in the stocks of B Ltd. Rs. 30,000 goods supplied by D Ltd. cost plus 20%. Give Journal entires in the books of both the Companies.

Solution:

Part I: In the Books of D Ltd.

	Particulars		*Debit* *Rs.*	*Credit* *Rs.*
1.	Realisation A/c	Dr.	3,50,000	
	To Sundry Assets A/c			3,50,000
	[Being the assets taken over by B Ltd. transferred to Realisation A/c]			
2.	Creditors A/c	Dr.	95,000	
	To Realisation A/c			95,000
	[Being Creditors taken over by B Ltd. transferred Realisation A/c]			
3.	B Ltd. A/c	Dr.	2,12,500	
	To Realisation A/c			2,12,500
	[Being purchase consideration (WN # 2) receivable]			
4.	Shares in B Ltd. A/c	Dr.	2,12,500	
	To B Ltd. A/c			2,12,500
	[Being discharge of purchase consideration]			
5.	Shareholders A/c	Dr.	42,500	
	To Realisation A/c			42,500
	[Being realisation loss transferred to Shareholder A/c]			
6.	Share Capital A/c	Dr.	3,00,000	
	Reserves A/c	Dr.	55,000	
	To Shareholders A/c			3,55,000
	[Being Share capital and Reserves transferred to Shareholders A/c]			
7.	Shareholders A/c	Dr.	3,12,500	
	To Shares in B Ltd.			3,12,000
	[Being the settlement to shareholders for the amount due]			

Calculation of Purchase consideration - Net Assets Method

WN # 1: ***Intrinsic value of share***

	Particulars	*B Ltd (Rs.)*	*D Ltd. (Rs.)*
a)	Sundry Assets	7,50,000	3,50,000
b)	Investments in B Ltd. 10,000 shares @ Rs. 12 each	—	1,20,000
c)	Creditors	(1,50,000)	(95,000)
d)	Net Assets	6,00,000	3,75,000
e)	No. of shares outstanding	50,000	30,000
f)	Intrinsic Value of shares [d ÷ e]	12	12.5

WN # 2: ***Purchase Consideration***

	Particulars	*Amount*
a)	No. of shares of D Ltd.	30,000
b)	Value of shares @ Rs. 12.50	Rs. 3,75,000
c)	No. of shares issuable based on intrinsic value of Rs. 12 (3,75,000 ÷ 12)	31,250
d)	No. of shares held by D Ltd.	(10,000)
e)	Net shares to be issued	21,250
f)	Total consideration at par (21,250 x Rs. 10)	Rs. 2,12,500

Part - II : ***In the books of B Ltd.***

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest

	Particulars			*Debit (Rs.)*	*Credit (Rs.)*
1.	For Purchase Consideration Due:				
	Business Purchase A/c		Dr.	2,12,500	
	To Liquidator of D Ltd.'s A/c				2,12,500
2.	a. For of assets and liabilities taken over				
	i. Aggregate consideration to share holders of Selling Company				
	* Shares already held by D Ltd.	1,00,000			
	* Shares now issued	2,12,500			
	ii. Paid up capital of D Ltd.	3,12,500			
		(3,00,000)			
	iii. Excess	12,500			
	iv. Above excess to be adjusted against reserves of D Ltd.	12,500			
	v. Balance of reserves to be incorporated (55,000 - 12,500)	42,500			
	b. Assets A/c		Dr.	3,50,000	
	To Creditors A/c				95,000
	To Reserves A/c				42,500
	To Business Purchase A/c				2,12,500

Particulars		*Debit (Rs.)*	*Credit (Rs.)*
3. Discharge of Purchase consideration			
Liquidator of D Ltd.'s A/c	Dr.	2,12,500	
To Equity Share Capital A/c			2,12,500
4. Others			
a. Cancellation of Inter company owings			
Creditors A/c	Dr.	20,000	
To Sundry Assets A/c			20,000
b. Adjusted of Stock Reserve			
Reserve A/c	Dr.	5,000	
To Stock Reserve			5,000

Balance Sheet of B Ltd. as on 31.12.2008 (after Amalgamation)

Liabilities	*Amount*	*Assets*	*Amount*
Share Capital (of the above, 21,250 shares issued for consideration other than cash)	7,12,500	Sundry Asset (7,50,000+3,50,000– 20,000 – 5,000)	10,75,000
Reserves and Surplus			
Reserve (1,00,000+42,500 – 5,000)	1,37,500		
Creditors	2,25,000		
	10,75,000		**10,75,000**

Illustration - 25

Jay Ltd., and Krishna Ltd., had the following financial position as at 31st March, 2009.

	Jay Ltd.	**Krishna Ltd.**		**Jay Ltd.**	**Krishna Ltd.**
Share capital:	24,00,000	18,00,000	Goodwill	15,00,000	3,00,000
Equity shares of			Fixed assets	12,00,000	21,00,000
Rs. 100 each fully paid			Investment at cost	9,00,000	6,00,000
General Reserve	9,00,000	6,00,000	Current assets	9,00,000	7,50,000
Investment Allowance					
Reserve	—	9,00,000			
Liabilities	12,00,000	4,50,000			
	45,00,000	**37,50,000**		**45,00,000**	**37,50,000**

It was decided that Jay Ltd. will take over the business of Krishna Ltd., on that date, on the basis of the respective share values adjusting, wherever necessary, the book values of assets and liabilities on the strength of information given below:

1) Investment of Krishna Ltd., included 3,000 shares in Jay Ltd., acquired at a cost of Rs. 150 per share. The other investments of Krishna Ltd., have a market value of Rs. 75,000;

2) Investment Allowance Reserve was in respect of additions made to Fixed assets by Krishna Ltd., in the years 2004-2007 on which Income Tax relief has been obtained. In terms of the Income Tax Act, the company has to carry forward till 2011, reserve of Rs. 4,50,000 for utilisation;

3) Goodwill of Jay Ltd., and Krishna Ltd., are to be taken at Rs. 12,00,000 and Rs. 6,00,000 respectively;

4) The market value of investments of Jay Ltd., was Rs. 6,00,000;
5) Current assets of Jay Ltd., included Rs. 24,00,000 of stock in trade obtained from Krishna Ltd. which company sold at a profit of 25% over cost ;
6) Fixed assets of Jay Ltd., and Krishna Ltd., are valued at Rs. 15,00,000 and Rs. 22,50,000 respectively.

Suggest the scheme of absorption and show the journal entries necessary in the books of Jay Ltd. Also prepare the Balance Sheet of that company after takeover of the business of Krishna Ltd.

Solution :

Part I : ***Purchase Consideration***

WN # 1 : ***Intrinsic Value of Shares***

Particulars	Jay Ltd. Rs.	Krishna Ltd. Rs.
Goodwill	12,00,000	6,00,000
Fixed assets	15,00,000	22,50,000
Investments - Outside	6,00,000	75,000
- Inter Co [13,000 shares @ Rs. 125 each]	—	3,75,000
Current assets	9,00,000	2,50,000
Liabilities	(12,00,000)	(4,50,000)
Net assets	30,00,000	36,00,000
No. of shares outstanding	24,000	18,000
Intrinsic value per share (30,00,000/125); (36,00,000/180)	125	200

WN # 2 : ***Purchase Consideration***

Particulars	Krishna Ltd. Rs.
Total no. of shares outstanding in Krishna Ltd.	18,000
Value of shares @ Rs. 200/- each	36,00,000
No. of shares issuable on the basis of Intrisic value of share (36,00,0000 ÷ 125)	28,800
Less : Shares already held	(3,000)
No. of shares to be issued	25,800
Shares price	125
Purchase Consideration (25,800 × 125)	**32,25,000**

Part II : In the Books of Jay Ltd.

- Nature of Amalgamation - Purchase
- Method of Accounting - Purchase

Particulars		*Debit (Rs.)*	*Credit (Rs.)*
1. For Purchase Consideration Due			
Business Purchase A/c	Dr.	32,25,000	
To Liquidator of Krishna Ltd. A/c			32,25,000
2. For Assets and Liabilities taken over :			
Goodwill A/c	Dr.	6,00,000	

Particulars		*Debit (Rs.)*	*Credit (Rs.)*
Fixed Assets A/c	Dr.	22,50,000	
Investments A/c	Dr.	75,000	
Current Assets A/c	Dr.	7,50,000	
To Liabilities A/c			4,50,000
To Business Purchase A/c			32,25,000
3. For Discharge of Purchase consideration			
Liquidator of Krishna Ltd. A/c	Dr.	32,25,000	
To Equity Share Capital A/c			25,80,000
To Securities Premium A/c			6,45,000
4. Contra entry for statutory reserve			
Amalgamation adjustment A/c	Dr.	60,000	
To Investment allowance A/c			60,000
5. For adjustment of stock reserve			
Goodwill A/c	Dr.	48,000	
To Stock Reserve A/c			48,000

Balance Sheet of Jay Ltd. (after amalgamation)

Liabilities	*Amount (Rs)*	*Assets*	*Amount Rs*
Share capital	49,80,000	Goodwill	21,48,000
49,800 shares of Rs. 1000 (of which		Fixed Assets	34,50,000
25,800 shares of Rs. 1000		Investment	9,75,000
each issued for consideration		Curent Assets:	16,02,000
other than cash)		Miscellaneous Expenditure	
Reserves and surplus		Amalgamation Adjustment A/c	4,50,000
Securities premium	6,45,000		
Investment Allowance Reserve	4,50,000		
General reserve	9,00,000		
Current liabilities	16,50,000		
	86,25,000		**86,25,000**

V. Cross Holding

Illustration - 26

The following Balance sheets of A Ltd. and B Ltd. as at 31st March, 2009 are given to you:

	A Ltd. Rs.	*B Ltd. Rs.*
Liabmties:		
Equity Share capital		
of Rs.10 each	15,00,000	5,00,000

	A Ltd. *Rs.*	*B Ltd.* *Rs.*
General Reserve	2,00,000	1,00,000
Profit and Loss Account	1,60,000	10,000
10% Debentures	—	3,00,000
Current liabilities	2,00,000	90,000
	20,60,000	**10,00,000**
Assets:		
Fixed Assets	10,00,000	50,000
Sundry Debtors	2,90,000	1,50,000
Stock	4,80,000	2,10,000
10,000 shares in B Ltd.	1,50,000	—
30,000 shares in A Ltd.	—	5,00,000
Cash at bank	1,40,000	90,000
	20,60,000	**10,00,000**

B Ltd. traded raw material which were required by A Ltd. for manufacture of its products. Stock of A Ltd. includes Rs. 1,00,000 for purchases made from B Ltd. on which the company (B Ltd.) made a profit of 12% on selling price. A Ltd. owed Rs. 25,000 to B Ltd. in this respect. It was decided that A Ltd. should absorb B Ltd. on the basis of the intrinsic value of the shares of the two companies. Before absorption, A Ltd. declared a dividend of 10%. A Ltd. also decided to revalue the shares in B Ltd. before recording entries relating to the absorption.

Show the journal entries, which A Ltd. must pass to record the acquisition and prepare its balance sheet immediately thereafter. All workings should from part of your answer.

Solution :

Part* I *- Purchase consideration - Net Asset Method.

WN #1: ***Net assets excluding inter company investment at the time of Amalgamation***

Rs.

Particulars	*A*	*B*
Fixed Assets	10,00,000	50,000
Sundry Debtors	2,90,000	1,50,000
Stock	4,80,000	2,10,000
Cash	1,40,000	90,000
Dividend Receivable		30,000
Less :		
10% Debentures	—	(3,00,000)
Current liabilities	(2,00,000)	(90,000)
Proposed Dividend	(1,50,000)	
	15,60,000	**1,40,000**

WN # 2 : ***Intrinsic value of investment***

$$
\begin{aligned}
A &= 15,60,000 + 0.2\ B \\
B &= 1,40,000 + 0.2\ A \\
A &= 15,60,000 + 0.2\ (1,40,000 + 0.2A) \\
A &= 15,60,000 + 28,000 + 0.04A \\
0.96A &= 15,88,000 \\
A &= 16,54,166.67 \\
B &= 1,40,000 + 0.2\ (16,54,166.67) \\
&= 4,70,833.32
\end{aligned}
$$

Summary **:**

Particulars	*A Ltd.*	*B Ltd.*
a) Net Assets (Rs.)	16,54,167	4,70,833
b) No. of shares outstanding	1,50,000	50,000
c) Intrinsic value per share	Rs. 11	Rs. 9.4

WN # 3: Purchase consideration

Total no. of B Ltd.'s shares outstanding	50,000
Less: No. of shares held by A Ltd	10,000
Shares held by outsiders	40,000
Value of the above shares (40,000 × Rs. 9.40)	Rs. 3,76,000
Number of shares issuable at intrinsic value (3,76,000÷11)	34,182
Less: Number of shares already held by B Ltd.	30,000
Number of shares to be issued	4,182
Purchase consideration (4182 x 11)	Rs. 46,002

In Shares	In Cash
Rs. 46,000	Rs.2

Part II - In the books of Selling Company - B Ltd.

Section A: Pre-Amalgamation Event

Particulars		*Debit*	*Credit*
i. Dividend Receivable			
Dividend Receivable A/c	Dr.	30,000	
To Profit and Loss A/c			30,000

Note : Revised Profit and Loss A/c balance = Rs. 10,000 + 30,000

= Rs. 40,000

Section B* : *Entries relating to Amalgamation

Realisation Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Fixed Assets	50,000	By Debentures	3,00,000
To Debtors	1,50,000	By Creditors	90,000
To Stock	2,10,000	By A Ltd.'s A/c (Purchasing Co.)	46,002
To Cash	90,000	By Share capital (Head as Investment)	1,00,000
To Dividend Receivable	30,000		
To Profit transferred to share holders	6,002		
	5,36,002		**5,36,002**

Particulars		*Debit Rs.*	*Credit Rs.*
1. Transfer to Realisation Account			
a. Transfer of Assets			
Realisation A/c	Dr.	5,30,000	
To Fixed Assets A/c			50,000
To Debtors A/c			1,50,000
To Stock A/c			2,10,000
To Cash A/c			90,000
To Dividend Receivable A/c			30,000
(Being assets taken over by transferred to Realisation A/c)			
b. Transfer of Liabilities			
10% Debentures A/c	Dr.	3,00,000	
Creditors A/c	Dr.	90,000	
To Realisation A/c			3,90,000
(Being liabilities taken over by A Ltd. transferred to Realisation A/c)			
2a. **Purchase consideration due:**			
A Ltd A/c	Dr.	46,002	
To Realisation A/c			46,002
b. Receipt of Purchase Consideration :			
Cash A/c	Dr.	2	
Equity shares of A Ltd A/c	Dr.	46,000	
To A Ltd A/c			46,002

Particulars	*Debit Rs.*	*Credit Rs.*
3. Cancellation of paid up capital to the extent		
of A Ltd's Interest (Purchasing Co.) :		
Share Capital A/c Dr.	1,00,000	
To Realisation A/c		1,00,000
4. a. Amount due to outside shareholders :		
Transfer of remaining Share capital and all reserves		
Share Capital A/c Dr.	4,00,000	
General Reserve A/c Dr.	1,00,000	
Profit & Loss A/c Dr.	40,000	
To Shareholders A/c		5,40,000
b. Transfer of profit on realisation to shareholders :		
Realisation A/c Dr.	6,002	
To Shareholders A/c		6,002
5. Settlement of amount to outsiders		
(5,40,000 + 6,002) :		
Shareholders A/c Dr.	5,46,002	
To Equity shares of A Ltd. (5,00,000 + 46,000)		5,46,000
To Cash A/c		2

PART III - In the books of A Ltd (Purchasing co.)

Section A - Pre Amalgamation Events.

Particulars	*Debit*	*Credit*
1. Proposed dividend :		
Profit & Loss A/c Dr.	1,50,000	
To Proposed Dividend A/c		1,50,000
2. Revaluation of Investments		
Profit and Loss A/c Dr.	56,000	
To Investments A/c [1,50,000 - (10,000 × 9.4)]		56,000

Section B - Amalgamation events

- Nature of Amalgamation : Merger
- Method of Accounting : Pooling of Interest

(Rs.)

Particulars	*Debit*	*Credit*
3. For Purchase Consideration Due :-		
Business Purchase A/c Dr.	46,002	
To Liquidator of B Ltd.'s A/c		46,002
4. For assets and liabilities taken over :		

Particulars				Debit	Credit
a. Aggregate investment - Consideration Paid					
i. Investment of A Ltd. in B		94,000			
ii. Paid to outsiders.					
I. Now issued	46,002				
II. Already held by A Ltd. in B Ltd.	5,00,000	5,46,002			
		6,40,002			
III. Less: Paid up capital		(5,00,000)			
IV. Excess		1,40,002			
b. Above excess to be adjusted against					
i. General reserve of B Ltd.			1,00,000		
ii. P & L A/c of B Ltd.			40,000		
c. Balance of B Ltd reserve to be incorporated			1,40,000		
i. General reserve (1,00,000 – 1,00,000)			Nil		
ii. Profit and Loss A/c (40,000 – 40,000)			Nil		
Fixed Assets A/c			Dr.	50,000	
Sundry Debtors A/c			Dr.	1,50,000	
Stock A/c			Dr.	2,10,000	
Cash at Bank A/c (90,000 + 2)			Dr.	90,002	
Dividend Receivable A/c			Dr.	30,000	
To Debentures A/c					3,00,000
To Creditors A/c					90,000
To Business Purchase A/c					46,002
To Investments in B Ltd A/c					94,000
5. Discharge of Purchase Consideration:					
Liquidator of B Ltd A/c			Dr.	46,002	
To Equity Share Capital A/c					41,818
To Securities Premium A/c					4,182
To cash A/c					2
6. Others					
a. Cancellation of inter company dividends.					
Proposed Dividend A/c			Dr.	30,000	
To Dividend Receivable A/c					30,000
b. Cancellation of inter company owings.					
Creditors A/c			Dr.	25,000	
To Debtors A/c					25,000
c. Creation of Stock Reserve					
Profit & Loss A/c			Dr.	12,000	
To Stock Reserve A/c					12,000

A Ltd
Balance Sheet as at 31st-March 2009

Liabilities		*Rs.*	*Assets*		*Rs.*
Share Capital:			Fixed assets		
Authorised, issued,			(10 Lakhs + 50,000)		10,50,000
subscribed and fully			Current assets, Loans		
paid up equity shares		15,41,820	and Advances		
of Rs.10 each [of which			Stock (480+210)	6,90,000	
4182 shares			Less: Reserve	(12,000)	6,78,000
were issued for			debtors (290+150-25)		4,15,000
consideration other			Cash at bank		
than cash]			(1,40,000 + 90,002)		2,30,002
Reserves and Surplus:					
Securities premium	4,182				
General reserve	2,00,000				
Profit and Loss A/c	(58,000)	1,46,182			
Secured Loans :					
10% Debentures		3,00,000			
Current liabilities					
and Provisions					
A. Current liabilities		2,65,000			
B. Proposed dividend		1,20,000			
		23,73,002			**23,73,002**

Illustration 27:

The following are the Balance Sheets of A Ltd. and B Ltd. as on 31st December 2008.

Liabiltiies	*A Ltd. Rs.*	*BLtd. Rs.*	*Assets*	*A Ltd. Rs.*	*BLtd. Rs.*
Share capital			**Fixed Assets**	7,00,000	2,50,000
Equity shares of	6,00,000	3,00,000	**Investment:**		
Rs. 10 each			6,000 shares of B		
10% Preference	2,00,000	1,00,000	Ltd.	80,000	-
shares of Rs. 10			5,000 shares of A		
each			Ltd.	-	80,000
Reserves and	3,00,000	2,00,000	**Current Assets:**		
surplus			Stock	2,40,000	3,20,000
Secured loans:			Debtors	3,60,000	1,90,000
12% Debentures	2,00,000	1,50,000	Bills receivable	60,000	20,000
Current liabilities			Cash at bank	1,10,000	40,000
Sundry creditors	2,20,000	1,25,000			
Bills payable	30,000	25,000			
	15,50,000	**9,00,000**		**15,50,000**	**9,00,000**

Fixed assets of both the companies are to be revalued at 15% above book value. Stock in—trade and Debtors are taken over at 5% lesser than their book value. Both the companies are to pay 10% Equity dividend, Preference dividend having been already paid.

After the above transactions are given effect to, A Ltd. will absorb B Ltd. on the following terms.

i. 8 Equity shares of Rs. 10 each will be issued by A Ltd. at par against 6 shares of B Ltd.

ii. 10% Preference Shareholders of B Ltd. will be paid at 10% discount by issue of 10% Preference Shares of Rs. 100 each at par in A Ltd.

iii. 12% Debentureholders of B Ltd. are to be paid at 8% premium by 12% Debentues in A Ltd. issued at a discount of 10%.

iv. Rs. 30,000 is to be paid by A Ltd. to B Ltd. for Liquidation expenses. Sundry creditors of B Ltd. include Rs. 10,000 due to A Ltd.

Prepare :

(a) Absorption entries in the books of A Ltd.

(b) Statement of consideration payable by A Ltd.

Solution:

Part - I ***Purchase consideration payable by A Ltd.***

A. *Equity share holders:*

No of equity shares of B Ltd.	30,000
Less:- Held by A Ltd.	6,000
No. of equity shares held by outsiders	24,000
Exchange ratio	8:6
No. of equity shares to be issued by A Ltd. (24,000 × 8/6)	32,000
Less: Already held by B Ltd. in A Ltd.	(5,000)
No. of equity shares to be issued now	27,000
Value of shares to be issued 27,000 × 10 =	Rs. 2,70,000

B. *Preference share holders:*

Preference Share capital of B Ltd.	1,00,000
Payable at discount of 10% [100,000 - (10% of 100,000)]	90,000
10% Preference shares to be issued at par by A Ltd. to B Ltd.	Rs. 90,000

C. *Purchase consideration (A+B)*	Rs. 3,60,000

Part II - Absorption entries* in *the books of A Ltd.

A. Pre - Amalagamation Events :-

Particulars		*Debit*	*Credit*
1. Revaluation of Fixed assets			
Fixed Assets A/c	Dr.	1,05,000	
To Revaluation Reserve A/c			1,05,000
2. Dividend received from B Ltd. on 600 shares			
Bank A/c	Dr.	6,000	
To Reserves and Surplus			6,000

Particulars		*Debit*	*Credit*
3. Dividend on equity Share capital @ 10%			
i. Due entry			
Reserves and Surplus	Dr.	60,000	
To Proposed Dividend A/c			60,000
ii. Payment entry			
Proposed Dividend A/c	Dr.	60,000	
To Bank A/c			60,000

B. Amalgamation Events

Nature of Amalgamation - Purchase

Method of Accounting - Purchase

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due:			
Business purchase A/c	Dr.	3,60,000	
To Liquidator of B Ltd.			3,60,000
2. For assets and liabilities taken over			
Fixed Assets (115% of 2,50,000)	Dr.	2,87,500	
Stock A/c (95% of 3,20,000)	Dr.	3,04,000	
Debtors A/c [95% of 200,000] - (5% of 190,000)	Dr.	1,80,500	
Bills Receivable A/c	Dr.	20,000	
Bank A/c *	Dr.	15,000	
To 12% Debentures of B Ltd A/c			1,62,000
To Sundry creditors A/c			1,25,000
To Bills payable A/c			25,000
To Business Purchase A/c			3,60,000
To Investment in B Ltd. A/c			80,000
To Capital Reserve A/c (Balancing Figure)			55,000
3. For Discharge of Purchase consideration			
Liquidator of B Ltd A/c	Dr.	3,60,000	
To Equity Share Capital A/c			2,70,000
To 10% Preference Share Capital A/c			90,000
4. Liquidation expenses incurred by B Ltd, later reimbursed by A Ltd.			
Capital Reserve A/c	Dr.	30,000	
To Bank A/c			30,000
5. Discharge to debenture holders of B Ltd.			
12% Debenture Holders A/c	Dr.	1,62,000	
Discount on Issue of debentures A/c	Dr.	18,000	
To 12% Debentures A/c.			1,80,000

	Particulars		Debit	Credit
6.	Cancellation of inter company owings			
	Sundry Creditors A/c	Dr.	10,000	
	To Sundry Debtors A/c			10,000

* Bank Balance of B Ltd.		
Balance as per Balance Sheet		40,000
Add : Dividend Received from A Ltd (10% on 50,000)		5,000
Less : Dividend paid on Share capital (10% on 3,00,000)		[30,000]
		15,000
# 12% Debentures of B Ltd.		1,50,000
Payable at 8% premium	1,50,000 × 108%	
	= 1,62,000	

VI. Chain Holding

Illustration - 28

The following are the summarized Balance Sheet of A Ltd. and B Ltd.

Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity Share Capital A/c	32,000	28,000	Sundry assets	42,000	33,000
Profit and Loss A/c	5,000	—	Shares in B Ltd.	20,000	—
Creditors	15,000	6,000	Profit and Loss A/c	—	1,000
Loan - C Ltd.	10,000	—			
	62,000	**34,000**		**62,000**	**34,000**

The whole of the shares of A Ltd. are held by C Ltd. and the entire Share capital of B Ltd. is held by A Ltd.

A new company Z Ltd. is formed to acquire the sundry assets and liabilities of A Ltd. and B Ltd. For the purpose, the sundry assets of A Ltd. are revalued at Rs. 30,000 and those of B Ltd. at Rs. 20,000.

Show the journal entries and prepare necessary ledgers A/c to close the books of A Ltd. and B Ltd.

Solution:

In the Books of A Ltd.

(Rs.)

	Particulars		Debit	Credit
1.	Realisation A/c	Dr.	62,000	
	To Sundry Assets A/c			42,000
	To Investment in B Ltd. A/c			20,000
	[Being sundry assets and shares in B Ltd. transferred to Realisation A/c on sale of business of A Ltd.]			
2.	Creditors A/c	Dr.	15,000	
	Loan (C Ltd.) A/c	Dr.	10,000	

Particulars	*Debit*	*Credit*
To Realisation A/c		25,000
[Sundry creditors and loans transferred to Realisation A/c on sale of business to Z Ltd.]		
3. Z Ltd. A/c Dr.	5,000	
To Realisation A/c		5,000
[Amount of purchase consideration receivable from Z Ltd.]		
4. Shares in Z Ltd. A/c Dr.	5,000	
To Z Ltd. A/c		5,000
[Amount of purchase consideration received as shares of B Ltd.]		
5. Shares in Z Ltd. A/c Dr.	14,000	
To Realisation A/c		14,000
[Amount of shares in Z Ltd. received against investment in Z Ltd.]		
6. Shareholders (C Ltd.) A/c Dr.	18,000	
To Realisation A/c		18,000
[Loss on realisation transferred to Shareholders A/c]		
7. Equity Share Capital A/c Dr.	32,000	
Profit and Loss A/c Dr.	5,000	
To Realisation A/c		37,000
[Balance of Share capital and Profit and Loss A/c transfer to Share holder A/c]		
8. Shareholders (C Ltd.) A/c Dr.	19,000	
To Shares in Z Ltd. A/c		19,000
[Amount payable to shareholders discharged by issue of shares in Z Ltd. (14,000 ÷ 5,000)]		

In the Books of B Ltd.

Particulars	*Debit*	*Credit*
1. Realisation A/c Dr.	33,000	
To Sundry Assets A/c		33,000
[Being Sundry Assets and Shares in B Ltd. transferred to Realisation account on sale of business to Z Ltd.]		
2. Creditors A/c Dr.	6,000	
To Realisation A/c		6,000
[Sundry Creditor is transferred to Realisation A/c on sale of Business to Z Ltd.]		
3. Z Ltd. A/c Dr.	14,000	
To Realisation A/c		14,000

	Particulars		*Debit*	*Credit*
	[Amount of purchase consideration receivable from Z Ltd. on transfer sundry assets, creditor and Loan vide agreement dated.....]			
4.	Equity Share Capital A/c	Dr.	28,000	
	To Shareholders (A Ltd.) A/c			28,000
	[Being amount of Share capital transferred to Shareholder A/c]			
5.	Shareholders A/c	Dr.	14,000	
	To Realisation A/c			13,000
	To Profit and Loss A/c			1,000
	[Loss on realisation and Profit and Loss A/c debit balance transferred to Share holders A/c]			
6.	Shares in Z Ltd. A/c	Dr.	14,000	
	To Z Ltd. A/c			14,000
	[Amount of purchase consideration received in shares of Z Ltd.]			
7.	Shareholders (A Ltd.) A/c	Dr.	14,000	
	To Shares in Z Ltd.			14,000
	[Amount payable to shareholders discharged by issue of shares in Z Ltd.]			

WN # 1 : ***Calculation of Purchase Consideration (Net Assets Method)***

Particulars	*A Ltd.*	*B Ltd.*
Value of net assets	30,000	20,000
Creditors	(15,000)	(6,000)
Loans from C Ltd.	(10,000)	—
Purchase Consideration	**5,000**	**14,000**

In the Books of B Ltd. :

Realisation Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Sundry Assets	33,000	By Creditors A/c	6,000
		By A Ltd. (Purchase Consideration)	14,000
		By Shareholders (A Ltd.) A/c (Loss on Realisation)	13,000
	33,000		**33,000**

Shareholders (A Ltd.) Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Realisation A/c	13,000	By Share Capital A/c	28,000
To Profit and Loss A/c	1,000		
To Shares in Z Ltd. A/c	14,000		
	28,000		**28,000**

In the Books of A Ltd. :

Realisation Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Sundry Assets	42,000	By Creditors A/c	15,000
To Investments in B Ltd.	20,000	By Loan (Z Ltd.)	10,000
		By A Ltd. (Purchase consideration)	5,000
		By Shares in A Ltd.	14,000
		By Shareholders A/c (Loss on Realisation)	18,000
	62,000		**62,000**

Sundry Shareholders (A Ltd.) Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Realisation A/c	18,000	By Share capital A/c	32,000
To Shares in Z Ltd. (14,000 from B Ltd. 5,000 from Z Ltd.)	19,000	By Profit and Loss A/c	5,000
	37,000		**37,000**

VII. Internal Reconstruction

Illustration - 29:

The Balance Sheet of Z Ltd. before reconstruction is:

Liabilities	*Rs.*	*Assets*	*Rs.*
		Building at cost	
12,000 7% Preference		Less: Depreciation	4,00,000
shares of Rs.50 each	6,00,000	Plant at cost	
7,500 Equity shares of Rs. 100		Less: Depreciation	2,68,000
each	7,50,000	Trade Marks and Goodwill	
		at Cost	3,18,000

Liabilities	*Rs.*	*Assets*	*Rs.*
(Note : Preference dividend is		Stock	4,00,000
in arrear for five years)		Debtors	3,28,000
Loan	5,73,000	Preliminary expenses	11,000
Sundry creditors	2,07,000	Profit and Loss A/c	4,40,000
Other liabilities	35,000		
Total	**21,65,000**	**Total**	**21,65,000**

The Company is now earning profits short of working capital and a scheme of reconstruction has been approved by both classes of shareholders. A summary of the scheme is as follows:

a. The Equity Shareholders have agreed that their Rs. 100 shares should be reduced to Rs. 5 by cancellation of Rs. 95 per share. They have also agreed to subscribe in each for the six new Equity Shares of Rs. 5 each for each Equity Share held.

b. The Preference Shareholders have agreed to cancel the arrears of dividends and to accept for each Rs.50 share, 4 new 5 per cent Preference Shares of Rs.10 each, plus 3 new Equity Shares of Rs. 5 each, all credited as fully paid.

c. Lenders to the Company of Rs. 1,50,000 have agreed to convert their loan into share and for this purpose they will be allotted 12,000 new preference shares of Rs.10 each and 6,000 new equity share of Rs. 5 each.

d. The Directors have agreed to subscribe in cash for 40,000, new Equity Shares of Rs. 5 each in addition to any shares to be subscribed by them under (a) above.

e. Of the cash received by the issue of new shares, Rs.2,00,000 is to be used to reduce the loan due by the Company.

f. The equity Share capital cancelled is to be applied:
   i. to write off the preliminary expenses;
   ii. to write off the debit balance in the Profit and Loss A/c ; and
   iii. to write off Rs.35,000 from the value of Plant.

Any balance remaining is to be used to write down the value of Trade Marks and Goodwill.

Show by journal entries how the financial books are affected by the scheme and prepare the balance sheet of company after reconstruction. The nominal capital as reduced is to be increased to the old figures of Rs. 6,50,000 for Preference capital and Rs.7,50,000 for Equity capital.

Solution :

Particulars		*Debit*	*Credit*
1. Reduction of Equity capital			
Equity Share capital A/c (Face Value Rs. 100)	Dr.	7,50,000	
To Equity Share capital (Face value Rs. 5) A/c			37,500
To Reconstruction A/c			7,12,500

Particulars		*Debit*	*Credit*
2. Right issue : (7,500 × 6 = 45,000 Shares)			
(a) Bank A/c	Dr.	1,12,500	
To Equity Share Application A/c			1,12,500
(b) Equity Share Application A/c	Dr.	1,12,500	
To Equity Share Capital A/c			1,12,500
3. Cancellation of arrears of preference dividend			
NO ENTRY (as it was not provided in the Books of Accounts)			
Note :			
(a) On cancellation, it ceases to be a contingent liability and hence no further disclosure			
(b) Preference shareholders have to forego voting rights presently enjoyed at par with equity share holders			
4. Conversion of preference shares			
7% Preference Share Capital A/c	Dr.	6,00,000	
Reconstruction A/c (balancing figure)	Dr.	60,000	
To 5% Preference Share Capital (12,000×4×10)			4,80,000
To Equity Share Capital (6,000 × 6 × 5)			1,80,000
5. Conversion of Loan			
Loan A/c	Dr.	1,50,000	
To 5% Preference Share Capital A/c			1,20,000
To Equity Share Capital A/c			30,000
6. Subscription by directors:			
(a) Bank A/c	Dr.	1,00,000	
To Equity Share Application A/c			1,00,000
(b) Equity Share Application A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
7. Repayment of loan			
Loan A/c	Dr.	I2,00,000	
To Bank			2,00,000
8. Utilisation of reconstruction surplus			
Reconstruction A/c	Dr.	6,52,500	
To Preliminary Expenses A/c			11,000
To Profit and Loss A/c			4,40,000
To Plant A/c			35,000
To Trademark and Goodwill A/c			1,66,500

Reconstruction Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Preference shareholders	60,000	By Equity Share capital (FV Rs. 50)	7,12,500
To Preliminary expenses	11,000		
To Profit and Loss A/c	4,40,000		
To Plant A/c	35,000		
To Trademark and Goodwill	1,66,500		
	7,12,500		7,12,500

Bank Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Equity share application A/c	1,12,500	By Loan A/c	2,00,000
To Equity share application A/c	1,00,000	By Balance c/d	12, 500
	2,12,500		2,12,500

Balance sheet of Z Ltd. (and Reduced)

Liabilities		***Rs.***	***Assets***	***Rs.***	***Rs.***
Authorised and issued			Fixed assets :		
capital			Building at Cost		
60,000 Preference shares		6,00,000	Less: Depreciation		4,00,000
of Rs. 10 each			Plant Cost		
1,50,000 Equity shares of		7,50,000	Less: Depreciation	2,68,000	
Rs. 5 each			Less: Reduction	35,000	2,33,000
Issued, subscribed and paid up			Trade mark and		
Equity capital 90,000 equity			Goodwill at Cost	3,18,000	
shares of Rs. 5 each		4,50,000	Less: Reduction	1,66,500	1,51,500
			Current assets:		
5% Preference Share			Stock		4,00,000
capital			Debtors		3,28,000
60,000 Preference shares		6,00,000	Bank		12,500
of Rs. 10 each			Miscellaneous Exp.		
Loan	5,73,000		Preliminary Exp.	11,000	
Less: Reduction	3,50,000	2,23,000	Less: Reduced	11,000	Nil
Current liabilities and					
Provisions					
Sundry creditors		2,07,000			
Other Liabilities		35,000			
		15,25,000			**15,25,000**

Illustration - 30

M Ltd. is in the hands of a Receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 31st March, 2009 :

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital	3,60,000	Property, Machinery	
in shares of Rs.60 each		and Plant etc. (Cost	
Rs. 30 paid up	-	Rs. 3,90,000)	
First Debentures	3,00,000	estimated at	1,50,000
Second Debentures	6,00,000	Cash in hand of	
Unsecured Creditors	4,50,000	the Receiver	2,10,000
		Charged under Debentures	4,20,000
		Uncalled Capital	1,80,000
		Deficiency	7,50,000
	17,10,000		**17,10,000**

A holds the First Debentures for Rs. 3,00,000 and Second Debentures for Rs. 3,00,000. He is also an unsecured creditor for Rs. 90,000. B holds Second Debentures for Rs. 3,00,000 and is an unsecured creditor for Rs. 60,000.

The following scheme of reconstruction is proposed:-

1. A is to cancel Rs. 2,10,000 of the total debt owing to him, to advance Rs. 30,000 in cash and to take First Debentures (in cancellation of those already issued to him) for Rs. 5,10,000 in satisfaction of all his claims.
2. B is to accept Rs. 90,000 in cash in satisfaction of all claims by him.
3. Unsecured creditors (other than A and B) are to accept four shares of Rs.7.50 each, fully paid in satisfaction of 75% of every Rs.60 of their claim. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal Share capital is to be increased accordingly.
4. Uncalled capital is to be called up in full and Rs. 52. 50 per share cancelled, thus taking the shares of Rs. 7.50 each.

   Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries and the Balance Sheet of the Company after the scheme has been carried into effect.

Solution :

WN # 1 : ***Calculation of P & L Debit Balance at the time of Reconstruction***

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital	1,80,000	Fixed assets	3,90,000
1 st Debenture	3,00,000	(Book value)	
2nd Debenture	6,00,000	Cash	2,70,000
Unsecured creditors	4,50,000	Profit and Loss A/c (Bal. fig.)	8,70,000
	15,30,000		**15,30,000**

Particulars		*Debit Rs.*	*Credit Rs.*
1. Restructuring of A’s liability:			
a. Ascertainment of amount due			
1st DebenturesA/c	Dr.	3,00,000	
2nd Debentures A/c	Dr.	3,00,000	
Unsecured Creditors A/c	Dr.	90,000	
To A’s A/c			6,90,000
b. Waiver			
A’s A/c	Dr.	2,10,000	
To Reconstruction A/c			2,10,000
c. Cash brought in			
Bank A/c	Dr.	30,000	
To A’s A/c			30,000
d. Conversion of liability			
A’s A/c	Dr.	5,10,000	
To 1st Debentures A/c			5,10,000
2. Restructuring of B’s liability:			
2nd Debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	60,000	
To Bank A/c			90,000
To Reconstruction A/c			2,70,000
3. Restructuring of other unsecured creditors*			
(4,50,000 - 90,000 - 60,000 = 3,00,000)			
Unsecured Creditors A/c	Dr.	3,00,000	
To Equity Share capital A/c			1,50,000
To Loan (Unsecured) A/c			75,000
To Reconstruction A/c			75,000
4. Share capital			
a. Call money due:			
Share call A/c	Dr.	1.80,000	
To Share capital A/c			1,80,000
b. Share Call Money Received :			
Bank A/c	Dr.	1,80,000	
To Share call A/c			1,80,000
c. Capital Reduction :			
Equity Share Capital A/c (Face value Rs. 60)	Dr.	3,60,000	
To Equity Share capital (Face value Rs.7.50)			45,000
To Reconstruction A/c			3,15,000
5. Utilisation of reconstruction surplus			
Reconstruction A/c	Dr.	8,70,000	
To Profit and Loss A/c			8,70,000

a.	Scheme of settlement unit of liability is	60
b.	75% share (60 x .75)	45
	i. 4 Equity shares @ Rs. 7.5	30
	ii. Waiver	15
c.	25% share (60 x .25)	15
	[Can be carried forward as unsecured loan]	
	Note : Liability is settled in the Ratio of	
	30:15:15 (i.e. 2:1:1)	

Balance Sheet (and Reduced)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital	1,95,000	Fixed assets	3,90,000
Debentures	5,10,000	Cash	3,90,000
Unsecured Loans	75,000		
	7,80,000		**7,80,000**

Dr. *Reconstruction Account* Cr.

Particulars	*Rs.*	*Particulars*	*Rs.*
To Profit and Loss A/c	8,70,000	By A's A/c	2,10,000
		By B's A/c	2,70,000
		By Unsecured creditors	75,000
		By Equity Share Capital	3,15,000
	8,70,000		**8,70,000**

Dr. *Cash/Bank Account* Cr.

Particulars	*Rs.*	*Particulars*	*Rs.*
To A's A/c	3,00,000	By B's A/c	90,000
To Share call A/c	1,80,000	By Balance c/d	3,90,000
	4,80,000		**4,80,000**

Illustration - 31

The following was the Balance Sheet of Bhushan Developers Ltd., as on 31st March 2009 :

Liabilities		*Rs.*	*Assets*	*Rs.*
Authorised capital :			Goodwill	10,000
20,000 Equity Shares of			Land and buildings	20,500
Rs.10 each		2,00,000	Machinery	50,850
Issued, subscribed and			Stock	10,275
paid up capital			Book debts	15,000
12,000 Shares of			Cash at bank	1,500
Rs.10 each	1,20,000		Profit and Loss A/c :	
Less: Calls in arrear			Balance as per last	
(Rs. 3 per share				

Liabilities		*Rs.*	*Assets*		*Rs.*
			Balance Sheet		22,000
on 3,000 shares)	(9,000)		Less: Profit for the year		(1,200)
		1,11,000			
Sundry creditors		15,425			20,800
Provision for taxation		4,000	Preliminary expenses		1,500
		1,30,425			**1,30,425**

The directors have had a valuation made of the machinery and find it overvalued by .. Rs.10,000. It is proposed to write down this asset to its true value and to extinguish the deficiency in the Profit and loss account and to write off goodwill and preliminary expenses, by the adoption of the following course :

1. Forfeit the shares on which the call is outstanding.
2. Reduce the paid up capital by Rs.3 per share.
3. Reissue the forfeited shares at Rs.5 per share.
4. Utilise the provision for taxes, if necessary.

The shares on which the calls were in arrear were duly forfeited and reissued on payment of Rs.5 per share. You are requested to draft the journal entries necessary and the Balance sheet of the Company after carrying out the terms of the scheme as set above.

Solution :

	Particulars		*Debit Rs.*	*Credit Rs.*
1.	Forfeiture of 3,000 shares :			
	Equity Share Capital A/c	Dr.	30,000	
	To Calls in arrears A/c			9,000
	To Share forfeiture A/c			21,000
2.	Reduction of capital			
	Equity Share capital (Face value - Rs. 10)	Dr.	90,000	
	To Equity Share capital (Face value Rs. 7) A/c			63,000
	To Reconstruction A/c			27,000
3.	Re-issue of forfeiture shares :			
	Bank A/c	Dr.	15,000	
	Shares Forfeiture A/c	Dr.	6,000	
	To Equity Share Capital A/c			21,000
4.	Transfer of unutlised balance in share forfeiture A/c to Capital Reserve			
	Shares Forfeiture A/c	Dr.	15,000	
	To Capital Reserve			15,000
5.	Utilisation of Reconstruction A/c			
	Reconstruction A/c	Dr.	27,000	
	Capital Reserve A/c	Dr.	15,000	
	Provision for Tax A/c (Balancing Figure)	Dr.	300	
	To Profit and Loss A/c			20,800
	To Preliminary Expenses A/c			1,500
	To Machinery A/c			10,000
	To Goodwill A/c			10,000

Balance sheet* of *Bhushan Developers Ltd. (and Reduced) as at 01.04.09

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs*	*Rs.*
Authorised Capital :			Goodwill	10,000	
20,000 Equity Shares of			Less: Reduced	10,000	Nil
Rs. 10 each		20,00,000	Land and Building		20,500
Issued, Subscribed			Machinery	50,850	
and paid up Capital		84,000	Less: Reduced	10,000	40,850
12,000 shares of Rs.7 each			Stock		10,275
Sundry creditors		15,425	Book Debts		15,000
Provision for tax 4,000			Cash at Bank		16,500
Less: Reduced 300		3,700	Profit and Loss A/c	20,800	
			Less: Reduced	20,800	Nil
			Preliminary Expenses	1,500	
			Less: Reduced	1,500	Nil
		1,03,125			**1,03,125**

Illustration - 32

The Balance sheet of Z Ltd. at 31st March 2009 was as follows:

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs*	*Rs.*
Share capital			Intangibles		68,000
Authorised		14,00,000	Freehold premises at cost		1,40,000
Issued and subscribed capital			Plant and equipment at cost		
64,000 8% cumulative			Less depreciation		2,40,000
preference shares of			Investments in shares in		
Rs. 10 each fully paid			Q Ltd. at cost		3,24,000
64,000 equity shares of			Stocks		2,48,000
Rs.10 each, Rs.7.5 paid		4,80,000	Debtors		3,20,000
Loans from directors		60,000	Deferred revenue expenditure		48,000
Sundry creditors		4,40,000	Profit and Loss A/c		4,40,000
Bank overdraft		1,08,000			
		18,28,000			**18,28,000**

Note : The arrear of preference dividends amount to Rs. 51,200.

A scheme of reconstruction was duly approved with effect from 1 April 2009 under the conditions stated below:

a. The unpaid amount on the equity shares would be called up.

b. The preference shareholders would forego their arrear dividends. In addition, they would accept a reduction of Rs. 2.5 per share. The dividend rate would be enhanced to 10%.

c. The equity shareholders would accept a reduction of Rs. 7.5 per share.

d. Z Ltd. holds 21,600 shares in Q Ltd. This represents 15% of the Share capital of that ompany. Q Ltd. is not a quoted company. The average net profit (after tax) of the company is Rs. 2,50,000. The shares would be valued based on 12% capitalisation rate.

e. A bad debt provision at 2% would be created.

f. The other assets would be valued as under:

	Rs.
Intangibles	48,000
Plant	1,40,000
Freehold premises	3,80,000
Stocks	2,50,000

g. The profit and loss account debit balance and the balance standing to the debit of the deferred revenue expenditure account would be eliminated.

h. The directors would have to take equity shares at the new face value of Rs. 2.5 per share in settlement of their loan.

The equity shareholders, including the directors, who would receive equity shares in settlement of their loans, would take up two new equity shares for every one held.

i. The preference shareholders would take up one new preference share for every four held.

j. The authorised Share capital would be restated to Rs. 14,00,000.

k. The new face values of the shares-preference and equity will be maintained at their reduced levels.

You are required

1. to prepare the necessary ledger accounts to effect the above; and
2. to prepare the balance sheet of the company after reconstruction.

Solution:

Share Call Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Equity Share Capital A/c	1,60,000	By Bank A/c	1,60,000
	1,60,000		**1,60,000**

Equity Share Capital Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Reconstruction A/c	4,80,000	By Balance b/d	4,80,000
To Equity Share Capital A/c	1,60,000	By Equity Share Call A/c	1,60,000
	5,40,000		**5,40,000**

8% Preference Share Capital Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Reconstruction A/c	1,60,000	By Balance b/d	6,40,000
To 10% Preference Share Capital A/c	4,80,000		
	6,40,000		**6,40,000**

Investment in shares in Q Ltd. Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	3,24,000	By Reconstruction A/c	11,500
		By Balance c/d (WN # 1)	3,12,500
	3,24,000		**3,24,000**

WN # 1 : *Value of investments*

Particulars	*Amount Rs.*
Average net profit (after tax)	2,50,000
Capitalisation Rate	12%
Value of Q Ltd.	2083333.33
Share of Z Ltd.	15%
Value of Z Ltd. investment in Q Ltd.	3,12,500

Bank Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Equity Share Call A/c	1,60,000	By Balance b/d	2,08,000
To Equity Share Application Money A/c	4,40,000	By Balance c/d	5,12,000
To Preference Share Application Money A/c	120,000		
	7,20,000		**7,20,000**

Reconstruction Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Provision for Bad Debts A/c	6,400	By Equity Share capital A/c	4,80,000
To Intangible A/c	20,000	By 8% Preference Share Capital A/c	1,60,000
To Plant A/c	1,00,000		
To Profit and Loss A/c	4,40,000	By Freehold Property A/c	2,40,000
To Deferred revenue Exp. A/c	48,000	By Stock A/c	2,000
To Investment in Q Ltd. A/c	11,500		
To Capital Reserve A/c	2,56,100		
	8,82,000		**8,82,000**

Provision for Bad debts Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	6,400	By Reconstruction A/c	6,400
	6,400		**6,400**

Intangibles Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	68,000	By Reconstruction A/c	20,000
		By Balance c/d	48,000
	68,000		**68,000**

Plant Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	2,40,000	By Reconstruction A/c	1,00,000
		By Balance c/d	1,40,000
	2,40,000		**2,40,000**

Freehold Premises Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	1,40,000	By Balance c/d	3,80,000
To Reconstruction A/c	2,40,000		
	3,80,000		**3,80,000**

Stock Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	2,48,000	By Balance c/d	2,50,000
To Reconstruction A/c	2,000		
	2,50,000		**2,50,000**

Profit and Loss Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	4,40,000	By Reconstruction A/c	4,40,000
	4,40,000		**4,40,000**

Deferred Revenue Expense Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	48,000	By Reconstruction A/c	48,000
	48,000		**48,000**

Loans from Directors Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Equity Share capital (No. 24,000) (Face value of Rs 2.5)	60,000	By Balance b/d	60,000
	60,000		**60,000**

Equity Share capital Account (Face value Rs. 2.5)

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	6,60,000	By Equity Share capital (Face value Rs. 10)	1,60,000
		By Loans from directors A/c	60,000
		By Share application money A/c	4,40,000
	6,00,000		**6,00,000**

10% Preference Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Balance b/d	6,00,000	By 8% Preference Share Capital	4,80,000
		By Share application money A/c	1,20,000
	6,00,000		**6,00,000**

Share Application Money Account

Dr. Cr.

Particulars	*Amount*	*Particulars*	*Amount*
To Equity Share Capital	4,40,000	By Bank A/c	4,40,000
(Face value Rs. 25)		By Bank A/c	1,20,000
To 10% preference Share Capital	1,20,000		
	6,00,000		**6,00,000**

Balance Sheet of Z Ltd. as on 01.04.2009

Liabilities	*Amount*	*Assets*		*Amount*
Authorised Share		Fixed assets		
capital:	14,00,000	Intangibles	68,000	
2,64,000 share of		Less: Reduced	(20,000)	48,000
Rs. 2.5 each	6,60,000			
(of above 24,000)		Feehold Premises	1,40,000	
shares of Rs. 2.5 Lakhs		Add: Increased	2,40,000	3,80,000
issued for		Plant and Equipment net of		
consideration other		Depreciation	2,40,000	
than cash to directors)		Less: Reduced	(1,00,000)	1,40,000
10% Preference Share	6,00,000	Investment in Shares in		
capital 80,000 shares		Q Ltd. at Cost	3,24,000	
of Rs. 7.5 each		Less: Reduced	(11,500)	3,12,500
Reserve and surplus		Stock	2,48,000	
Capital reserve	2,56,100	Add: Increased	2,000	2,50,000
Sundry creditors	4,40,00	Debtors	3,20,000	
		Less: Provision	(6,400)	3,13,600
		Bank		5,12,000
		Deferred Revenue Exp.	48,000	
		Less: Reduced	(48,000)	Nil
		Profit and Loss A/c	4,40,000	
		Less: Reduced	(4,40,000)	Nil
	19,56,100			**19,56,100**

Notes:

1. It is assumed that there is permanent decline in the value of investments of Q Ltd.
2. Preference dividend, on cancellation, ceases to be a contingent liability. Hence, it is needles to disclose the interest as Contingent Liability.

VIII. Reverse Merger

Illustration - 33

The following are the Balance sheets of AB Ltd. and XY Ltd. as on 31.12.2008.

('000)

Liabilities	*AB Ltd. Rs.*	*XY Ltd. Rs.*	*Assets*	*AB Ltd. Rs.*	*XY Ltd. Rs.*
Share capital:			Fixed assets		
Equity Shares of Rs.100	2,000	1,000	(net of depreciation)	2,700	850
each fully paid up			Investments	700	–
Reserves and surplus	800	–	Sundry Debtors	400	150
10% Debentures	500	–	Cash and Bank	250	–
Loan from Financial			Profit and Loss A/c	–	800
Institutions	250	400			

Liabilities	*AB Ltd. Rs.*	*XY Ltd. Rs.*	*Assets*	*AB Ltd. Rs.*	*XY Ltd. Rs.*
Bank Overdraft	–	100			
Sundry creditors	300	300			
Proposed Dividend	200	–			
Total	**4,050**	**1,800**	**Total**	**4,050**	**1,800**

It was decided that XY Ltd. will acquire the business of AB Ltd. for enjoying the benefit of carry forward of business loss. After acquisition, XY Ltd. will be renamed as Z Ltd. The following scheme has been approved for the merger.

i. XY Ltd. will reduce its shares to Rs. 10 and then consolidate 10 such shares into one share of Rs. 100 each (New Share).

ii. Financial institutions agreed to waive 15% of the loan of XY Ltd.

iii. Shareholders of AB Ltd. will be given one new share of XY Ltd. in exchange of every share held in AB Ltd.

iv. AB Ltd. will cancel 20% holdings of XY Ltd. Investments were held at Rs. 250 thousands.

v. After merger, the proposed dividend of AB Ltd. will be paid to the shareholders of AB Ltd.

vi. Authorised Capital of XY Ltd. will be raised accordingly to carry out the scheme. vii. Sundry creditors of XY Ltd. includes payables to AB Ltd. Rs. 1,00,000.

Pass the necessary entries to implement the scheme in the books of AB Ltd. and XY Ltd. and prepare a Balance Sheet of Z Ltd.

Solution:

Part - I Purchase consideration

WN # 1: ***Shareholding of AB Ltd. in XY Ltd.***

Particulars		*Amount Rs.*
a.	Original Share capital of XY Ltd. [10,000 equity shares of Rs. 100 each]	10,00,000
b.	Share capital of XY Ltd. after reduction [10,000 equity shares of Rs. 10 each]	1,00,000
c.	Share capital of XY Ltd. after reconsolidation [1000 equity shares of Rs. 100 each]	1,00,000
d.	Holding of AB Ltd in XY Ltd.	20%
e.	Value of holding of AB Ltd in XY Ltd. [200 equity shares of Rs. 100 each]	20,000

WN # 2 : ***Purchase consideration***

a.	No. of equity shares of AB Ltd. (20,00,000 ÷ 100)	20,000
b.	Exchange ratio	1:1
c.	No. of equity shares to be given by XY Ltd. to AB Ltd.	20,000
d.	Less : No. of Equity shares held by AB Ltd. in XY Ltd.	200
e.	No. of shares now to be given	19,800
f.	Purchase consideration (19,800 equity shares of Rs. 100 each)	19,80,000

Part - II : Journal entries in the books of AB Ltd.

(Rs. '000)

Particulars		*Debit*	*Credit*
1. a. Transfer to realisation account of all Assets taken *over* except investment held by selling company in purchasing company			
Realisation A/c	Dr.	3,800	
To Fixed assets A/c			2,700
To Investments [700 - 250] A/c			450
To Sundry Debtors A/c			400
To Cash and Bank A/c			250
b. Transfer to realisation account of all liabilities taken over			
10% Debentures A/c	Dr.	500	
Loan from financial institations A/c	Dr.	250	
Sundry Creditors A/c	Dr.	300	
Proposed Dividend A/c	Dr.	200	
To Realisation A/c			1250
2. Purchase consideration			
a. Due entry			
XY Ltd. A/c	Dr.	1,980	
To Realisation A/c			1,980
b. Receipt			
Shares in XY Ltd. A/c	Dr.	1,980	
To XY Ltd. A/c			1,980
3. Transfer of realisation loss to share holders			
Equity shareholders A/ c	Dr.	570	
To Realisation A/c			570
4. Transfer of Share capital and Reserves and surplus to equity share holders			
Share capital A/c	Dr.	2,000	
Reserves and surplus A/c	Dr.	800	
To Equity shareholders			2,800
5. Settlement to share holders by transfer of purchase consideration now received and shares already held by AB Ltd. in XY Ltd.			
Equity shareholders A/c	Dr.	2,230	
To Equity shares of XY Ltd.			2,230

Part. III. Journal entries in the books of XY Ltd.

(Rs. '000)

Particulars		*Debit*	*Credit*
1. Reduction of Share capital			
Equity Share Capital (Rs. 100) A/c	Dr.	1,000	
To Equity Share Capital (Rs. 10) A/c			100
To Reconstruction A/c			900
2. Consolidation of equity shares of Rs.10 each to Rs. 100 each			
Equity Share Capital (Rs. 10) A/c	Dr.	100	
To Equity Share Capital (Rs. 100) A/c			100
3. Waiver of loan by financial institution			
Loan from financial institution A/c	Dr.	60	
To Reconstruction A/c			60
4. Write off the debit balance of Profit and Loss A/c by utilising Reconstruction A/c and balance of Reconstruction A/c transferred to Capital reserve			
Reconstruction A/c	Dr.	960	
To Profit and Loss A/c			800
To Capital Reserve A/c			160

***Entries relating to Amalgamation* :**

- Nature of Amalgamation - Merger
- Method of Accounting - Pooling of Interest Method

(Rs. '000)

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due			
Business Purchase A/c Dr.		1,980	
To Liquidator of AB Ltd. A/c			1,980
2. For assets and liabilities taken over			
Purchase consideration now paid	1,980		
Shares already held by AB Ltd.	250		
Total consideration	2,230		
Less: Paid-up Share capital of AB Ltd.	2,000		
Excess Purchase Consideration Paid	230		
This excess is to be adjusted against reserves of AB Ltd.			
Reserves of AB Ltd. 800			
Less: Excess as above 230			
Balance to be incorporated 570			

Particulars		*Debit*	*Credit*
Fxed assets (net of depreciation) A/c	Dr.	2,700	
Investment A/c	Dr.	450	
Sundry Debtors A/c	Dr.	400	
Cash and Bank A/c	Dr.	250	
To Reserves and Surplus A/c			570
To Debentures A/c			500
To Loan from financial institutions A/c			250
To Sundry Creditors A/c			300
To Proposed Dividend A/c			200
To Business Purchase A/c			1,980
3. Discharge of purchase consideration			
Liquidator of AB Ltd. A/c	Dr.	1,980	
To Equity Share capital of XY Ltd. A/c			1,980
4. Payment of proposed divided to shareholders of AB Ltd.			
Proposed Dividend A/c	Dr.	200	
To Bank A/c			200
5. Cancellation of inter company owings			
Sundry Creditors A/c	Dr.	100	
To Sundry Debtors A/c			100

***Balance sheet of Z Ltd. as* on 31st *March* 09**
(After Acquisition)

(Rs.'000)

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Share capital		Fixed assets net of depreciation	3,550
20,800 equity shares @		[2,700 + 850]	
Rs.100/- each [1980+20+80]	2,080		
Reserves and surplus		Investments [700-250]	450
Capital reserves	160	Sundry debtors [400 + 150 – 100]	450
General reserves	570		
Secured loan :			
10% Debentures	500		
Loan from Finanacial Institution (340 + 250)	590		
Bank over draft [200+100-250]	50		
Current liabilities and provisions			
Creditors [600-100]	500		
	4,450		**4,450**

IX. External Reconstruction

Illustration - 37

A Ltd. is engaged in the manufacture of D and N. It has two wholly owned subsidiaries. B Ltd. and C Ltd. which have never traded. The draft financial statement of parent company shows:

Balance Sheet as on 31st March, 2009

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital	40,000	Fixed Assets	21,400
Reserves and surplus	48,800	Investment in B Ltd.	10,000
Secured loan	12,000	Investment in C Ltd.	10,000
Sundry creditors	90,000	Current assets	
Owing to subsidiaries	20,000	Stock and Work-in-progress	43,400
Proposed dividend	4,000	Sundry debtors	9,360
		Cash at bank	36,400
	2,14,800		**2,14,800**

Profit and Loss Account for the year ended 31st March, 2009

	Rs.
Net Profit	37,200
Dividend Paid	4,000
Transfer to Reserve	33,200

The two managing directors Mr. Kali and Mr. Prem who own 40% and 60% respectively of the Share capital of A Ltd. will become individually concerned with B Ltd. and C Ltd. respectively in order to allow them to develop their own interests.

They have agreed to a scheme of reconstruction whereby the respective trade and assets apart from cash at bank and liabilities will be transferred to the two subsidiaries. The resulting inter-company debts will be waived and A Ltd. will be placed into liquidation. The liquidator will retain Rs. 5,200 of the cash at bank to meet the costs of liquidation and reorganisation and pay dividend. He will distribute the remaining cash at bank and shares in two subsidiaries to A Ltd's shareholders Mr. Kali and Mr. Prem.

As far as his cash distribution pool permits, each director will then purchase, at net assets value, those shares in his own company distributed by the liquidator to his former colleague. It has been agreed that B Ltd. will receive a first tranch of the assets of A Ltd. comprising stock and work in progress of Rs. 15,000. C Ltd. will take over the liability for the Secured Loan. The remainder of the net assets will be transferred to the subsidiary companies in the ratio of 75% to B Ltd. and 25% of C Ltd. with the group freehold property, included in the Fixed assets at Rs. 15,000 being revalued at the open market value of Rs. 42,000 and being transferred to C Ltd.as a part of its share.

You are required to :

a. Produce the proforma balance sheets of the two former subsidiary immediately after reorganisation.

b. Calculate the final share holdings in each of the two companies.

Solution:

Purchase Consideration:

Particulars	*B Ltd.* *Rs.*	*C Ltd.* *Rs.*
Stock in trade	15,000	—
Secured Loan	—	(12,000)
Remaining Net Assets in the Ratio of 75:25 (WN#1)	60,300*	20,100*
	75,300	**8,100**
Total Purchase Consideration	**Rs. 83,400**	

WN # 1 : Net Asset Value:

	Particulars	*Rs.*	*Rs.*
a.	Fixed Asset:	15,000	
	Add: Increase due to Revaluation	27,000	
	Others (21,400 – 15,000)	6,400	48,400
b.	Stock and Work-in-progress	43,400	
	Less: Separately taken by B Ltd.	15,000	28,400
c.	Sundry Debtors		93,600
d.	Total Assets (a+b+c)		1,70,400
e.	Sundry Creditors		(90,000)
f.	Net Assets		80,400
g.	B Ltd. Share (75% of Net Assets)		60,300
h.	A Ltd. Share (25% of Net Assets)		20,100

Shareholders Account

Dr. Cr.

	Kali (40%)	**Prem (60%)**		**Kali (40%)**	**Prem (60%)**
To Cash	12,480@	18,720@	By Share capital	16,000	24,000
To B Ltd.	33,360		By Reserve	19,520	29,280
To C Ltd.		50,040	By Realisation (Profit)	10,320#	15,480#
	45,840	**68,760**		**45,840**	**68,760**

Cash

Particulars	*Amount*
Opening balance	36,400
Retained by liquidator	(5,200)
Closing balance	31,200
Kalii's share [40% of (c)]	12,480
Prem's share [60% of (c)]	18,720

Realisation Profit

Particulars	*Amount*
Dividend	4,000
Revaluation on Fixed assets (42,000 – 15,000)	27,000
Liquidation expenses:	(5,200)
Net realisation profit	25,800
Kali [40% of (d)]	10,320
Prem [60% of (d)]	15,480

WN # 2 : Statement showing Goodwill* or *Capital Reserves

	Particulars	***B Ltd. (Rs.)***	***C Ltd. (Rs.)***
a.	Purchase Consideration	75,300	8,100
b.	Less: Net Assets as at the date of acquisition representedby :	10,000	10,000
	- Share capital		
c.	Goodwill		**1,900**
d.	Capital Reserves	**65,300**	

Proforma Balance Sheet of B Ltd. as on 31st March, 2009.

Liabilities	***Amount Rs.***	***Assets***	***Amount Rs.***
Share Capital	10,000	Fixed Assets	6,400
Reserves and Surplus	65,300	Current Assets:	
Current liabilities		Stocks and Work-in-Progress	43,400
Creditors	68,100	Debtors	93,600
	1,43,400		**1,43,400**

Proforma Balance Sheet of C Ltd. as on 31st March, 2009.

Liabilities	***Amount Rs.***	***Assets***	***Amount Rs.***
Share Capital	10,000	Fixed assets	42,000
Secured Loan	12,000	Goodwill	1,900
Current liabilities	21,900		
	43,900		**43,900**

X. Surrender of Shares

Illustration - 35

The business of P Ltd. was being carried on continuously at losses. The following are the extracts from the Balance Sheet of the Comapny as on 31st March, 2009.

Balance Sheet as on 31st March, 2009

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Authorised, Issed and Subscribed Capital : 30,000 Equity Shares of Rs. 10 each fully paid	3,00,000	Goodwill	50,000
		Plant	3,00,000
		Loose Tools	10,000
		Debtors	2,50,000
2,000 8% Cumulative Pref. Shares of Rs. 100 each fully paid	2,00,000	Stock	1,50,000
		Cash	10,000
Securities Premium	90,000	Bank	35,000
Unsecured Loan(From Director)	50,000	Preliminary Expenses	5,000
Sundry creditors	3,00,000	Profit & Loss Account	2,00,000
Outstanding Expenses (including Directors' remuneration Rs.20,000)	70,000		
	10,10,000		**10,10,000**

Note : Dividends on Cumulative Preference Shares are in arrears for 3 years.
The following scheme of reconstruction has been agreed upon and duly approved by the Court.

1. Equity shares to be converted into 1,50,000 shares of Rs. 2 each.
2. Equity shareholders to surrender to the Company 90 per cent of their holding.
3. Preference shareholders agree to forego their right to arrears to dividends inconsideration of which 8 percent Preference Shares are. to be converted into 9 per cent Preference Shares.
4. Sundry creditors agree to reduce their claim by one fifth in consideration of their getting shares of Rs. 35,000 out of the surrendered equity shares.
5. Directors agree to forego the amounts due on account of unsecured loan and Director's remuneration.
6. Surrendered shares not otherwise utilised to be cancelled.
7. Assets to be reduced as under :

Goodwill by	Rs. 50,000
Plant by	Rs. 40,000
Tools by	Rs. 8,000
Sundry Debtors by	Rs. 15,000
Stock by	Rs. 20,000

8. Any surplus after meeting the losses should be utilised in writing down the value of the plant further.
9. Expenses of reconstruction amounted to Rs. 10,000.

10. Further 50,000 Equity shares were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid-up.

A member holding 100 equity shares opposed the scheme and his shares were taken over by the Director on payment of Rs. 1,000 as fixed by the Court.

You are required to pass the journal entries for giving effect to the above arrangement and also to draw up the resultant Balance Sheet of the Company.

Solution:

Particulars			*Debit Rs.*	*Credit Rs.*
a.	Sub Division of Shares			
	Equity Share Capital (Rs. 10 each) A/c	Dr.	3,00,000	
	To Equity Share Capital (Rs. 2 each) A/c			3,00,000
b.	Surrender of Shares			
	Equity Share Capital (Rs. 2) A/c	Dr.	2,70,000	
	To Shares Surrendered A/c			2,70,000
c.	Conversion of Preference Share Capital			
	8% Cumulative Preference Share Capital A/c	Dr.	2,00,000	
	To 9% Cumulative Preference Share Capital A/c			2,00,000
d.	Surrendered shares issued to creditors under reconstruction scheme			
	Shares Surrendered A/c	Dr.	35,000	
	To Equity Share Capital A/c			35,000
e.	Expenses Paid			
	Expenses A/c	Dr.	10,000	
	To Bank A/c			10,000
f.	Cancellation of unissued surrendered shares			
	Shares Surrendered A/c	Dr.	2,35,000	
	To Capital Reduction A/c			2,35,000
g.	Amount sacrificed by Directors			
	Unsecured Loan A/c	Dr.	50,000	
	Sundry Creditors A/c	Dr.	60,000	
	Outstanding Expenses A/c	Dr.	20,000	
	To Capital Reduction A/c			1,30,000
h.	Assets Written off			
	Capital Reduction A/c	Dr.	3,65,000	
	To Goodwill A/c			50,000
	To Loose tools A/c			8,000
	To Sundry debtors A/c			15,000

Particulars	*Debit Rs.*	*Credit Rs.*
To Stock - in - trade A/c		20,000
To Profit and Loss A/c		2,00,000
To Preliminary expenses A/c		5,000
To Expenses A/c		10,000
To Plant A/c		57,000
i. Issue of Shares		
Applications received		
Bank A/c Dr.	1,00,000	
To Share Application A/c		1,00,000
Allotment of Shares		
Share Application A/c Dr.	1,00,000	
To Share Capital A/c		1,00,000
(Being 50000 equity shares of Rs. 2 each issued as fully paid as per Board's Resolution dated...)		

Note 1 :
a. Cancellation of Preference dividend need not be journalised; on cancellation it cease to be contingent liability and hence no further disclosure.
b. Preference shareholders have to forego policy rights presently enjoyed at par with Equity Shareholders.

Note 2 : The transfer of 100 shares by the dissentient shareholders to the director concerned need not be journalised.

Note 3 : It has been assumed that the share premium account is to be kept infact since the scheme is silent about it.

Balance Sheet of P Ltd (And Reduced) as on 31st March 2009.

Liabilities	*Amount Rs.*	*Amount Rs.*	*Assets*	*Amount Rs.*	*Amount Rs.*
Share capital			Fixed assets		
Authorised			Goodwill	50,000	
1,50,000 Equity shares of Rs. 2 each		<u>3,00,000</u>	Less : Amount written off under the scheme of reconstruction	<u>50,000</u>	Nil
2000 9% Preference shares of Rs.100 each		<u>2,00,000</u>	Plant	3,00,000	
			Less : Amount written off under the scheme of		

Liabilities	*Amount Rs.*	*Assets*		*Amount Rs.*
		reconstruction	57,000	2,43,000
Issued, subscribed and		Current assets, Loans		
paid up		Advances		
82,500 Equity Shares of Rs. 10		Loose tools.		2,000
each fully paid		Stock-in-trade		1,30,000
(Of the above 17,500		Sundry Debtors		2,35,,000
shares have been issued for		Cash at Bank		1,25,000
consideration other than cash		Cash in Hand		10,000
under the scheme of	1,65,000			
reconstruction)				
20,000 9% Cumulative preference				
shares of Rs. 100 each fully paid	2,00,000			
Reserves and surplus:				
Share Premium	90,000			
Secured Loans	Nil			
Unsecured Loans	Nil			
Current liabilities and				
provisions :				
Sundry creditors	2,40,000			
Outstanding expenses	50,000			
	7,45,000			**7,45,000**

XI. Demerger

Illustration - 36

The following is the Balance Sheet of P Ltd.

Liabilities	*Rs.*
Equity Share Capital	2,00,000
Reserves and Surplus	4,00,000
Secured Loan	2,00,000
Unsecured Loans	6,00,000
	14,00,000

Assets	*Rs.*	*Rs.*
Fixed Assets		7,00,000
Investments		4,00,000
(Market Value Rs. 9,00,000)		
Current Assets	4,00,000	
Less: Current liabilities	(1,00,000)	3,00,000
		14,00,000

The company consists of three divisions. The scheme was agreed upon, according to which a new company B Ltd. is to be formed. It will takeover investmen.ts at Rs. 9,00,000 and unsecured loans at balance sheet value. It is to allot equity shares of Rs.10 each at par to the shareholders of P Ltd. in satisfaction of the amount due under the arrangement. The scheme was duly approved by the High Court. Pass journal entries in the books of P Ltd.

Solution:

In the Books of P Ltd.

Particulars			*Debit Rs.*	*Credit Rs.*
1.	B Ltd. A/c	Dr.	9,00,000	
	To Investments A/c			4,00,000
	To Shareholders A/c			5,00,000
	[Being investments transferred at agreed value of Rs. 9,00,000]			
2.	Unsecured Loans A/c	Dr.	6,00,000	
	To B Ltd. A/c			6,00,000
	[Being unsecured loan taken over by B Ltd.]			
3.	Shareholders A/c	Dr.	3,00,000	
	To B Ltd. A/c			3,00,000
	[Being allotment by B Ltd. of 30,000 Equity shares of Rs. 10 each to shareholders of the company]			
4.	Shareholders A/c	Dr.	2,00,000	
	To Capital Reserve			2,00,000
	[Being balance in Shareholders A/c transferred to Capital Reserve]			

Illustration - 37

B Ltd. carried on manufacturing business. Its products were sold to wholesalers and the company had its own retail shop. A Ltd. carried on similar manufacturing business, but all goods produced were sold through the company's own retail shops.

The summarised Balance Sheets of the two companies as at 31st March, 2009 were as follows:

Liabilities	*B Ltd. Rs.*	*A Ltd. Rs.*	*Assets*	*B Ltd. Rs.*	*A Ltd. Rs.*
Share capital			Fixed assets:		
Authorised Equity	40,00,000	6,00,000	Freehold	10,00,000	2,50,000
Shares of Rs. 100 each			Properties at cost		
Issued and Fully	25,00,000	6,00,000	Plant and		
paid up			Machinery at cost	13,00,000	1,00,000
Profit and Loss A/c	3,40,000	90,000	less depreciation		
Creditors	4,20,000	70,000	Current assets:		
			Stock	4,80,000	1,20,000
			Debtors	2,30,000	80,000
			Bank	2,50,000	2,10,000
	32,60,000	**7,60,000**		**32,60,00**	**7,60,000**

The original cost of Plant and Machinery was :

B Ltd.	Rs. 26,00,000
A Ltd.	Rs. 2,00,000

The following arrangements were made and carried out on April 1, 2009:

1. B Ltd. purchased from the shareholders of A Ltd. all the issued shares @ Rs. 140 per share.
2. The shareholders of A Ltd. took over one of the freehold properties of A Ltd. for Rs. 60,000, at the book value of the same. It was agreed that the amount should be set off against the amount due to them under (1) above and the balance due to them to be satisfied by the issue of an appropriate number of equity shares in B Ltd. at Rs. 195 per share.

   The necessary transfer in regard to the setting off the price of the property taken over by the shareholders against the amount due to them from B Ltd. were made in the books of the two companies.
3. All manufacturing was to be carried on by B Ltd. and all retail business is to be carried on by A Ltd. in this connection.
   i. B Ltd. purchased the whole of A Ltd's plant and machinery for Rs. 1,50,000 and certain of their free-hold property (cost Rs. 1,00,000) at Rs. 1,20,000.
   ii. A Ltd. purchased B Ltd's freehold retail shop buildings (cost to B and Co. Ltd. Rs. 75,000) at Rs. 60,000 and took over the retail stock at Rs. 80,000 at the book value.
4. B Ltd. drew a cheque in favour of A Ltd. for the net amount due, taking into account all the matters mentioned above.
5. Immediately after the transfer of shares in (1) above, A Ltd. declared and paid a dividend of Rs. 60,000 (Ignore income tax)

Draft the balance sheet of both the companies immediately after the completion of the transaction.

Solution:

In the books of B Ltd

Calculation of purchase consideration and Number of shares to be issued

Particulars		*Amount*
a.	Number of Equity shares of A Ltd.	6,000
b.	Purchase price of B Ltd. per share	Rs. 140
c.	Purchase consideration (6,000 x 140)	Rs. 8,40,000
d.	Value of Freehold property to be adjusted against the consideration due	Rs. 60,000
e.	Net Consideration (c – d)	Rs. 7,80,000
f.	Issue price per share of B Ltd.	Rs. 195
g.	Number of shares to be issued (e ÷ f)	4,000

Freehold Properties Account

Dr. Cr.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Balance b/d	10,00,000	By A Ltd.	60,000
To A Ltd.	1,20,000	By Profit and Loss A/c	15,000
		By Balance c/d	10,45,000
	11,20,000		**11,20,000**

* Loss on sale of freehold retail shop building (Rs. 60,000 - Rs. 75,000)

Plant and Machinery Account

Dr. Cr.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Balance b/d	13,00,000	By Balance c/d	14,50,000
To A and Co (P) Ltd.	1,50,000		
	14,50,000		**14,50,000**

Investment in A Ltd. Account

Dr. Cr.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Share capital	4,00,000	By Bank A/c [Pre-acquisition Dividend)	60,000
To Securities Premium	3,80,000		
To A Ltd.	60,000	By Balance c/d	7,80,000
	8,40,000		**8,40,000**

Stock Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	4,80,000	By A Ltd.	80,000
		By Balance c/d	4,00,000
	4,80,000		**4,80,000**

A Ltd. Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Freehold property A/c	60,000	By Freehold Property A/c	1,20,000
To Stock Al/c	80,000	By Plant and Machinery A/c	1,50,000
To Bank (Net amount due to A Co., paid by way of cheque)	1,90,000	By Investment in A Ltd. A/c	60,000
	3,30,000		**3,30,000**

Bank Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2,50,000	By A Ltd.	1,90,000
To Investment in A Ltd. A/c (Pre-acquisition Dividend)	60,000	By Balance c/d	1,20,000
	3,10,000		**3,10,000**

Profit & Loss Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Freehold Property A/c	15,000	By Balance b/d	3,40,000
To Balance c/d	3,25,000		
	3,40,000		**3,40,000**

Share Capital Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance c/d	29,00,000	By Balance b/d	25,00,000
		By Investment in A Ltd.	4,00,000
	29,00,000		**29,00,000**

Securities Premium Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance c/d	3,80,000	By Investment in A Ltd.	3,80,000
	3,80,000		**3,80,000**

Balance Sheet of B Ltd. as on 31/03/2009

Liabilities	*Amount*	*Assets*	*Amount*
Share Capital		Fixed Assets	
[Authorised 40,000 shares of Rs. 100 each]	40,00,000	Freehold Properties	10,45,000
		Plant and Machinery less dep.	14,50,000
Issued, Subscribed and Paid up		Investment	
29,000 shares of Rs. 100 each fully paid		Shares in Subsidiary Co.	7,80,000
		Current assets, Loans and Advances :	
(of which 4,000 shares were issued pursuant to a contract without payment being received in cash)	29,00,000	Stock in trade	4,00,000
		Sundry debtors	2,30,000
		Cash at Bank	1,20,000
Reserves and Surplus :			
Securities Premium A/c	3,80,000		
Profit and Loss A/c	3,25,000		
Current liabilities and Provisions :			
Sundry Creditors	4,20,000		
	40,25,000		**40,25,000**

In the *books of A Ltd.*

Profit & Loss Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Dividend	60,000	By Balance b/d	90,000
To Balance c/d	1,00,000	By Freehold Properties A/c (Profit on transfer)	20,000
		By Plant Machinery A/c (Profit on transfer)	50,000
	1,60,000		**1,60,000**

Freehold Properties Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2,50,000	By B Ltd. A/c	1,20,000
To Profit and Loss A/c	20,000	By Shareholder A/c	60,000
To B Ltd. A/c	60,000	By Balance (c/d)	1,50,000
	3,30,000		**3,30,000**

Plant and Machinery Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,00,000	By B Ltd. A/c	1,50,000
To Profit and Loss A/c	50,000		
	1,50,000		**1,50,000**

Stock Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1,20,000	By Balance c/d	2,00,000
To B Ltd.	80,000		
	2,00,000		**2,00,000**

Bank Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2,10,000	By Dividend A/c	60,000
To B Ltd. A/c	1,90,000	By Balance c/d	3,40,000
	4,00,000		**4,00,000**

B Ltd. Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Freehold properties	1,20,000	By Stock A/c	80,000
To Plant and Machinery	1,50,000	By Bank A/c	1,90,000
	2,70,000		**2,70,000**

Balance Sheet of A Ltd. as* on *31.03.2009

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital :		Fixed assets	
Authorised 6,000 shares of Rs. 100 each	6,00,000	Freehold Properties	1,50,000
Issued, subscribed and paid up 6,000 shares of Rs. 100 each fully paid	6,00,000	Current assets, Loans and Advances:	
		Stock in trade	2,00,000
Reserves and surplus :		Sundry debtors	80,000
Profit and Loss A/c	1,00,000	Cash at Bank	3,40,000
Current liabilities and Provisions :			
Sundry creditors	70,000		
	7,70,000		**7,70,000**

Illustration - 38

Lazy Ltd. and Yummy Ltd. are two companies. On 31st March, 2009 their Balance Sheets were as under :

(Rs. in crores)

		Lazy Ltd.		*Yummy Ltd.*
Sources of funds				
Share capital				
Authroised :		500		500
Issued : Equity shares of Rs. 100 each fully paid up		300		200
Reserves and surplus.				
Capital reserves	40		20	
Revenue reserves	700		425	
Surplus	10	750	5	450
Owners' funds		1,050		650
Loan		250		350
Total		**1,300**		**1,000**
Funds' employed in :				
Fixed assets :				
Cost	1,000		700	
Less : Depreciation	(400)	600	(300)	400
Net Current assets :				
Current assets	2,000		1,500	
Less : Current liabilities	(1,300)	700	(900)	600
		1,300		**1,000**

Lazy Ltd. has 2 divisions - very profitable division A and loss making division B. Yummy Ltd. similarly has 2 divisions-very profitable .division B and loss making division A.

The two companies decided to reorganise. Necessary approval's from creditors and members and sanction by High Court have been obtained to the following scheme.

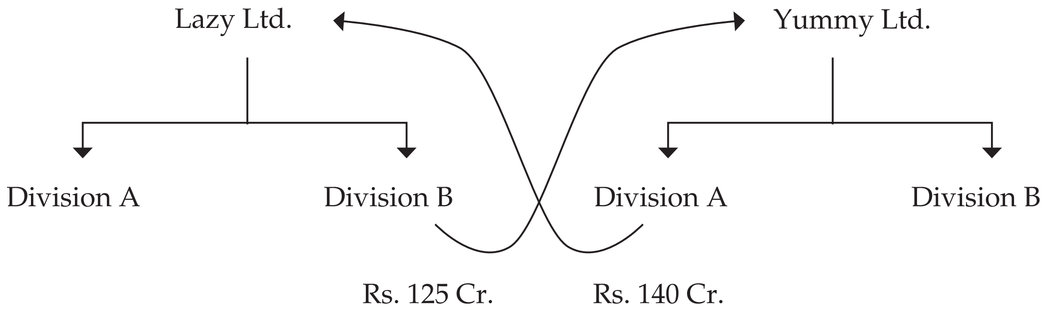
1. Division B of Lazy Ltd. which has Fixed assets costing Rs. 400 crores (written down value Rs. 160 crores). Current assets Rs. 900 crores, Current liabilities Rs. 750 crores and loan funds of Rs. 200 crores is to be transferred at Rs. 125 crores to Yummy Ltd.
2. Division A of Yummy Ltd. which has Fixed assets costing Rs. 500 crores (depreciation Rs.200 crores), Current assets Rs.800 crores Current liabilities Rs. 700 crores and loan funds Rs.250 crores is to be transferred at Rs.140 crores to Lazy Ltd.
3. The difference in the two consideration is to be treated as loan carrying interest at 15% per annum.
4. The directors of each of the companies revalued the Fixed assets taken over as follows :
    - i. Division A of Yummy Ltd. taken over: Rs. 325 crores.
    - ii. Division B of Lazy Ltd. taken over: Rs. 200 crores.

All the other assets and liabilities are recorded at the Balance sheet values.

a. The directors of both the companies ask you to prepare the Balance sheets after reconstruction (showing the corresponding figures before reconstruction).

b. Mr. Pravin, who owns 5,000 equity shares of Lazy Ltd. and 3,000 equity shares of Yummy Ltd. wants to know whether he has gained or lost in terms of net asset value of equity shares on the above recognisation.

Solution :



Books of Lazy Ltd.

A. Transfer of Division B

(Rs. in Crores)

Particulars		***Debit***	***Credit***
i. Due Entry :			
Yummy Ltd A/c	Dr.	125	
Current liabilities A/c	Dr.	750	
Loan Funds A/c	Dr.	200	
Provision for Depreciation A/c	Dr.	240	
To Fixed Assets A/c			400
To Current Assets A/c			900
To Capital Reserve A/c			15
ii. Receipt of consideration - Not Applicable			

B. Take over of division A of Yummy Ltd.

Particulars		***Debit***	***Credit***
i. Due Entry :			
Business Purchase A/c	Dr.	140	
To Yummy Ltd. A/c			140
ii. Incorporation of Assets and Liabilities taken over :			
Fixed assets A/c	Dr.	325	
Current assets A/c	Dr.	800	
To Current liabilities A/c			700
To Loan A/c			250
To Business Purchase A/c			140
To Capital Reserve A/c			35
iii. Discharge of consideration - Not Applicable			

Balance Sheet of Lazy Ltd. on 31.03.09

Rs. in Crores

Liabilities	***Amount***		***Assets***	***Amount***	
	@	*		@	*
Share capital	300	300	Fixed Assets		
Reserves and surplus			Cost (600 + 375)	925	1,000
Capital Reserve [40+15+35]	90	40	Less : Depreciation	(160)	(400)
Revenue Reserves	700	700	Net Block	765	600
Surplus	10	10	Current Assets	1,900	2,000
Loan funds [250+250–200]	300	250			
15% Loan - Yummy Ltd.	15	-			
Current liabilities	1,250	1,300			
	2,655	**2,600**		**2,665**	**2,600**

@ Before Reconstruction

* After Reconstruction

Part - II *Books of Yummy Ltd.*

A. Transfer of Division A to Lazy Ltd.

(Rs. in Crores)

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due:			
Lazy Ltd. A/c	Dr.	140	
Current liabilities A/c	Dr.	700	
Loan A/c	Dr.	250	
Provision for Depreciation A/c	Dr.	200	
Capital reserve A/c [balancing figure]	Dr.	10	
To Fixed Assets A/c			500
To Current Assets A/c			800
ii. Receipt of consideration - Not applicable			

B. Take over of **division** *B of Lazy Ltd.*

(Rs. in Crores)

Particulars		*Debit*	*Credit*
1. For Purchase Consideration Due:			
Business purchase A/c	Dr.	125	
To Lazy Ltd. A/c			125
ii. Incorporation of assets and liabilities taken over :			
Fixed Assets A/c	Dr.	200	
Currnt Assets A/c	Dr.	900	
To Current liabilities A/c			750
To Loan A/c			200
To Business Purchase A/c			125
To Capital Reserve A/c			25
iii. Discharge of consideration - Not Applicable			

Balance Sheet of Yummy Ltd. as **on** *31st March,* **2009**

Rs. in Crores

Liabilities	*Amount*		*Assets*	*Amount*	
	@	*		@	*
Share capital	200	200	Fixed Assets :		
Reserves and surplus			Cost	400	700
Capital Reserve	35	20	Less : Depreciation	(100)	(300)
Revenue Reserves	425	425	Net Block	300	400
Surplus	5	5	Current Assets	1,600	1,500
Loan	300	350	15% Loan	15	-
Current liabilities	950	900			
	1,915	**1900**		**1,915**	**1900**

@ Before Reconstruction

* After Reconstruction

Evaluation of Mr. Pravin's Investment

Rs. in Crores

	Lazy Ltd.		*Yummy Ltd*	
	Before Reconstruction	After Reconstruction	Before Reconstruction	After Reconstruction
a. Total assets (Rs. Corers)	1300	1415	1000	965
b. Outside liabilities (Rs. Corers)	250	315	350	300
c. Net Assets (Rs. Corers)	1050	1100	650	665
d. Number of shares (in Corers) Outstanding	3	3	2	2
e. Intrinsic Value (Rs. Per Share)[c/d]	350	367	325	332.50
f. Number of shares held	5,000	5,000	3,000	3,000
g. Value of shares held (Rs.)	17.5 Lakhs	18.35 Lakhs	9.75 Lakhs	9.975 Lakhs
h. Increase in value (Rs.)	85,000		22,500	
i. ***Total increase in value due to demerger***	***Rs. 1,07,500***			

Illustration - 39

The following is the Balance sheet of Diverse Ltd. having an authorised capital of Rs.1,000 Cr. as on 31st March, 2009 :

(Rs. in crores)

	Rs.	*Rs.*
Sources of funds :		
Shareholders' funds		
Share capital		
Equity shares of Rs.1 0 each fully paid in cash	250	
Reserves and surplus (Revenue)	750	1,000
Loan funds		
Secured against : (a) Fixed assets Rs. 300 Cr.		
(b) Working capital Rs. 100 Cr.	400	
Unsecured	600	1,000
		2,000
Employment of funds		
Fixed Assets		
Gross block	800	
Less: Depreciation	200	600
Investment at cost (Market value Rs.1 ,000 Cr.)		400
Net Current assets :		
Current assets	3,000	
Less: Current liabilities	(2,000)	1,000
		2,000

Capital commitments: Rs. 700 crores.

The company consists of 2 divisions.

i. Established division whose gross block was Rs.200 crores and net block was Rs. 30 crores; Current assets were Rs.1, 500 crores and working capital was Rs.1,200 crores; the entire amount being financed by shareholders' funds.
ii. New project division to which the remaining Fixed assets, Current assets and Current liabilities related.

The following scheme of reconstruction was agreed upon.

a. Two new companies Sunrise Ltd. and Khajana Ltd. are to be formed. The authorised capital of Sunrise Ltd. is to be Rs. 1,000 crores. The authorised capital of Khajana Ltd. is to be Rs.500 crores.

b. Khajana Ltd. is to take over investments at Rs.800 crores and unsecured loans at balance sheet value. It is to allot equity share of Rs. 10 each at par to the members of Diverse Ltd. in satisfaction of the amount due under the arrangement.

c. Sunrise Ltd. is to take over the Fixed assets and net working capital of the new project division along with the secured loans and obligation for capital commitments for which Diverse Ltd. is to continue to stand guarantee at book values. It is to allot one crore equity shares of Rs. 10 each as consideration to Diverse Ltd. Sunrise Ltd. . made an issue of unsecured convertible debentures of Rs.500 crores carrying interest at 15% per annum and having a right to convert into equity shares of Rs. 10 each at par on 31.3.2014. This issue was made to the members of Sunrise Ltd. as a right who grabbed the opportunity and subscribed in full.

d. Diverse Ltd. is to guarantee all liabilities transferred to the 2 companies.

e. Diverse Ltd. is to make a bonus issued of equity shares in the ratio of one equity share for every equity share held by making use of the Revenue reserves. .

Assume that the above scheme was duly approved by the Honourable High Court and that there are no other transactions. Ignore taxation.

You are asked to :

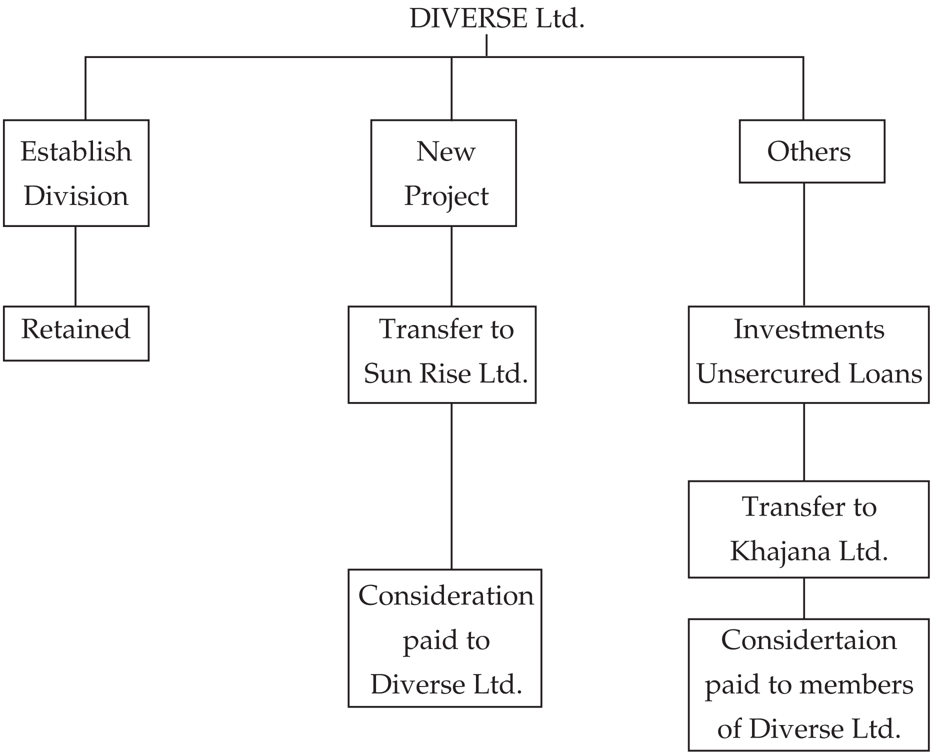
i. Pass journal entries in the books of Diverse Ltd., and

ii. Prepare the balance sheets of the three companies giving all the information required by the Companies Act, 1956 in the manner so required to the extent of available information.

Solution :

Part. I Basic Information

WN # 1 : ***Scheme of Reorganisation***



WN # 2 : ***Assets and Liabilities - Division Wise***

(Rs. in crores)

	Particulars	*Established Division*	*New Project Division*	*Others*
a.	Fixed Assets :			
	i) Gross Block	200	600	-
	ii) Accumulated depreciation	(170)	(30)	-
	iii) Net block	30	570	-
b.	Investments	-	-	400
c.	Net Current Assets			
	i) Current Assets	1500	1500	-
	ii) Current liabilities	(300)	(1700)	-
	iii) Net Current Assets	1200	200	-
d.	Secured loans	-	400	-
e.	Unsecured loans	-	-	600

WN # 3 : ***Purcahse considerations.***

A. For transfer to Khajana Ltd. - Net Assets Method.

(Rs. in crores)

	Particulars	*Amount*
i)	Investments	800
ii)	Unsecured loans	(600)
iii)	Net assets	200

Share of Khajana Ltd.
issued to members of
Diverse Ltd.

B. For transfer to Sunrise Ltd. - Payment Method $\boxed{\text{10 Crores}}$

1 crores shares of Rs. 10 each Issued to Diverse Ltd.

Part -II

Books of Khajana Ltd.

(Rs. in crores)

Particulars			*Debit*	*Credit*
i.	For Purchase Consideration Due: Business Purchase A/c	Dr.	200	
	To Shareholders of Diverse Ltd.			200
ii.	For Assets and Liabiltiies taken over			
	Investment A/c	Dr.	800	
	To Unsecured Loans			600
	To Business Purchase			200
iii.	For Discharge of purchase consideration			
	Shareholders of Diverse Ltd. A/c	Dr.	200	
	To Equity Share capital A/c			200

Balance Sheet of Khajana Ltd. as on 01.04.2009

(Rs. in crores)

Liabilities	*Rs.*	*Assets*	*Rs.*
Authorised Share capital Issued, subscribed and paid up Equity capital of Rs. 10 each fully paid	200	Investments at cost (Quoted investments with Market Value of Rs. 1000 Crores)	800
(The above shares are issued for consideration other than cash)			
Unsecurd Loans	600		
(Guaranteed by Diverse Ltd.)			
	800		**800**

Part III : ***Books of Sunrise Ltd.***

(Rs. in crores)

Particulars		*Debit*	*Credit*
II. For Purchase Consideration Due:			
Business purchase A/ c	Dr.	10	
To Diverse Ltd.			10
b. For assets and Liabilities taken over			
Good will A/c (Balancing Figure)	Dr.	40	
Fixed Asset A/ c	Dr.	570	
Current Assets A/c	Dr.	1500	
To Current liabilities A/c			1700
To Business Purchase A/c			10
To Secured loan A/c			400
c. For Discharge of purchase consideration			
Diverse Ltd. A/c	Dr.	10	
To Equity Share capital			10
d. For Issue of unsecured convertible debentures			
i. Bank A/c	Dr.	500	
To Debenture Application A/c			500
ii. Debenture Application A/c	Dr.	500	
To 15% Debenture A/c			500

Balance sheet of Sunrise Ltd as* on *1st April, 2009

(Rs. in crores)

Liabilities	*Rs.*	*Assets*	*Rs.*
Authorised Share capital	1,000	Fixed assets:	
Issued, subscribed and Paid-up		- Goodwill	40
capital		- Other Fixed assets	570
Equity Shares of Rs. 10	10		
each fully paid-up		Current assets:	
(The above shares are issued for		- Bank	500
consideration other than cash. The		- Other Current assets	1,500
entire capital is held by Diverse Ltd)			
Debentures	500		
Secured Loan	400		
Current liabilities and Provisions	1,700		
	2,610		**2,610**

Note : 1. Capital commitments: Rs. 700 crores.
2. Secured Loans and Current liabilities guaranteed by M/s. Diverse Ltd.

Part - IV ***Books of Diverse Ltd.***

(Rs. in crores)

	Particulars		**Debit**	**Credit**
1.	Transfer to Khajana Ltd.			
i.	For Purchase Consideration Due:			
	Khajana Ltd. A/c	Dr.	200	
	Unsecured Loans A/c	Dr.	600	
	To Investments A/c			400
	To Capital reserve A/c			400
ii.	Cancellation of balance in Khajana Ltd. not receivable, since consideration is paid directly to members :			
	Capital Reserve A/c	Dr.	200	
	To Khajana Ltd.			200
2.	Transfer to Sunrise Ltd :			
i.	For purchase consideration Due:			
	Sunrise Ltd A/c	Dr.	10	
	Current liabilities A/c	Dr.	1700	
	Secured Loan A/c	Dr.	400	
	Provision for depreciation A/c	Dr.	30	
	To Fixed Asset A/c			600
	To Current Assets A/c			1500
	To Capital Reserve A/c			40

	Particulars		Debit	Credit
ii.	Receipt of consideration			
	Equity shares of Sunrise Ltd.	Dr.	10	
	To Sunrise Ltd.			10
iii.	Others			
	a. Subscripiton to unsecured convertible debenture of Sunrise Ltd.			
	Investments in Debenture of Sunrise Ltd. A/c	Dr.	500	
	To Bank			500
	b. Bonus issue			
	i. Revenue Reserves A/c	Dr.	250	
	To Bonus to Shareholders A/c			250
	ii. Bonus to Share holders A/c	Dr.	250	
	To Equity Share capital A/c			250

Balance Sheet of Diverse Ltd.

Liabilities		Rs.	Assets		Rs.
Authorised, issued, subscribed and fully paid equity shares of Rs.10 each (out of which 25 crores Equity shares are issued for consideration other than cash)		500	Fixed assets		
			Gross Block	200	
			Less: Depreciation		
			Net Block		
			Investment (Un quoated)		
			- Shares of Sunrise	10	
Reserve Surplus :			- Debentures of Sunrise	500	510
Capital reserve		240	Current assets Loans and Advances		1,000
Revenue reserve	750				
Less: Bonus Issue	(250)	500			
Current liabilities and Provisions		300			
		1,540			**1,540**

Capital committment by Sunrise Ltd. Rs. 700 Crores, Guarantees given in respect of liabilities transferred to Sunrise Ltd, and Khajana Ltd. amounting to Rs. 2100 Crores and Rs. 600 Crores respectively.

Illustration - 40

The Balance Sheet of Z Ltd. as at 31st March, 2008 is given below. In it, the respective shares of the company's two divisions namely "S" Division and "W" Division in the various assets and liabilities have also been shown.

(All amounts in crores of Rupees)

	S Division	*W Division*	*Total*
Fixed assets :			
Cost	875	249	
Less : Depreciation	360	81	
Written-down value	515	168	683
Investments			97
Net Current assets :			
Current assets	445	585	
Less: Current liabilities	(270)	(93)	
	175	492	667
			1,447
Financed by :			
Loan funds		15	417
Own funds			
Equity Share capital : Shares of Rs. 10 each			345
Reserves and surplus			685
			1,447

Loan funds included, inter alia, bank Loans of Rs. 15 crore specifically taken for W Division and Debentures of the paid up value of Rs. 125 crore redeemable at any time between 1st October, 2007 and 30th September, 2008.

On 1st April, 2008 the company sold all of its investments for Rs. 102 crore and redeemed all the debentures at par, the cash transactions being recorded in the Bank Account pertaining to S Division.

Then a new company named Y Ltd. was incorporated with an authorized capital of Rs. 900 crore divided into shares of Rs. 10 each. All the assets and liabilities pertaining to W Division were transferred to the newly formed company; Y Ltd, allotting to Z Ltd's shareholders its two fully paid equity shares of Rs. 10 each at par for every fully paid equity share of Rs. 10 each held in Z Ltd. as discharge of consideration for the division taken over.

Y Ltd. recorded in its books the Fixed assets at Rs. 218 crore and all other assets and liabilities at the same values at which they appeared in the books of Z Ltd.

You are required to :

i. Show the journal entries in the books of Z Ltd.

ii. Prepare Z Ltd's Balance Sheet immediately after the demerger and the initial Balance Sheet of Y Ltd. (Schedules in both cases need not be prepared).

iii. Calculate the intrinsic value of one share of Z Ltd. immediately before the demerger and immediately after the demerger; and

iv. Calculate the gain, if any, per share to the shareholders of Z Ltd. arising out of the demerger.

Solution :

Journal entries in the books of Z Ltd.

(Rs. crores)

Particulars			*Debit*	*Credit*
a.	Bank A/c	Dr.	102	
	To Investments A/c			97
	To Profit & Loss A/c			5
	[Being sale of investments and profit realised thereon]			
b.	Debenture A/c	Dr.	125	
	To Bank A/c			125
	[Being redemption of debentures at par]			
c.	Bank Loan A/c	Dr.	15	
	Current liabilities A/c	Dr.	93	
	Provision for Depreciation A/c	Dr.	81	
	Reserves and Surplus A/c	Dr.	645	
	To Fixed Assets A/c			249
	To Current Assets A/c			585
	[Being assets and liabilities of W Division transferred to Y Ltd.]			

Balance Sheet of-Z Ltd. After Demerger as **on 01.04.08.**

(Rs. in crores)

Liabilities	*Amount*	*Assets*		*Amount*
Share capital :		Fixed Assts :		
Issued, subscribed and		Cost	875	
fully paid up Equity Shares		Less : Provision for Dep.	(360)	
of Rs. 10 each	345			515
Reserves and surplus		Current assets (WN # 3)		422
Revenue reserves (WN # 1)	45			
Loan Funds (WN # 2)	277			
Current liabilities and				
Provisions :				
Current liabilities	270			
(pertaining to S Division)				
	937			**937**

WN # 1: ***Revenue Reserves***

Particulars	*Rs. in Crores*
Balance as 31.03.2008	685
Add : Profit on sale of investment	5
Less: Loss on demerger	(645)
Balance as on 01.04.2008	45

WN # 2 : ***Loan Funds***

Particulars	*Rs. in Crores*
Balance as 31.03.2008	417
Less: Bank Loan transferred to Y Ltd.	(15)
Less: Debentures redeemed	(125)
Balance as on 01.04.2008	277

WN # 3: ***Current Assets***

Particulars	*Rs. in Crores*
Balance as 31.03.2008	445
Add: Cash received on sale of investments	102
Less: Cash paid on redemption of debentures	(125)
Balance as on 01.04.2008	422

Balance sheet of Y Ltd. as on 01.04.2008

(Rs in crores)

Liabilities	*Amount*	*Assets*	*Amount*
Share capital		Fixed assets (given)	218
Authorised Capital	900	Current assets	585
Equity Shares of Rs. 10 each			
Issued, Subscribed and Paid-up Capital of Equity Shares of Rs. 10 each (345 ×½)	690		
(The above shares were issued for a consideration other than cash)			
Reserves and surplus			
Capital reserves (WN # 4)			
Secured Loan			
Loan Fund	5		
Bank Loan	15		
Current liabilities and Provisions			
Current liabilities	93		
Total	**803**	**Total**	**803**

WN # 4 : ***Capital Reserves***

Particulars		**Rs. in *Crores***	**Rs. in *Crores***
i.	Purchase consideration		690
ii.	Less: Net Assets taken Over		
	Assets taken over (218 + 585)	803	
	Less: Liabilities taken over (93+15)	(108)	(695)
iii.	*Capital reserves* [(i) - (ii)}		5

Calculation of Intrinsic value per share before and after demerger

Rs. in Crores

Particulars	*Before Demerger*	*After Demerger*
Fixed Assets	683	515
Net Current Assets (WN # 5)	644	152
Total assets	1,327	667
Less : Loan funds (WN # 6)	(292)	(277)
Net asset value	1,035	390
Number of shares	34.5	34.5
Intrinsic value per share [(v)+(vi)]	***Rs. 30***	***Rs. 11.30***

WN # 5 : ***Current Assets***

Rs. in Crores

Particulars	*Before Demerger*	*After Demerger*
Balance as per balance sheet	667	175
Less : Cash paid on redemption of debentures	(125)	(125)
Add : Cash received on sale of investments	102	102
	644	**152**

WN # 6 : ***Loan Funds***

Rs. in Crores

Particulars	*Before Demerger*	*After Demerger*
Balance as per balance sheet	417	417
Less : Redemption of debentures	(125)	(125)
Less : Transfer of loan funds to Y Ltd.	-	(15)
	292	**277**

IV. ***Gain per share to the shareholders of Z Ltd. arising out of the demerger :***

For every share in Z Ltd, the shareholders will hold 2 shares in Y Ltd. also.

		Rs.
I.	**After demerger**	
i.	Value of one share in Z Ltd.	11.30
ii.	Value of two share in Y Ltd. (Rs. 10 x 2)	20.00
iii.	Total Value after merger for each share	31.30
II.	**Before demerger**	
i.	Value of one share in Z Ltd. before merger	30.00
III.	**Gain per share**	**1.30**

XII. Sales of Division

Illustration - 41

X Ltd. has 2 divisions A and B.

Division A has been making constant profits while Division B has been invariably suffering losses. On 31st March, 2009 the divisionwise Balance Sheet was :

(Rs. Crores)

		A	B	Total
Fixed Assets cost		250	500	750
Depreciation		225	400	625
	(i)	25	100	125
Current Assets :		200	500	700
Less : Current liabilities		25	400	425
	(ii)	175	100	275
	(i) + (ii)	200	200	400
Financed by :				
Loan		—	300	300
Capital : Equity Rs. 10 each		25	_	25
Surplus		175	(100)	75
		200	200	400

Division B along with its assets and liabilities was sold for Rs. 25 crores to Y Ltd. a new comapny, who allotted 1 crore equity shares of Rs. 10 each at a premium of Rs. 15 per share to the memebers of B Ltd. in full settlement of the consideration in proportion to their shareholding in the company.

Asssuming that there are no other transactions, you are asked to :

i. Pass journal entries in the books of X Ltd.

ii. Prepare the Balance Sheet of X Ltd. after the entires in (i).

iii. Prepare the Balance Sheet of Y Ltd.

Solution :

Part I - Books of A Ltd :

Basic Information :

A Ltd.

Division A
Profit Making
Retained by X Ltd

Division B
Loss Making
Assets and Liabilites
transferred to Y Ltd for
consideration of Rs. 25 Crores.

I. ***Journal Entries***

(Rs. Crores)

Particulars		***Debit***	***Credit***
i. Sale of Assets and Liabilities to Y Ltd.			
Y Ltd A/c	Dr.	25	
Loan A/c	Dr.	300	
Current liabilities A/c	Dr.	400	
Provision for depreciation A/c	Dr.	400	
To Fixed Assets A/c			500
To Current Assets A/c			500
To Capital Reserve A/c (bal fig)			125
ii. Receipt of consideration from B Ltd.			
Equity shares in Y Ltd.	Dr.	25	
To Y Ltd. A/c		25	

II.

Balance Sheet of X Ltd as at 31.3.2009

(Rs. in Crores)

Liabilities	***Rs.***	***Assets***	***Rs.***	
Share capital:		Fixed Assets		
Authorised Equity shares of		Gross Block Cost:	250	
Rs. 10 each		Less: Depreciation	225	25
issued and Subscribed	25	Investment in equity		
Reserves and surplus		shares of Y Ltd.		
* Capital reserve	125	(Face Value of Rs. 10		
* Profit and Loss (Existing)	75	subscribed at a		
Current liabilities	25	premium of Rs. 15 each		25
		Current Assets		200
	250			**250**

Note:

Division 'B' was sold to M/s. Y Ltd. The consideration received for the transfer was equity shares of Y Ltd. of Rs. 10 each fully paid, issued at a premium of Rs. 15.

Total value of consideration = 1 Crore shares × (Rs. 10 + Rs. 15)

= 1 Crore × Rs. 25

= Rs. 25 Crores

Part II - In the books of Y Ltd.

Journal Entries

(Rs. in Crore)

	Particulars		*Debit*	*Credit*
a.	For Business purchase			
	Business Purchase A/c	Dr.	25	
	To X Ltd A/c			25
b.	Assets and liabilities taken over			
	Fixed Assets A/c	Dr.	100	
	Current Assets A/c	Dr.	500	
	Goodwill A/c (Balancing Figure)	Dr.	125	
	To Loan A/c			300
	To Current liabilities A/c			400
	To Business Purchase A/c			25
c.	Discharge of liability			
	X Ltd A/c	Dr.	25	
	To Equity Share capital A/c			10
	To Securities premium A/c			15

Balance Sheet of M/s Y Ltd. as at 31.3.2009

(Rs. in Crores)

Liabilities	*Amount*	*Assets*	*Amount*
Share capital:		Goodwill	125
Authorised Equity Shares of Rs. 10 each		Fixed Assets	100
1 Crore Shares issued for consideration other than by way of cash	10	Current Assets	500
Reserves and surplues			
Securities Premium	15		
Loan	300		
Current liabilities	400		
	725		**725**

Note:

a) Goodwill due to business purchase should be amortized over a period of 5 years.

b) Fixed assets:

Gross Block	500
Less: Accumulated Depn.	400
Net Blcok	100

XIII. Impact of Reconstruction over Wealth of Investor and Company

Illustration - 42

AB Ltd has 2 divisions - A and B. The Balance Sheet as at 31, October 2008 was as under:

(in Crores)

		A		B		Total
Fixed assets						
Cost		600		300		900
Depreciation		500		100		600
W.D.V.		100		200		300
Net Current Assets						
Current Assets	400		300		700	
Less: Current Liabilities	100	300	100	200	200	500
Total		**400**		**400**		**800**
Financed by:						
Loans		—		100		100
(Secured by a charge on Fixed assets)		—		100		100
Own funds:						
Equity capital						50
(Fully paid up Rs. 10 shares)						650
Reserves and surplus						700
Total		**400**		**400**		**800**

It is decided to form a new company B Ltd., to take over the assets and liabilities of B division.

According B. Ltd. was incorporated to take over at balance sheet figures, the assets and liabilities of that division. B Ltd. is to allot 5 crores equity shars of Rs. 10 each in the company to the members of AB Ltd., in full settlement of the consideration. The members of AB Ltd. are therefore to become members of B Ltd. as well without having to make any further investment.

a. You are asked to pass journal entries in relation to the above in the books of AB Ltd. and B. Ltd. Also show the Balance Sheets of the 2 companies as on the morning of 1st November, 2008, showing corresponding previous year's figures.

b. The directors of the 2 companies, ask you to find out the net asset value of equity shares pre and post demerger.

c. Comment on the impact of demerger on "shareholders wealth".

Solution:

Part I: In the Books of M/s. AB Ltd.

(Rs. in crores)

	Particulars		*Debit*	*Credit*
i.	Transfer of assets and liabilities of Division B to B Ltd.			
	(a) For Purchase Consideration Due:			
	A Ltd. A/c	Dr.	50	
	Loan funds A/c	Dr.	100	
	Curent liabilities A/c	Dr.	100	
	Povision for depreciation A/c	Dr.	100	
	Profit and Loss A/c (balancing figure)	Dr.	250	
	To Fixed Assets A/c			300
	To Current Assets A/c			300
ii.	Cancellation of balance in A Ltd. not receivable since consideration is paid to members of AB Ltd. in full			
	Reserves A/c	Dr.	50	
	To A Ltd.			50

Part II: In the Books of B Ltd.

(Rs in crores)

	Particulars		*Debit Rs.*	*Credit Rs.*
i.	For Purchase Consideration Due:			
	Business Purchase A/c	Dr.	50	
	To Shareholders of AB Ltd. A/c			
ii.	Assets and liabilities taken over			
	Fixed Assets A/c	Dr.	200	
	Current Assets A/c	Dr.	300	
	To Loan A/c			100
	To Current liabilities A/c			100
	To Capital Reserve (balancing figure)			250
	To Business Purchase A/c			50
iii.	Discharge of purchase consideration			
	Shareholders of AB Ltd.	Dr.	50	
	To Equity Share capital A/c			50

Part III : Balance Sheet of two companies after reorganisation.

Balance Sheet of Z Ltd. as on 01.11.2008

(Rs. in crores)

	Before AB	*Before AB*	*Before B Ltd.*
Sources of Funds			
i. Share capital	50	50	50
ii. Reserves and surplus			
a. Capital Reserve	Nil	Nil	250
b. Revenue Reserve	650	*350	Nil
iii. Loan Funds	100	Nil	100
	800	**400**	**400**
Application of Funds :			
i. Fixed Asset			
Gross Block	900	600	300
Less : Depreciation	600	500	100
Net Block	300	100	200
ii. Current assets (Net)	500	300	200
	800	**400**	**400**

* Revenue reserve :

Opening balance-	- 650
Less : Transfer to B Ltd.	- (250)
Less : Cancel due from B Ltd.	- (50)
Closing balance	- 350

Net assets before and after reorganisation

(Rs. in crores)

	A	*B*	*AB*
Value of total assets	800	400	400
Less : Loan funds	(100)	—	(100)
Net assets	700	400	300
Net assets belonging to Equity share holders after December		700	

Conclusion :

The impact on share holders wealth after reorganisation is Nil.

XIV. Buy back of shares:

Illustration - 43

K Ltd. furnishes you with the following Balance Sheet as at 31st March, 2009:

		(Rs. in Crores)
Sources of Funds		
Share capital :		
Authorised		100
Issued:		
12% redeemable preference shares of Rs. 100 each fully paid	75	
Equity shares of Rs. 10 each fully paid	25	100
Reserves and surplus		
Capital Reserve	15	
Securities Premium	25	
Revenue Reserves	260	300
		400
Funds employed in:		
Fixed assets: cost	100	
Less: Provision for depreciation	100	nil
Investments at cost (Market value Rs. 400 Cr.)		100
Current assets	340	
Less: Current liabilities	40	300
		400

The company redeemed preference shares on 1 st April 2009. It also bought back 50 lakh equity shares of Rs. 10 each at Rs. 50 share. The payments for the above were made out of the huge bank balances, which appeared as a part of Current assets.

You are asked to :

i. Pass journal entries to record the above

ii. Prepare Balance Sheet

iii. Value equity share on net asset basis.

Solution:

Part I - Journal entries in the books of K Ltd.

Rs. in crores

Particulars		*Debit*	*Credit*
a. Redemption of Preference Shares on 1st April 2009			
i. Due Entry			
12% Preference Share capital A/c	Dr.	75	
To Preference Share Hodlers A/c			75
ii. Payment Entry			
Preference Shareholders A/c	Dr.	75	
To Bank A/c			75
b. Shares bought back			
i. On buy back			
Shares bought back A/c	Dr.	25	
To Bank A/c			25
(50 lakhs shares × Rs. 50 per share)			
ii. On Cancellation			
Equity Share capital A/c (50 Lakhs × Rs. 10)	Dr.	5	
Securities premium A/c (50 Lakhs × Rs. 40)	Dr.	20	
To Shares bought back A/c			25
iii. Transfer to Capital Redemption Reserve			
Revenue reserve A/c	Dr.	80	
To Capital Redemption Reserve A/c			80
(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

Part-II: Balance Sheet of K Ltd after reconstruction:

Balance Sheet of K Ltd as at 1.4.2009

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Share capital			Fixed assets		
Authorised			Cost:		
Issued, subscribed and paid up			Less : Provision for	100	
equity shares of 200 lakhs of			Depreciation	(100)	Nil
Rs. 10 each		20	Investment at Cost		
12% Redeemable preference			(Market Value of		
shares were redeemed at par.			Investments=Rs. 400 Crores)		100
Reserves and surplus			Current assets as on 31.3.2009	340	
Capital reserve	15		Less: Bank payment for		
Capital Redemption Reserve	80		redemption and buy back	(100)	240
Share Premium (25-20)	5				
Revenue reserve (260-80)	180	280			
Current liabilities		40			
		340			**340**

Part - III - Net Asset Value of Equity Shares

(Rs. in crores)

Particulars	*Amount*	*Amount*
a. i. Fixed assets	Nil	
ii. Investments (at market value)	400	
iii. Current assets	240	640
b. Less : Current liabilities		(40)
Net assets available for equity share holders		600
c. No. of equity shares outstanding (in lakhs)		2
d. Value per equity share of Rs. 10 each = (600÷2)		Rs. 300

Illustration - 44

The following was the balance sheet of Diamond Ltd. as at 31st March, 2009.

Liabilities	**Rs, in lakhs**
10% Redeemable Preference Shares of Rs. 10 each, fully paid up	2,500
Equity Shares of Rs. 10 each fully paid up	8,000
Capital Redemption Reserve	1,000
Securities Premium	800
General Reserve	6,000
Profit and Loss Account	300
9% Debentures	5,000
Sundry creditors	2,300
Sundry Provisions	1,000
	26,900

Assets	**Rs, in lakhs**
Fixed assets	14,000
Investments	3,000
Cash at Bank	1,650
Other Current assets	8,250
	26,900

On 1st April, 2009 the company redeemed all of its preference shares at a premium of 10% and bought back 25% of its equity shares @ Rs. 20 per share. In order to make cash available, the company sold all the investments for Rs.3, 150 lakh and raised a bank loan amounting to Rs. 2,000 lakhs on the security of the company's plant.

Pass journal entries for all the above mentioned transactions including cash transactions and prepare the company's balance sheet immediately thereafter. The amount of securities premium has been utilized to the maximum extent allowed by law.

Solution:

Journal Entries

Particulars			*Debit Rs.*	*Credit Rs.*
1.	Bank A/c	Dr.	3,150	
	To Investment A/c			3,000
	To Profit and Loss A/c			150
	(Being sale of investments and profit thereon)			
2.	Bank A/c	Dr.	2,000	
	To Bank Loan A/c			2,000
	(Being loan taken from bank)			
3.	10% Redeemable preference Share Capital A/c	Dr.	2,500	
	Premium on redemption of preference shareholder A/c	Dr.	200	
	To Preference shareholder A/c			2,750
	(Being redemption of preference shares)			
4	Preference shareholders A/c	Dr.	2,750	
	To Bank A/c			2,750
	(Being payment of amount due to preference shareholders)			
5.	Securities premium A/c	Dr.	250	
	To Premium on redemption of preference share A/c	Dr.		250
	(Being use of securities premium to provide premium on redemption of preference shares)			
6.	Equity Share capital A/c	Dr.	2,000	
	Securities premium A/c [800 - 250]	Dr.	550	
	General reserves A/c [(200x20) - 2000 - 550]	Dr.	1,450	
	To Equity shareholders A/c			4,000
	(being buy back of equity shares)			
	Note: Balance of General Reserve [6000 - 1450] = Rs. 4550.			
7.	General Reserves A/ c	Dr.	4,500	
	To Capital Redemption Reserve A/c (2000 + 2500)			4,500
	(Being creation of capital redemption reserve to the extent of the face value of preference share redeemed and equity shares bought back).			
	Note: Balance in General reserve as on 01.04.09 (4550 - 4500) = Rs. 50.			
8.	Equity shareholders A/c	Dr.	4,000	
	To Bank A/c			4,000
	(Being payment of amount due to equity shareholders).			
	Note: Cash at Bank [1650+3150+2000-2750-4000] = Rs.50			

Balance Sheet of Diamond Ltd., as on 01.04.09

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital		Fixed assets	
Issued, subscribed and paid up equity shares of Rs. 10 each	6,000	Current asset, Loans and Advances	14,000
Reserves and surplus			
Capital Redemption Reserve (1000 + 4500)	5,500	Cash at Bank	50
		Other Current assets	8,250
General Reserves	50		
Profit and Loss A/c (300+ 150)	450		
Secured Loans			
9% Debentures	5,000		
Bank Loan	2,000		
Current liabilities and Provisions			
Sundry creditors	2,300		
Provisions	1,000		
Total	**22,300**	**Total**	**22,300**

Illustration - 45

XYZ Ltd. has the following capital structure on of 31st March 2009.

	Particulars	*Rs. in Crores*
a.	Equity Share capital (Shares of Rs. 10 each)	300
b.	Reserves :	
	General Reserve	270
	Security Premium	100
	Profit and Loss A/c	50
	Export Reserve (Statutory reserve)	80
c.	Loan Funds	800

The shareholders have on recommendation of Board of Directors approved vide special resolution at their meeting on 10th April 2009 a proposal to buy back maximum permissible equity shares considering the huge cash surplus following A/c of one of its divisions.

The market price was hovering in the range of Rs. 25/- and in order to induce existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% above market.

Advice the company on maximum number of shares that can be bought back and record journal entries for the same assuming the buy back has been completed in full within the next 3 months.

If borrowed funds were Rs. 1200 Lakhs, and 1500 Lakhs respectively would your answer change?

Solution:

Maximum shares that can be bought back

		Situation I	*Situation II*	*Situation III*
a.	Shares outstanding test (WN # 1)	7.5	7.5	7.5
b.	Resources test (WN # 2)	6	6	6
c.	Debt Equity ratio test (WN # 3)	10.67	4	—
d.	Maximum number of shares for buy back - LEAST of the above	6	4	—

Particulars			**Situation I**		**Situation II**	
			Debit	**Credit**	**Debit**	**Credit**
a.	Shares bought back A/c	Dr.	180		120	
	To Bank A/c			180		120
	[Being purchase of shares from public]					
b.	Share capital A/c	Dr.	60		40	
	Securities premium A/c	Dr.	100		80	
	General reserve A/c (*balancing figure*)	Dr.	20		—	
	To Shares bought back A/c			180		120
	[Being cancellation of shares bought on buy back]					
c.	General Reserves A/c					
	To Capital Redemption Reserve A/c					
	[Being transfer of reserves to capital redemption reserve to the extent capital is redeemed]					

Note: Under situation III, the company does not qualify the debt equity ratio test. Therefore the company cannot perform the buy back of shares (Under section 77A of the Companies Act, 1956)

WORKING NOTES:

WN # 1 : Shares outstanding test

	Particulars	**Amount**
a.	No. of shares outstanding	30 crores
b.	25% of shares outstanding	7.5 crores

WN # 2 : Resources test

(Rs. in Crores)

	Particulars	Amount
a.	Paid up capital	300
b.	Free reserves	420
c.	Shareholders fund (a+b)	720
d.	25% of shareholders fund	180
e.	Buyback price per share	Rs. 30
f.	Number of shares that can be bought back	6 Crores

WN # 3 : Debt Equity ratio test :

(Rs. in Crores)

	Particulars	*Situation I*	*Situation II*	*Situation III*
a.	Borrowed Funds	800	1,200	1,500
b.	Minimum equity to be maintained after buy back in the ratio 2:1	400	600	750
c.	Present equity	720	720	720
d.	Maximum possible dilution in equity	320	120	—
e.	Maximum shares that can be bought back @ Rs. 30/- per share	10.67	4	—

XV. Conversion:

Illustration - 46

X Co. Ltd. was incorporated on 1st July, 2008 to take over the business of Mr. A as and from 1st April, 2008, Mr. A's Balance Sheet, as at that date, was as under :

Liabilities	*Rs.*	*Assets*	*Rs.*
Trade creditors	36,000	Building	80,000
Capital	1,94,000	Furniture and 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 Rs. 10 each, Rs. 8 per share paid up and cash of Rs. 5,000.

The company issued to the public for cash 20,000 equity shares of Rs. 10 each on which by 31 st March, 2009, Rs.8 per share was called and paid up except in the case of 1,000 shares on which the 3rd call of Rs. 2 per share had not been reatised. In the case of 2,000 shares, the entire face value of the shares has 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, 2009.

	Rs.
Discount (including Rs. 1,000 allowed on vendor's debtors)	6,000
Preliminary Expenses	10,000
Director's 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, 2009 was Rs. 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 Rs. 60,000 in the period.

Prepare the Trading and Profit and Loss account for the period ended 31 st March, 2009 of X Co. Ltd. and its Balance Sheet as at that date.

Solution:

Part I: Calculation of purchase consideration.

	Particulars	Rs.
a.	Consideration paid in the form of cash	56,000
b.	Consideration paid in the form of equity shares of X Co. Ltd 10,000 Shares of Rs. 10 each, Rs.8 paid up	80,000
c.	Total consideration	1,36,000

Part II : ***In the Books of Mr. A.***

Realisation Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Building	80,000	By X Co. Ltd (Purchase consideration)	1,36,000
To Furniture	10,000		
To Stock	30,000		
To Profit on Realisation	16,000		
	1,36,000		**1,36,000**

Journal Entries

Particulars			*Debit* *Rs.*	*Credit* *Rs.*
a.	For Purchase Consideration Due:			
	X Co. Ltd. A/c	Dr.	1,36,000	
	To Realisation A/c			1,36,000
b.	Receipt entry			
	Equity shares in X Ltd. A/c	Dr.	80,000	
	Cash I Bank A/c	Dr.	56,000	
	To X Co. Ltd. A/c			1,36,000
c.	Other receipts from X Ltd - Debtors collection			
	i. Recovery of debtors.			
	X Co. Ltd. (Vendor Drs)	Dr.	90,000	
	To Debtors A/c			90,000
	ii. Receipt of cash and commission paid.			
	Discount on Debtors A/c	Dr.	1,000	
	Commission to X Co. Ltd A/c	Dr.	3,000	
	Cash/Bank A/c	Dr.	57,000	
	To X Co. Ltd A/c			61,000
	[Since the debtors are held by Mr. A, the discount given to debtors are to be borne by Mr. A. Commission = Cash collected × 5% = 60,000 × 5% = 3,000 ∴ Balance in vendor debtors A/c (90,000–61,000=29,000)			
d.	Settlement to creditors			
	Creditors A/c	Dr.	36,000	
	To Bank A/c			36,000
	[Since creditors are also held by Mr. A. and not taken over by X Co. Ltd.]			

Cash/Bank Account

Dr. Cr.

Particulars	**Rs.**	**Particulars**	**Rs.**
To balance b/d	20,000	By Creditors	36,000
To X. Co. (Purchase Consideration)	56,000	By balance c/d	97,000
To X Co. (Debtors Collection)	57,000		
	1,33,000		1,33,000
To bal b/d	97,000		

Balance sheet of Mr. A as at 1 st April 2008

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital	1,94,000	Investment in equity shares of X	
Add : Realisation Profit	16,000	Co. Ltd (Rs. 8 paid)	80,000
Less : Discount to debtors	(1,000)	Vendor Debtors (X Ltd.)	29,000
Less : Commission Paid.	(3,000)	Cash /Bank	97,000
	2,06,000		**2,06,000**

Part III - In the books of X Co. Ltd.

Particulars		***Debit***	***Credit***
a. Take over business of Mr. A			
i. For Purchase Consideration Due:			
Business Purchase A/c	Dr.	1,36,000	
To Mr. A			1,36,000
ii. For Assets taken over			
Goodwill A/c (balancing figure)	Dr.	16,000	
Building A/c	Dr.	80,000	
Furniture and fixture A/c	Dr.	10,000	
Stock A/c	Dr.	30,000	
To Business Purchase A/c			1,36,000
iii. Discharge of Purchase Consideration			
Mr. A A/c	Dr.	1,36,000	
To Equity Share capital A/c			80,000
To Bank / Cash A/c			56,000
b. Public Issue of shares			
i. Bank A/c	Dr.	1,36,000	
To Equity shares capital A/c			1,36,000
[Being Rs. 8/- per share received on 17,000 shares (20,000 - 1,000 - 2,000)]			
ii. Bank A/c	Dr.	6,000	
Calls in Arrears A/c	Dr.	2,000	
To Equity Share capital A/c			8,000
[Being receipt of Rs. 61 - on 1000 shares. Rs.2/- on 3rd call had not been realised]			
iii. Bank A/c	Dr.	20,000	
To Equity Share capital A/c			16,000
To Calls in advance A/c			4,000
[Being on 2,000 shares, the entire amount of Share capital received. Rs. 2/- per share not called up transferred to calls in advance A/c)			
Underwriting commission A/c	Dr.	4,000	
To Equity Share capital A/c			4,000
[Being 2% on the face value of the public issue paid as underwriting commission. Commission discharged as fully paid equity shares. 20,000 shares × Rs. 10 each = 2,00,000 2% × 2,00,000 = 4,000]			

Debtors Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Sales (Assuming fully credit)	4,60,000	By Discount (6,000 - 1,000) By Cash received (balancing figure) By Balance cld (1,60,000 - 29,000)*	5,000 3,24,000 1,31,000
	4,60,000		**4,60,000**

. Vendor Debtors Taken over :

Particulars		*Rs.*
i.	Particulars Debtors taken over from Mr. A	90,000
ii.	Less : Discount given	(1,000)
iii.	Less : Cash collected	(60,000)
iv.	Balance in vendor debtors	29,000

Creditors Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Cash (Balancing figure) To Balance c/d	2,72,000 48,0000	By Purchases (assuming fully on credit)	3,20,000
	3,20,000		3,20,000

Cash / Bank Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Realisation from debtors	3,24,000	By Purchase consideration to Mr.A	56,000
To Receipt from vendor debtors	60,000	By Remittance of vendor Debtors collection (60000 – 3000)	57,000
To Equity Share capital (1,36,000 + 6,000 + 20,000)	1,62,000	By Payment to creditors	2,72,000
		By Preliminary expenses	10,000
		By Directors fees	12,000
		By Salaries	48,000
		By Balance c/d (balancing figure)	91,000
	5,46,000		**5,46,000**

Computation of Goodwill on acquisition

Particulars	**Rs.**	**Rs.**
Purchase Consideration		
- in shares of Rs. 10 each	80,000	
- in cash	56,000	1,36,000
Less : Assets taken over :		
- Building	80,000	
- Furniture and Fittings	10,000	
- Stock	30,000	1,20,000
Goodwill		16,000

Trading Account of X Co. Ltd. for the year ended 31st March, 2009

Dr. Cr.

Particulars	**Rs.**	**Particulars**	**Rs.**
To Opening Stock	30,000	By Sales	4,60,000
To Purchase	3,20,000	By Closing Stock	52,000
To Gross profit c/d	1,62,000		
	5,12,000		**5,12,000**

Profit and Loss Account of X Co. Ltd. for period from 1st July 2008 to 31st March 2009.

Dr. Cr.

Particulars	**1.4.08 to 30.06.08**	**1.7.08 to 31.3.09**	**Particulars**	**1.4.08 to 30.6.08**	**1.7.08 to 31.3.09**
To Discount	-	5,000	By Gross profit	40,500	1,21,500
To Directors fees	.	12,000	By Commission Received	.	3,000
To Salaries	-	48,000			
To Depreciation	1,250	3,750			
To Capital Reserve	39,250	-			
To P & L A/c	-	55,750			
	40,500	**1,24,500**		**40,500**	**1,24,500**

Note :

a. Entire salary and discount pertains to post incorporation period.

b. Depreciation :

i. Pre-incorporation:

Building : 80,000 × 5% × $\frac{3}{2}$ = 1,000

Furniture : 10,000 × 10% × $\frac{3}{2}$ = 250 1,250

ii. Post-incorporation :

Building: 80,000 × 5% × 9/12 = 3,000

Furniture: 10,000 × 10% × 9/12 = 750 3,750

* Profit during 1.4.93 to 30.6.93 reduces the cost of Acquisition and hence transferred to Capital reserve.

Balance sheet of X. Co. Ltd. as at 31.03.2009.

Liabilities		*Rs.*	*Assets*		*Rs.*
Share capital			Building	80,000	
Authorised		3,00,000	Less : Depreciation		
Share capital			@ 5%	4,000	76,000
Issued and			Furniture	10,000	
subscribed capital		3,00,000	Less : Depreciation		
30,000 shares of Rs. 10			@ 10%	1,000	9,000
each Rs. 8			Current assets,		
Called up Capital			Loans and Advances		
30,000 shares of			i) Stock	52,000	
Rs. 8 each	2,40,000		ii) Debtors	1,31,000	
Less : Calls in arrears	2,000		iii) Cash	91,000	2,74,000
1000 x Rs.2/-	2,38,000		Miscellaneous		
[Out of the above			Expenses		
shares 10,000 shares			i) Preliminary		
were issued to Mr. A			Expenses	10,000	
for consideration other			ii) Underwriting		
than cash]			Commission	4,000	14,000
400 shares of Rs. 10					
each fully paid (to be					
issued to underwriter					
for consideration other					
than cash)	4,000	2,42,000			
Reserves and surplus					
Capital reserve*	23,250				
Profit and Loss A/c	55,750	79,000			
Current liabilities and					
Provision :					
Creditors	48,000				
Calls in Advance	4,000	52,000			
		3,73,000			**3,73,000**

* **Note :** Since both Capital Reserve and goodwill arise out of the business acquisition, they can be netted off against each other.

Therefore, Capital Reserve is Rs. 23,250.

Pre incorporation profits	:	39,250
Less : Goodwill on business purchase	:	(16,000)
Balance of Capital Reserve	:	23,250

STUDY NOTE - 3

Group Financial Statements

This Study Note includes:

- Holding Company
- Consolidated Income
- Preparation of the Group Cash Flow Statement

3.1 Holding Company

The tendency to combine in order to derive advantages of economics of scale as well as market power/monopoly power, firms may amalgamate – one firm may absorb another firm in which case their size increases and legal in a larger firm comes into existence. This implies dissolution of one or more existing firms. A legal procedure has to be followed for this purpose. However, Firms may continue without any dissolution by investing in the shares of another company and thereby, acquiring ownership interest to the extent of the holding. If a company holds more than 51% of the issued share capital of another firm or controls composition of Board of Directors of another firm, the company holding the majority share is termed as holding company and the company whose shares are held is termed as subsidiary company.

A partly owned subsidiary is one in which the holding company (or the group) does not hold all the shares. The interest of shareholders outside the group is called 'Minority Interest'.

While the wholly owned subsidiary is one where all the shares are owned by the holding company. From legal point of view both the companies continue to enjoy, separate legal entity but from the point of view of investor, lender as well as management, then, may very well be regarded as single entity. Legally accounts of these companies are complied separately but a more realistic picture will be presented if consolidated accounts especially with respect to published statements- income and position statements are also included in published reports. For this purpose inter company transactions have to be eliminated from all stages and a single Profit and Loss Account and Balance Sheet compiled for the group as a whole. If a company is a subsidiary company, it is also deemed to be a subsidiary of the holding company.

3.2 Methods of Combination

In order to be able to account for combinations, we must first explore some of the methods which may be used to effect them. Such methods may best be classified as to whether or not a group structure results from the combination. Let us take as an example: two companies L and M and assume that the respective Boards of Directors and owners have agreed to combine their business.

Combinations Which Result in a Group Structure

Two such combinations may be considered. In the first case, company L (say) may purchase the shares of Co. M (say) and thereby acquire a subsidiary company, alternatively Co. M may purchase the shares of Co. L. The choice of consideration given in exchange for the shares acquired, will determine whether or not the old shareholders in what becomes the subsidiary Co., have any interest in the combined business. Thus, if Co. L issues shares in exchange for shares in Co. M the old shareholders of Co. M have an interest in the resulting holding company and thereby in the group. Whereas, if Co. L pay cash for the shares in Co. M, the old shareholders in M take their cash and cease to have any, interest in the resulting group.

In the second case a new company LM (say) may be established to purchase the shares of both M Co. and L Co. Thus the shareholders in L and M may sell their shares to LM in exchange for shares in LM. The resulting group structure would be:-

The shareholders in LM would be the old shareholders in LM would be the old shareholders in the two separate companies and their respective interests would depend, as in the above examples, upon the valuation placed the two separate companies–which should in turn depend upon the bargaining between the two Boards of Directors.

It would be possible for LM Co. to issue not only shares but also loan stock in order tom purchase shares in L Co. and M Co. It would be difficult for payment to be made in cash and LM Co. is a newly formed company, although it could, of course offer – shares or raise loan to obtain cash.

Combinations not Resulting in Group Structure

Again, two such combinations may be considered. First, instead of purchasing the shares of Co.M.Co.L may obtain control of the net assets of M by making a direct purchase of those net assets. The net assets would thus be absorbed into Co.L and Co.M would itself receive the consideration. This, in due course would be distributed to the shareholders of M by its liquidator. Once again, the choice of consideration determines whether or not the old shareholders in Co. M have any interest in the enlarged Co.L, second, instead of one of the companies purchasing the net assets of the other, a new company may be formed to purchase the net assets of both the existing companies. Thus a new company LM may be formed to purchase the net assets of Co.L and Co.M. If payments is made by issue of shares in Co. LM these will be distributed by the respective liquidators so that the end result in one company, LM which own the net assets previously held by the separate companies and has as its shareholders the old shareholders in the two separate companies.

Preference for Group Structure

The above are methods of effecting combination between two or indeed more, companies. It appears that the majority of large business combination makes use of a group structure rather than a purchase of assets or net assets. Such a structure is advantageous in that separate companies enjoying limited liability as already is existence. It follows that names and associated Goodwill, of the original Companies are not lost and, in addition, that it is not necessary to renegotiate contractual agreement. All sorts of other factors will be important in practice, some example are the desire to retain staff, the impact of taxation and stamp duty, whether or not there is remaining minority interest.

Choice of Consideration

As discussed above, the choice of consideration will determine who is interested in the single business created by the combination and therefore be affected by the size of the companies and also by the intention of the parties to the combination and also by the conditions in the market securities and taxation system in force.

The main type of consideration are cash, loan stock, equity shares and some form of convertible securities, all sorts of combinations of these are possible.

3.3 Accounting Treatment

It seems to be intention of the companies act that the financial year of holding and subsidiary firm should end on the same date. Section 212 of The Companies Act 1956 requires a that a holding company shall attach to its Balance Sheet the following documents.

- A copy of the Balance Sheet of the subsidiary.

- A copy of the Profit and Loss Account of the subsidiary.
- A copy of the board of Directors report and auditor's report.
- A statement of holding company's interest.

Accounting Standard AS–21 which has come into effect 1–4–2001 requires that holding company shall also present consolidated financial statement in addition to the separate financial statements as stated above. Student is advised to study AS–21 in this context. Consolidated Balance Sheet with respect to the consolidation process is carried out on a step by step basis so that common transaction are eliminated and the assets and liabilities of the entire group are presented in a single Balance Sheet and P/L Account at market prices. The consolidation of the Balance Sheet is carried out in the following steps :

1. **Elimination of inter company investments account:** a holding company by definition holds majority shares in the subsidiary company which appears as an investment on the assets side of the Balance Sheet of the holding company. In the context of subsidiary company it is part of issued capital on the liability side.

As a first step in the consolidated process the investment account in the Balance Sheet of the holding company in the subsidiary company is eliminated and the assets (leaving aside fictitious assets or including an adjustment for them) and all outside liabilities will be incorporated into the holding company's Balance Sheet as shown below :-

Balance Sheet as on 31-03-2010

	H	S		H	S
Share Capital @Rs. 10 each	20000	10000	Sundry Assets	20000	10000
Sundry Liabilities	10000	5000	Investments in S.	10000	-
			Ltd. (1000 shares)		
	30000	15000		30000	10000

Solution:

Consolidated Balance Sheet

Rs.	Rs.	Rs.			Rs.
Share Capital		20000	Sundry Assets	20000	
Sundry Liabilities			H		
H	10000		S	15000	35000
S	50000	15000			
		35000			35000

In the above case the subsidiary firm is fully owned by the holding company and therefore the entire net assets of the subsidiary firm are in the ownership of the holding company and for the purpose consolidation they have been incorporated into Balance Sheet of the holding company. However, very often the holding company have holds only majority shares in which case the extent of the ownership interest (no. of shares held in the form of investments by the Holding company/ total issued capital of S limited in terms of number of shares) In the process of consolidated therefore, assets and liabilities should be incorporated only to the extent of ownership interest. However, this method is not allowed in practice as per convention.

2. **Determination of Minority Interest:** The shares of the subsidiary firm held by outsiders i.e. other than the Holding company are in aggregate termed as minority interest since majority shares are held by Holding company. As per I, even in case of partly owned subsidiary firm the entire assets and liabilities of the subsidiary companies are incorporated in the consolidated Balance Sheet and an additional calculation is made to determine the extent of minority interest in the assets of subsidiary firms and this is shown as additional liability in consolidated Balance Sheet. The claim of the majority (or outside) shareholders will consist of the face value of the shares held by them plus a proportional share in any increases in the value of assets of the company minus their portion of company's losses or decrease in the value of assets of the company.

Illustration:

From the following prepare a consolidated Balance Sheet.

(Figures in Rupees)

	H	S		H	S
Share Capital@Rs. 10 each	20000	10000	Shares in S. Ltd.	80000	
S. Liabilities	10000	5000	800 shares		
			Other assets	22000	15000
	30000	15000		30000	15000

H limited has acquired the shares on the closing Date of the Balance Sheet

Solution

Consolidated Balance Sheet

	Rs.	Rs.		Rs.	Rs.
Share Capital		20000	Sundry assets		
Sundry Liabilities			H	22000	
H	10000		S	15000	37000
S	5000	15000			
Minority Interest		2000			
		37000			37000

Net Assets available for distribution of Equity shareholders of S Limited =
(Assets - Liabilities) = (15000 - 5000) = Rs. 10000
Minority Interest = (10000*1/5) = 2000
(800/1000) = (4/5) Majority Interest

3. **Goodwill, Capital Reserve / Cost of Control –** In the Balance Sheet of subsidiary company when a company acquires shares there are likely to be accumulated Profit/Losses. These will not be incorporated into the consolidated Balance Sheet but with respect to the Holding companies cost of investment reflected on the assets side in the holding's company Balance Sheet a comparison will be carried out with the actual value of these investments. The subsidiary Co's Balance Sheet (paid up value of shares + accumulated profit or – accumulated losses = market value of the investment). The difference between the cost of acquisition of share and the market value determined above will be goodwill if cost of acquisition is less and accordingly goodwill A/c or capital reserve A/c will be incorporated into the consolidated Balance Sheet. This figure is also termed as cost of control since the holding company has a controlling investment in the subsidiary firm.

Illustration:

H Ltd. Acquires 3/4 of the share capital of S Ltd. On 31-12-2009 whose Balance Sheets are follows:

	H	S		H	S
Share Capital@Rs.	20000	10000	Fixed assets	20000	10000
10 each			Current assets	13000	12000
General Reserves	5000	3000	Shares in B Ltd.	10000	
P/L Account	3000	2000	(3/4)		
10% Debentures	10000	5000			
S.creditors	5000	2000			
	43000	22000		43000	22000

Required to compile consolidated Balance Sheet on 31-12-2009.

Solution:

In case of partly owned subsidiary firm the H Co's interests in the accumulated profit or loss the subsidiary firm is only to the extent of the ownership interest. The balance due to minority will be adjusted for the minority interest.

Cost of Control

Amount paid for shares in S Ltd. / cost of acquisition		
Of shares		Rs.10000
Less: Paid up value in S Ltd.	7500	
Share of General Reserve (3/4 of Rs.3000)	2250	
Share of P/L Account (3/4 of 2000)	1500	
		11250
Capital Reserve		1250

Minority Interest

Paid up value	2500
General Reserve (1/4)	750
P/L Account (1/4)	500
Minority Interest	3750

Consolidated Balance Sheet

	Rs.	Rs.		Rs.	Rs.
Share Capital		20000	Fixed assets		
General Reserve		5000	H	20000	
P/L Accounting		3000	S	10000	
Capital Reserve		1250		--------	30000
10% Debenture			Current Assets		
H	10000		H	13000	
S	5000		S	12000	
	---------	15000		---------	25000
S/ Creditors					
H	5000				
S	2000				
	---------	7000			
Minority Interest		3750			
		55000			55000

(S Company Balance Sheet

(Net assets – Debentures – Creditors) = (22000 - 5000 - 2000) = 15000

= Net assets available for equity shareholders.

Minorities share in 15000 = (1/4) * 15000 = 3750

(including paid up value of share capital and accumulated profits)

4. **Capital profit/ revenue profit:** The date of acquisition of shares by the holding company may not coincide with the closing of financial year i.e they may be acquired during the course of financial year. However, the published statements will be compiled only with respect to the closing date of financial year. In such a case, the date of acquisition of shares does not coincide with the date of Balance Sheet and accordingly adjustments have to be made. The Profit and Loss of the subsidiary company prior to the date of acquisition are capital in nature while post dated profits are revenue in nature. From the accounting point of view the pre – acquisition profits will be adjusted for in the cost of control extent of holding company's ownership interest while the post acquisition profit will be treated as revenue in nature and therefore in the closing Balance Sheet as shown in the Profit/Loss Account of the holding company. For this purpose in the absence of any further information it is perfumed that the subsidiary company earns uniformly throughout the year, for example, if the date of acquisition is in the middle of first year 1/2 the profit of the subsidiary company will be capital in nature, the other 1/2 as revenue , with respect to the minorities the treatment is identical for either share in capital or revenue profit which are added on, to the minority interest. In some cases in the analysis of profit additional adjustments have to be made before they are analysed into capital and revenue profit. All accumulated profit except current year profit which has to be segregated into capital and revenue will be treated as capital profit.

5. **Inter Company Transactions:** The holding and subsidiary firm may have centered into the following transaction and these common transactions will be eliminated while compiling the consolidated Balance Sheet.

   a) The holding or the subsidiary firm may have granted loans (short term) to each other.

   b) They may have sold goods on credit in which case the inter company transactions will be included in debtors and creditors.

   c) The subsidiary or holding company may have drawn Bills of Exchange on each other in which case the common transaction will be included in Bills Payable/ Bills Receivable.

   In all the above cases where the companies were treated as separate entities, these transactions would appear on the liabilities side on the Balance Sheet of one and on the assets side of the other's Balance Sheet. However, when the entire group is being treated as a single entity it is undesirable to include common transaction and therefore they will be eliminated in the consolidated Balance Sheet from the liabilities as well as assets side.

6. **Contingent Liabilities:** A contingent liability appears as a footnote. This is on account of a liability which may or may not arise in the future. While preparing a consolidated Balance Sheet they may be categorized as external current liabilities or internal current liabilities. External liabilities between the holding and subsidiary firm and the outsiders. Internal current liabilities is on account of transactions between the firms belonging to the same group. The external liabilities continue unchanged for the same group while internal liabilities no longer appears as a footnote as it is generally incorporated on the liability side.

Illustration:

The following are Balance Sheet of H & S Company as on 31-12-2009 (in Rs.)

	H	S		H	S
Share Capital@Rs. 10	20000	10000	Fixed Assets	30000	15000
each			Current Assets	35000	25000
General Reserve	10000	5000	Shares in S Ltd. (8000)	10000	
P/L balance as 1/1999	5000	4000			
12% Debenture	20000	10000			
S. creditors	10000	5000			
Profit for the year	10000	6000			
	75000	40000		75000	40000

H Limited acquired shares in S Limited on 01-07-2009. S limited has a balance of Rs. 4000/- in General Reserve on 01-01-2009. On the account fire goods costing Rs. 2000 of S Limited were destroyed in March 2009. The loss has been charged to the Profit and Loss Account for the year.

Required to prepare a consolidated Balance Sheet.

Solution

Working Notes:

1. Analysis of profit (of S)

Particulars	Capital Profit	Revenue Profit
General Reserve 01-01-2009	4000	-
Profit/ Loss Account	4000	-
Profit for the year prior to transfer		
General Reserve + Loss on fire in March	4500	4500
(6000+1000+2000)/2	------------	------------
	4500	
Less: Loss on A/c of fire in March	2000	
	------------	------------
	10500	4500
Less: Minority Interest (1/5)	2100	900
	------------	------------
	8400	3600
	------------	------------

2. Cost of Control

Cost of acquiring of shares			10000
Less: Nominal value of shares 800*10		8000	
Share capital Profits of H		8400	
		------------	16400

Capital Reserve			6400

Minority Interest			
Nominal value of share 200*10		2000	
Share of capital profit	2100		
Share of revenue profit	900		
	------------	3000	

		5000	

	Rs.	Rs.		Rs.	Rs.
Share Capital		20000	Fixed assets		
General Reserve		10000	H	30000	
P/L A/c			S	15000	
H	15000				45000
S	3600				
12% Debentures		18600	Current Assets	35000	
H	20000		H	25000	
S	10000		S		60000
		30000			
Sundry Interest		15000			
		105000			

7. **Unrealized gains:** If goods have been sold by holding company to subsidiary company or vice versa, presumably they would be including a profit margin on the cost price. However, when the firms are treated as a single entity, stock or inventory should be valued at cost i.e excluding profits. The firm that has sold the goods must have credited the profit of account of the sales: therefore, profit or selling company has to be reduced and the stock account of the company that has purchased the goods also has to be reduced for which purpose the following entry is passed.

   Profit & Loss A/c (selling company) Dr.

   To stock company (purchasing company)

   (with the company of profit included in the inter

   company sales of goods that can be…..)

   By making a deduction for the inter company sale of goods, the adjustments is made only in relation to those goods that can still be traced in the inventories of the purchasing company. If the goods are not traceable no adjustments is required. A finer accounting analysis can be performed by taking into consideration extent of the ownership interest of the holding company in the subsidiary firm accordingly making the above entry to the extent of ownership interest. As per decision of the Institute Chartered Accountants, this method no longer followed and the total profit included in inventories (irrespective of it belonging to majority or minority) is deducted from both sides of the Balance Sheet.

8. **Revaluation of assets and Liabilities:-** The Holding company may revalue the Assets and Liabilities of the subsidiary firm at the time of acquisition of shares in terms of market prices. In such a case the rate of revaluation is, assumed to be the same date as acquisition of shares. The profit or loss on revaluation is capital in nature and accordingly will be adjusted for in the analysis of profit under capital profits. The date of acquisition of shares as considered earlier also may not coincide with date of Balance Sheet in which case as stated earlier the current years profit has to be segregated between capital and revenue. Since the date of revaluation of assets is the date of acquisition of shares, a change in depreciation may be required on the revalued assets from the date of acquisition till the closing of Balance Sheet. For, presumably the Balance Sheet of the subsidiary company has been

made or complied in terms of its original values. Information with respect to revaluation has to be explicitly stated by an agreement between the firms at the time of acquisition of majority share by the holding company.

Preference Shares

The Holding or Subsidiary Company may have Preference shares at the time of consolidation. The preference shares of the holding company continue as they are in the consolidated Balance Sheet. With respect to the Subsidiary firm if preference share capital has been issued there are 2 possibilities.

- All preference shares are held by the outsiders i .e. other than holding company i.e which case the paid up value of the preference shares of the Subsidiary company is added to the minority interest.
- It is possible that part whole of the preference. shares of the Subsidiary company is held by the Holding Company. In such a case the cost of acquiring of the preference shares (shown in the investment account in the assets side in the Balance Sheet of the holding company) is compared with the paid up value (shown in Balance Sheet of Subsidiary firm) and the difference if any, adjusted in the cost of control. (if preference shares are issued after date of acquisition the adjustments remain the same)

Arrears of preference dividends may be payable or outstanding at the time of consolidation of Balance Sheet and usually preference dividends are cumulative in nature. If the subsidiary company, has adequate profits, it is reasonable to assume that these dividends will be paid. The minorities shares will be added to Minority Interest while with respect to the holding company the treatment will differ in terms of the divided being paid out of pre acquisition or post acquisition profits or both.

In case the dividends are paid out of pre-acquisition profits (capital profit), the dividend due to the holding company will be adjusted for in the cost of control. In case post acquisitions revenue profits are employed, the dividend due to the holding company will be credited (added on) to the Profit and Loss Account of the holding company in the consolidated Balance Sheet. It is possible that a combination of both pre and post acquisition profit is employed for the purpose of making dividend payment in which case the dividend paid out of the capital profit will be adjusted for in the cost of control and the portion out of revenue profit will be adjusted for in the P/L Account of Holding company, the total being amount due to the holding company with respect to minorities no distinction is made between capital and revenue profit for the purpose of making dividend payment and the dividend payable to them will be added to minority interest.

Bonus Shares

The Subsidiary company may issue Bonus shares either at the time of acquisition of shares by the holding company or after the acquisition of shares by the Holding company. For issuing bonus shares, the accumulated profits in the Balance Sheet of the subsidiary company are employed. These profits may be capital or revenue in nature or a combination of both. At the time of bonus issue the share of the Holding company as well as the minorities increases proportionately (in terms of the ration of bonus issue) but the proportion of their ownership remains the same as before. If bonus shares are issued out of capital profits are adjusted accordingly and bonus shares transferred to cost of control. If bonus shares issued out of revenue profit of subsidiary company to that extent revenue profit stand capitalized and will affect capital reserve or goodwill as the case may be.

DIVIDEND ON EQUITY SHARES

The Subsidiary company may declare dividend on its equity shares and the following are the possibilities with respect to it.

a. **Intention to propose dividend:** In such a case since the proposal has not been approved in the meeting the intention may be ignored and no adjustment is required (in terms of calculation) with respect to this dividend intention.

b. **Proposed dividend:** It is possible that dividend has been proposed in a meeting on the closing date of the financial year but no notification of this fact has been made in the books of the Holding company. In such a case, the amount of dividend declared may be added to the profits of the Subsidiary company (assuming this has been deducted) and then the analysis of profits is performed in the usual manner. No adjustment is needed in the books of the Holding company.

c. **Dividends Payable:** In some cases, the dividends that have been declared by the Subsidiary firm may have been adjusted for in both the books i.e. the Subsidiary and Holding company. In this case adjustment is made in the books of the Subsidiary company. In the books of the Holding company the dividend that are receivable fro the Subsidiary company will be credited to Profit and Loss Account of the Holding company (in terms of income receivable on investments).It is possible that these dividends have been paid by the subsidiary firm out of Capital profit, revenue profit, combination of both profit

   i) If dividend of subsidiary company have been declared totally out of capital profit, then it is incorrect that this capital income should stand credited to the revenue P/L Account of the holding company. Therefore one adjustment entry is made for remaining dividend from the P/L Account of the holding company and they are transferred to cost of control.

   P/L Account (H Ltd.) Dr

   To Cost of control/Investment Account

   With the amount of dividend receivable from the Subsidiary firm

   ii) If the dividend of the subsidiary firm have been declared out of Revenue profit then they should be credited to the P/L A/c. of the Holding Company and of they are already included therein as per our presumption, no adjustment is required.

   iii) The dividend receivable by Holding Company may be partly out of capital profit or out of revenue profit of Subsidiary company. The portion paid out of capital profit will be eliminated form P/L Account of Holding company and transferred to cost of control with respect to the portion of the dividend receivable out of revenue profit no adjustment is required. With respect to the minorities irrespective of the dividend declared by the Subsidiary company being payable out of capital profit or revenue profit will be added to minority interest.

d) **Dividend paid:** The Subsidiary company may have declared a dividend in the course of the financial year and this fact has been adjusted for in both the books and in fact the cash liability has already been met by subsidiary firm for the purpose of dividend payment. This implies there is no liability outstanding with respect to payment of dividends therefore no addition on account dividends has to be made to minority interest. With respect to Holding company has stated in point (iii) the dividend must have been credited to P/L Account out of capital profit, revenue profit are a combination from the subsidiary company's books. The portion out of capital profit stated earlier will be transferred from the P/L Account of the Holding company to the cost of control.

Share Premium:

The share premium account may appear in the Balance Sheet of the Holding company at the time of consolidation. It will continue as share premium account. However if the holding company has issued some of its own shares to the subsidiary company the share premium due on this share will be adjusted for in the cost of control. If share premium appears in the books of subsidiary company, it may be prior to the acquisition of shares by the holding company in which case it is treated as capital profit in the analysis of profit. However, the share premium arises after acquisition of share by H company it will continue as share premium in the consolidated Balance Sheet.

Preliminary Expenses:

If the Holding company has preliminary expenses they continue as such. If subsidiary company has preliminary expenses they may be treated as a capital loss in the analysis of profit or clubbed with preliminary expenses of Holding company.

Provision for Taxation:

Taxes are payable to outside agencies and provision for taxation with respect to holding and subsidiary company will be shown as such in the consolidated Balance Sheet.

Sale of Share:

The holding company may sell some of the share of the subsidiary company that it holds as investment. The P/L on such sale is transfer to cost of control. This changes the proportion of the Holding company and minority interest and requires adjustment in calculation of cost of control, minority interest and an analysis of profit will have to be performed.

Purchase of shares in instalments:

The Holding company may acquire shares in the subsidiary firm not in once single instalment but in a number of instalments. If the earlier dates of the acquisition may be ignored. If however, shares have been acquired in major instalments, a step by step analysis of profit after taking into consideration the dates of acquisition will have to be performed in the analysis of profit between capital and revenue.

Debentures:

The subsidiary and the holding may have issued debentures at time of consolidation of Balance Sheet. These will be added and continued to appear in the debenture account in the consolidated Balance Sheet. However, if some portion of these debentures are held by the holding company or subsidiary company, this will be dedicated from the investment account on the asset side and the debentures account on the liabilities side at the time of consolidation.

Goodwill:

A goodwill account may appear in the books of Subsidiary and Holding at the time of consolidation. The aggregate goodwill be the total of these goodwill and will be adjusted for any goodwill or capital reserve that appear in the cost of control.

Interim Dividend:

When a dividend is paid in between an accounting year i.e, prior to completion of final accounts, it is termed as interim dividend. The general presumption with respect to this dividend is that it has been paid i.e, it has been adjusted for in the books of Holding and Subsidiary. No adjustment required with respect to minorities however, with respect to the Holding company, if capital profit have been employed for making dividend payment to the extent (wholly or partly) it will go to the cost of control from the P/L Account of Holding company.

A. PRELIMINARIES OF CONSOLIDATION

Illustration 1: Analysis of Balances in Reserves

Following are the balances in various reserves of P. Ltd., subsidiary of V Ltd. as on the date of controlling acquisition and the date of consolidation -

Accounts	Date of Acquisition	Date of Consolidation
General Reserve	60,000	1,20,000
Profit and Loss Account	25,000	80,000
Capital Redemption Reserve	40,000	55,000
Securities Premium	45,000	45,000
Capital Reserve	5,000	25,000
Preliminary Expenses	5,000	1,000
Underwriting Commission	10,000	5,000

Additional information -

1. One year after the date of controlling acquisition, Pushpak Ltd. had issued Bonus Shares for Rs.60,000 utilizing the balances in Capital Reserve and Capital Redemption Reserve in full, and sourcing the balance from General Reserve. The Director's did not utilize the balance in Securities Premium for this purpose.
2. In the intervening period, Preference Share Capital had been redeemed at a Premium of Rs.12,000. For statutory Compliance, a sum of Rs.40,000 had been transferred to Capital Redemption Reserve and a further sum of Rs. 15,000 had been transferred upon redemption of Debentures, which were also redeemed at a Premium of Rs.10,000.
3. To finance its redemption of Preference Capital, P Ltd. had issued Equity Capital at a Premium. The balance of Rs.5,000 against Underwriting Commission is incurred in this regard.
4. The Company has been writing off balances in Underwriting Commission A/c and Preliminary Expenses against balance in Securities Premium Account. The balance in Preliminary Expenses as on consolidation date is the amount as on acquisition date not yet written off.
5. Pushpak Ltd. had declared Equity and Preference Dividend of Rs.20,000 out of its P&L A/c balance as on date of acquisition.

How would the above balances as on date of consolidation be analyzed and classified for the purposes of consolidation?

Solution:

1. General Reserve

Balance as on Consolidation 1,20,000

	Date of Acquisition	60,000	Acquisition to Consolidation
Less:	Bonus Issue (60,000 - trfd. From Cap. Res. 50,000 - trfd. from CRR 40,000)	15,000	(balancing figure) **Rs.75,000**
	Balance **Capital Profit**	**45,000**	**Revenue Reserve**

2. Profit and Loss A/c

Balance as on Consolidation 80,000

	Date of Acquisition	25,000	Acquisition to Consolidation
Less:	Dividend out of this	20,000	(balancing figure) **Rs.75,000**
	Balance **Capital Profit**	**5,000**	**Revenue Profit**

3. Capital Redemption Reserve

Balance as on Consolidation 55,000

	Date of Acquisition	40,000
Less:	Bonus Shares	40,000
	Balance **Capital Profit**	**NIL**

Acquisition to Consolidation
(balancing figure) Rs.55,000

Redemption of Pref. Capital
Rs.40,000
Capital Redemption Res.

Redemption of Debentures
Rs. 15,000
Capital Redemption Res.

4. Securities Premium

Balance as on Consolidation 45,000

	Date of Acquisition	45,000
Less:	Premium on Redemption of Pref. Capital	(12,000)
Less:	Premium on Redemption of Debentures	(10,000)
Less:	Underwriting Commission and Prelim Exp. written off (10,000 + 4,000)	(14,000)
	Balance **Capital Profit**	**9,000**

Acquisition to Consolidation
Premium on Fresh Issue of Capital
(balancing figure) **Rs.36,000**
Securities Premium

5. Capital Reserve

Balance as on Consolidation 25,000

	Date of Acquisition	5,000
Less:	Bonus Shares	5,000
	Balance **Capital Profit**	**NIL**

Acquisition to Consolidation
(balancing figure) **Rs.25,000**
Capital Reserve

6. Preliminary Expenses

Balance as on Consolidation 1,000

	Date of Acquisition	5,000
Less:	Written off against Securities Prem.	4,000
	Balance **Capital Profit**	**1,000**

Acquisition to Consolidation
(balancing figure) **Rs.NIL**
Preliminary Expenses

7. Underwriting Commission

Balance as on Consolidation 5,000

	Date of Acquisition	10,000
Less:	Written off against Securities Prem.	10,000
	Balance **Capital Profit**	**NIL**

Acquisition to Consolidation
Rs.5,000
Underwriting Commission

Summary

Accounts (1)	Balance on DOC (2)	Considered Capital Profit (3)	Balance considered as such (4)
General Reserve	1,20,000	45,000	75,000
Profit and Loss Account	80,000	5,000	75,000
Capital Redemption Reserve	55,000	NIL	55,000
Securities Premium	45,000	9,000	36,000
Capital Reserve	25,000	NIL	25,000
Preliminary Expenses	1,000	1,000	NIL
Underwriting Commission	5,000	NIL	5,000

Note: In the course of consolidation, the amounts in Col. (3) and (4) shall be apportioned to Holding Company (P Ltd.) and Minority Interest (of V Ltd.) in the ration of their shareholding.

Illustration 2: Analysis of Reserves – Adjustment for Abnormal Loss, Dividend, etc.

A Ltd. acquired 80% interest in B Ltd. on 01.07.2007. A Ltd. is in the process of preparing its Consolidated Financial Statement as on 31.12.2008. The details of Profit and Loss A/c balances of B Ltd. is as under —

• Balance on 01.01.2007	Rs. 6,000
• Profit for 2007	Rs.10,000 (before Equity Dividend)
• Balance on 31.12.2008	Rs.33,800

In April 2007, B Ltd. lost stocks costing Rs.1,550 due to riots. The Insurance Company admitted a claim of Rs.650 only.

In August 2008, A Ltd. received Rs.9,600 as Dividend from B Ltd. in respect of the year ending 31.12.2007. B Ltd. has proposed a dividend of Rs.15,000 for the year ending 31.12.2008.

During 2008, B Ltd. had purchased shares of M Ltd. cum-dividend for Rs.34,500. B Ltd. received a dividend of Rs.7,500 on this investment, which was credited to its Profit and Loss Account. A provision for outstanding expenses of Rs.1,700 provided during the year was considered excessive. The balance in Profit and Loss Account as on 31.12.2008 is after providing for the expenses.

Analyse the balance in Profit and Loss Account as Capital and Revenue for the purposes of Consolidation.

Solution:

Analysis of Profit and Loss Account

	Balance as given on 31.12.2008	33,800	
Less:	Pre-Acqn. Dividend from M Ltd.	(7,500)	(to credit Investment in Maya A/c)
Less:	Proposed Dividend for 2008	(15,000)	
Add:	Excess Provision to be written back	1,700	(to debit Outstanding Expenses A/c)
	Corrected Balance as at 31.12.2008	**13,000**	

01.01.2007 **Rs.6,000** **Capital**	Profit for 2007 10,000 **Add:** Abnormal Loss 900 Profit without abnormal losses 10,900	Dividend for 2007 Rced. by A 9,600 for 80% Total Dividend = 9,600 + 80% = (bal. figure) (Rs. 12,000)	Profit for 2008 **Rs.9,000** **Revenue** (1,30-Opg. 60- Pft for 2004 1,00 + Dividend 1,20)

	1.7.2007 to 1.7.2007	1.1.2007 to 31.12.2007	From Opg Bal.	From Profit for 1.1.07 to 1.7.07	From Profit for 1.7.07 to 31.12.07
	5,450	**5,450**	(bal. figure)		
Less: Abnormal Loss	900)	**Revenue**	**(Rs.2,000)**	**(Rs.4,550)**	**(Rs.5,450)**
Bal. **Capital Profit**	**4,550**		**Capital**	**Capital**	**Revenue**

Total Capital Profit: 6,000 + 4,550 - 2,000 - 4,550 - **Rs.4,000;**

Total Revenue Profit: 9,000 + 5,450 - 5,450 = **Rs.9,000**

Abnormal Loss = Stock Loss in Riots Rs.1,550 **Less** Insurance Claim received Rs.650 = **Rs.900**

Notes:

- It has been assumed that the Profits arose evenly throughout the year.
- Dividend declared for 2004 = Rs. 12,000, but profit for 2007 is Rs. 1,00,000. So it **is** presumed that balance of Rs.2,000 has been declared from the opening reserve.

Illustration 3: Cost of Investment - Share Split

A Ltd. acquired 5,000 Shares of S Ltd. at Rs.48 per Share cum-Dividend constituting 62.50% holding in the latter. Immediately after purchase, S Ltd. declared and distributed a dividend at Rs.4 per Share, which S Ltd. credited to its Profit and Loss Account.

One year later, S Ltd. declared a Bonus of 1 fully paid Equity Share of Rs.10 each for every 5 Shares held. Later on, S Ltd. proposed to raise funds and made a Rights Issue of 1 Share for 5 held at Rs.36 per Share. A Ltd. exercised its right.

After some time, at its AGM, S Ltd. had decided to split its Equity Share of Rs.10 into Two Equity Shares of Rs.5 each. The necessary resolutions were passed and share certificates issued to all its existing shareholders.

To increase its stake in S Ltd. to 80%, A Ltd. acquired sufficient number of shares at Rs.30 each.

Ascertain the Cost of Control as on 31st December if Sreesha's share in Capital Profits (duly adjusted for purchase in lots) as on that date was Rs.3,15,000.

Solution: **1. Cost of Investment**

Particulars			Shares	Rs.
	Cost of First Acquisition	(5,000 x Rs.48)	5,000	2,40,000
Less:	Pre-Acquisition Dividend	(5,000 * Rs.4 per Share)	N.A.	(20,000)
	Corrected Cost of Investment		5,000	2,20,000
Add:	Bonus Shares	(1/5 * 5,000 Shares)	1,000	–
	Cost after Bonus Shares		6,000	2,20,000
Add:	Rights Shares	(1/5 x 6,000 Shares x Rs.36)	1,200	43,200
	Cost after Rights Issue before Share Split		**7,200**	**2,63,200**
	Cost after share split (WN 1)	(2 Sh. for 1 for 7,200 Sh = 7,200 x 2) **Add:**	14,400	2,63,200
	Acquisition to increase holding to 80% (WN 2)	(4,032 x Rs.30)	4,032	1,20,960
	Balance on date of Consolidation		**18,432**	**3,84,160**

Notes:

- **Share Split:** In case of Share Split, the Cost of Acquisition will not undergo any change. Only the number of Equity Shares and the face value will change. This is similar to adjustment for Bonus Issue. However, for Bonus Issue, the face value and paid up value of the share will be the same as the original share. In share split, the face value and paid up value will be lesser than that of the original shares.
- **Calculation of Number of Shares to be acquired to increase stake to 80%**

Particulars				Shares
a.	Shares held before acquisition			14,400
b.	% of holding			62.5%
c.	Hence, Total Number of Shares of S Ltd.	(a + b)	(14,400 - 62.50%)	23,040
d.	80% of above	(c x 80%)	(23,040 x 80%)	18,432
e.	Number of Shares to be acquired	(d - a)	(18,432 - 14,400)	4,032

2. Cost of Control

Particulars		Rs.
Cost of Investment	**(A)** (from 1 above)	**3,84,160**
Nominal Value of Equity Capital	(18,432 x Rs.5 per Share)	92,160
Share in Capital Profit		3,15,000
Total of Above	**(B)**	**4,07,160**
Capital Reserve (if B < A)	**(B-A)**	23,000

Illustration 4: Cost of Control - For different Investment Costs

C Ltd. has acquired 50,000 Shares of Rs.10 each in A Ltd. constituting 62.5% of the latter's Equity. On the same day, Arghya Ltd. had also acquired 10,000 8% Preference Shares of Rs.20 each.

The balances in Reserves of A Ltd. are -

Capital Reserve	Rs.60,000	(Fully Pre Acquisition)
Securities Premium	Rs.15,000	(Fully Post Acquisition)
General Reserve	Rs.78,000	(30% Pre Acquisition 70% Post Acquisition)
Profit and Loss A/c	Rs.90,000	(50% Pre Acquisition 50% Post Acquisition)

Ascertain the cost of control if total cost of investment is (a) Rs.7,50,000; (b) Rs.8,50,000; and (c) Rs.10,00,000.

Solution:

1. Determination of Capital Profit

Reserve Account	Total	Pre Acquisition	Post Acquisition
		Capital Profit	**Revenue Profit**
Capital Reserve	60,000	60,000	—
Securities Premium	15,000	—	15,000
General Reserve	78,000	23,400 (30% x Rs.78,000)	54,600 (70% x Rs.78,000)
Profit and Loss Account	90,000	45,000 (50% x Rs.90,000)	45,000 (50% x Rs.90,000)
Total	**Rs. 2,43,000**	**Rs. 1,28,400**	**Rs. 1,14,600**
Share of C Ltd. (62.5% of above)		**Rs.80,250**	**Rs.71,625**

2. Cost of Control

Particulars		Rs.	Rs.	Rs.
Cost of Investment	**(A)**	**7,50,000**	**8,50,000**	**10,00,000**
Nominal Value of Equity Capital	(50,000 x Rs. 10)	5,00,000	5,00,000	5,00,000
Nominal Value of Preference Capital	(20,000 x Rs. 20)	2,00,000	2,00,000	2,00,000
Share in Capital Profit		80,250	80,250	80,250
Total of Above	**(B)**	**7,80,250**	**7,80,250**	**7,80,250**
Goodwill (if A > B)	**(A-B)**	**—**	**69,750**	**2,19,750**
Capital Reserve (if B < A)	**(B-A)**	**30,250**	**—**	**—**

Illustration 5: Cost of Control - For Ex-Dividend and Cum-Dividend Acquisition

D Ltd. has made the following investments in S Ltd. a few years before –

1. 6,000 Equity Shares of Rs.10 each at Rs.1,50,000.
2. 200 12% Preference Shares of Rs.100 each at Rs.30,000.
3. 500 10% Debentures at Rs.95 per Debenture.

The Capital Profits of S Ltd. have been ascertained at Rs.96,000.

Determine the cost of control, under the following situations –

1. Shares were purchased Cum-Dividend and Equity Dividend was declared at 20% and the dividends were
   (a) Credited to Profit and Loss Account
   (b) Credited to Investment Account
2. Shares were purchased Ex-Dividend and Equity Dividend was declared at 20% and the dividends were
   (a) Credited to Profit and Loss Account
   (b) Credited to the Investment Accounts

Solution:

1. Cost of Control

Particulars	Cum-Dividend		Ex-Dividend	
Credited to	**P&L A/c**	**Invt. A/c**	**P&L A/c**	**Invt. A/c**
Cost of Investment				
Equity Capital	1,50,000	1,50,000	1,50,000	1,50,000
Preference Capital	30,000	30,000	30,000	30,000
Total Cost of Investment	1,80,000	1,80,000	1,80,000	1,80,000
Adjustment for Dividend out of Pre–Acquisition Profits				
Less: Only for Cum Dividend Purchase				
Preference Dividend (12% x Rs.20,000)	(2,400)	–	N.A.	N.A.
Equity Dividend (20% x Rs.60,000)	(12,000)	–	N.A.	N.A.
Add: Only for Ex-Dividend Purchase				
Preference Dividend (12% x Rs.20,000)	N.A.	N.A.	–	2,400
Equity Dividend (20% x Rs.60,000)	N.A.	N.A.	–	12,000
Corrected Cost of Investment (A)	**1,65,600**	**1,80,000**	**1,80,000**	**1,94,400**
Nominal Value of Equity Capital (6,000 x Rs.10)	60,000	60,000	60,000	60,000
Nominal Value of Pref. Capital (200 x Rs.100)	20,000	20,000	20,000	20,000
Share in Capital Profit	96,000	96,000	96,000	96,000
Total of Above (B)	**1,76,000**	**1,76,000**	**1,76,000**	**1,76,000**
Goodwill (if A > B) (A - B)	**–**	**4,000**	**4,000**	**18,400**
Capital Reserve (if B < A) (B - A)	**10,400**	**–**	**–**	**–**

Note: Investment in Debentures are not considered for determining Cost of Control since as per AS 21, Cost of Control is required to be determined only to the extent of share in the Equity of the Subsidiary i.e. Shareholders Networth. Debentures are excluded in computing Shareholders Networth and hence should not be considered in the determining Cost of Control. Gain or Loss on elimination of mutually held Debentures in the consolidation process will be adjusted against Group Reserves.

Illustration 6: Minority Interest

X Ltd. acquired 75% of the Equity Shares of Y Ltd. From the following Balance Sheet as at 31st December of Y Ltd. and additional information furnished, determine Minority Interest in Y Ltd. as on Balance Sheet date

Liabilities		Rs.	Assets		Rs.
Share Capital:	Equity Capital (Rs.100)	20,00,000	**Fixed Assets:**	(Net Block)	40,00,000
Reserves:	Securities Premium	3,00,000	**Current Assets:**	Stock in Trade	20,00,000
	General Reserve	7,00,000		Debtors	12,00,000
	Profit and Loss Account	12,00,000		Other Current Assets	8,00,000
Current Liabs:	Creditors	14,00,000			
	Bank Overdraft	24,00,000			
Total		**80,00,000**	**Total**		**80,00,000**

When X Ltd. acquired shares, balances in Reserves of Y Ltd. were as under - (a) Securities Premium Rs.3,00,000; (b) General Reserve Rs.1,00,000; (c) Profit and Loss Account Rs.4,00,000.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = X	**Acquisition:** Not Available	Holding Company = 75%
Subsidiary = Y	**Consolidation:** 31st December	Minority Interest = 25%

2. Analysis of Reserves and Surplus of Y Ltd.

(a) Securities Premium

Balance as per Balance Sheet Rs. 3,00,000

Balance on date of acquisition
Rs. 3,00,000
Capital Profit

Acquisition to Consolidation
(balancing figure) **Rs.NIL**
Securities Premium

(b) General Reserve

Balance as per Balance Sheet Rs.7,00,000

Balance on date of acquisition
Rs.1,00,000
Capital Profit

Acquisition to Consolidation
(balancing figure) **Rs.6,00,000**
Revenue Reserve (General Reserve)

(c) Profit and Loss Account

Balance as per Balance Sheet Rs.12,00,000

Balance on date of acquisition
Rs.4,00,000
Capital Profit

Acquisition to Consolidation
(balancing figure) **Rs.8,00,000**
Revenue Profit (P&L A/c)

3. Analysis of Net Worth of Y Ltd.

	Particulars		Total	Share of X Ltd.	Minority Interest
			100%	75%	25%
(a)	**Equity Share Capital**		**20,00,000**	15,00,000	5,00,000
(b)	**Capital Profits**	Securities Premium	3,00,000	6,00,000	2,00,000
	General Reserve		1,00,000	4,50,000	1,50,000
	Profit & Loss Account		4,00,000	6,00,000	2,00,000
	Total		**8,00,000**		
(c)	**Revenue Reserves**	General Reserve	**6,00,000**		
(d)	**Revenue Profits**	Profit & Loss A/c	**8,00,000**		
	Minority Interest				**10,50,000**

Illustration 7: Minority Interest - Investment in Preference Capital

J Ltd. acquired 60% of the Equity Shares and 35% of Preference Shares of K Ltd. The Balance Sheet of K Ltd. as on 31st December is as under —

Liabilities		Rs.	Assets		Rs.
Share Capital:	Equity Capital (Rs.100)	3,75,000	**Fixed Assets:**	(Net Block)	5,50,000
	Pref. Capital (Rs.100)	2,50,000	**Current Assets:**	Stock In Trade	1,70,000
Reserves:	Capital Reserve	37,500		Debtors	1,87,500
	General Reserve	1,70,000		Other Current Assets	67,500
	Profit and Loss Account	42,500	**Miscellaneous Expenditure:**		
Current Liabs:	Creditors	1,25,000		Preliminary Expenses	25,000
	Total	**10,00,000**	**Total**		**10,00,000**

When J Ltd. acquired shares, balances in Reserves of K Ltd. were as under – (a) Capital Reserve Rs.20,000; (b) General Reserve Rs.45,000; (c) Profit and Loss Account Rs.67,500; (d) Preliminary Expenses Rs.25,000.

Determine Minority Interest for the purpose of Consolidation.

Solution:

1. Basic Information

Company Status		Dates		Holding Status	
Holding Company	= J Ltd.	**Acquisition:**	Not Available	Holding Company	= 60%
Subsidiary	= K Ltd.	**Consolidation:**	31st December	Minority Interest	= 40%

2. Analysis of Reserves and Surplus of J Ltd.

(a) Capital Reserve

Balance as per Balance Sheet Rs.37,500

Balance on date of acquisition	Acquisition to Consolidation
Rs.20,000	(balancing figure) **Rs.17,500**
Capital Profit	**Capital Reserve**

(b) General Reserve

Balance as per Balance Sheet Rs.1,70,000

Balance on date of acquisition	Acquisition to Consolidation
Rs.45,000	(balancing figure) **Rs.1,25,000**
Capital Profit	**Revenue Reserve (General Reserve)**

(c) Profit and Loss Account

Balance as per Balance Sheet Rs.42,000

Balance on date of acquisition	Acquisition to Consolidation
Rs.67,500	(balancing figure) **(Rs.25,000)**
Capital Profit	**Revenue Profit (P&L A/c)**

(d) Preliminary Expenses

Balance as per Balance Sheet Rs.25,000

Balance on date of acquisition	Acquisition to Consolidation
(Rs.25,000)	(balancing figure) **Rs.NIL**
Capital Profit	**Preliminary Expenses**

3. Analysis of Net Worth of K Ltd.

	Particulars		**Total**	**Share of Manu Ltd.**	**Minority Interest**
			100%	**60%**	**40%**
(a)	**Equity Share Capital**		**3,75,000**	2,25,000	1,50,000
(b)	**Pref. Share Capital**	[35 : 65]	**2,50,000**	87,500	1,62,500
(b)	**Capital Profits**	Capital Reserve	20,000	1,29,000	86,000
	General Reserve		90,000	21,000	14,000
	Profit & Loss Account		1,35,000	1,50,000	1,00,000
	Preliminary Expenses		(50,000)	(30,000)	(20,000)
	Total		**2,15,000**		
(c)	**Capital Reserve**		**35,000**		
(c)	**Revenue Reserves**	General Reserve	**2,50,000**		
(d)	**Revenue Profits**	Profit & Loss A/c	**(50,000)**		
	Minority Interest				**8,05,000**

Illustration 8: Elimination of Unrealized Profits – Stock Movement

From the following information determine the amount of unrealized profits to be eliminated and the apportionment of the same, if Ca Ltd. holds 75% of the Equity Shares of D Ltd. -

1. Sales by C Ltd. to D Ltd. -
    (a) Goods costing Rs.5,00,000 at a profit of 20% on Sale Price. Entire stock were lying unsold as on the Balance Sheet date.
    (b) Goods costing Rs.7,00,000 at a profit of 25% on Cost Price. 40% of the goods were included in closing stock of D.
2. Sales by D Ltd. to C Ltd. -
    (a) Goods sold for Rs.7,50,000 on which D made profit of 25% on Cost. Entire stock were at C's godown as on the Balance Sheet date.
    (b) Goods sold for Rs.9,00,000 on which D made profit of 15% on Sale Price. 70% of the value of goods were included in closing stock of C.

Solution:

Transaction	Sale by C Ltd. (Molding) to D Ltd. (Subsidiary)	
Nature of Transaction	Downstream Transaction	
Profit on Transfer	Cost Rs.5,00,000 x Profit on Sale 20% ÷ Cost on Sale 80% = **Rs.1,25,000**	Cost Rs.70,0000 x Profit on Cost25% = **Rs.l,75,000**
% of Stock included in Closing Stock	100%	40%
Unrealized Profits to be eliminated (transferred to Stock Reserve)	Rs. 1,25,000 x 100% = **Rs.1,25,000**	Rs. 17,500 x 40% = **Rs.70,000**
Share of **Majority** - Reduced from Group Reserves	100% x Rs. 1,25,000 = **Rs.1,25,000**	100% x Rs.70,000 = **Rs.70,000**
Share of Minority	(Unrealized Profit on Downstream Transactions is fully adjusted against Group Reserves. Minority Interest is not relevant)	

Transaction	Sale by D Ltd. (Subsidiary) to C Ltd. (Holding)	
Nature of Transaction	Upstream Transaction	
Profit on Transfer	Sale Rs.7,50,000 x Profit on Cost 25% ÷ Sale to Cost 125% = **Rs. 1,50,000**	Sale Rs.9,00,000* Profit on Cost 15% = **Rs.l,35,000**
% of Stock included in Closing Stock	100%	70%
Unrealized Profits to be eliminated (reduced from Closing Stock)	Rs. 15,0000 x 100% = **Rs.l5,000**	Rs. 1,35,000 x 70% = **Rs.94,500**
Share of Majority - Reduced from Group Reserves	Share of Majority 75% x Unrealized Profits Rs. 1,50,000 = **Rs.l,12,500**	Share of Majority 75% x Unrealized Profits Rs.94,500 **= Rs.70,875**
Share of Minority - Reduced from Minority Interest	Share of Minority 25% x Unrealized Profits Rs. 1,50,000 = **Rs.37,500**	Share of Minority 25% x Unrealized Profits Rs.94,500 = **Rs.23,625**

Illustration 9: Elimination of Unrealized Profits - Transfer of Assets

In each of the following cases, ascertain (a) Unrealized Profits to be eliminated; (b) Unrealized Profits adjusted against Holding Company's Reserve and Minority Interest; and (c) balance in Asset Account as appearing in the Consolidated Balance Sheet –

(a) A Machine costing Rs.3,50,000 has been sold by Z Ltd. to its subsidiary F Ltd. (FPL) for Rs.4,20,000. During the year F Ltd. has charged depreciation of Rs.3,50,000 on the machinery. Z Ltd. holds 80% of the Equity of F Ltd. Machinery Account balance as appearing in the books of Companies - Z Ltd. Rs.9,57,500; F Ltd. Rs.6,85,000.

(b) C Ltd. sold 8 Workstations to its parent S Ltd. at Rs.25,000 each. The total cost of the Workstations to C was Rs.9,75,000. S holds 70% of the Equity Capital in C. The balances in the Asset Account "Computer and Peripherals" were – C Rs.2,50,000; S Rs.5,00,000. Depreciation at 30% was charged by S on the Workstations purchased from C.

Solution:

Sold by	**Z Ltd. (Holding Co.)**	**C Ltd. (Subsidiary Co.)**
Purchased by	F Ltd. (Subsidiary Co.)	S Ltd. (Holding Co.)
Nature of transfer	Downstream Transfer	Upstream Transfer
Sale Price **Less:** Cost to Seller	Rs.4,20,000 Rs.3,50,000	Rs.25,000 x 8 = Rs.2,00,000 Rs. 97,500
A. Profit on Transfer	Rs. 70,000	Rs. 1,02,500
B. Rate of Depreciation	35,000/4,20,000 - 8.33%	30%
C. Depn. on profit element (AxB)	70,000 x 8.33% = Rs.5,831	1,02,500 x 30% = Rs.30,750
Unrealized Profit to be eliminated (A - C)	**Rs.64,169**	**Rs.71,750**
- Adjusted against Holding Co's Reserves	100% x Rs.64,169 = **Rs.64,169**	Share of Holding Co. 70% x Rs.71,750 = **Rs.50,225**
- Adjusted against Minority Interest	Unrealized profits on downstream transfer are adjusted fully against Group Reserves only	Share of Minority 30% x Rs.71,750 = **Rs.21,525**
Consolidated Asset Balance (Holding Co. bal. + Subsidiary Co. bal. **Less** Unrealized Profit)	9,57,500 + 6,85,000 - 64,169 = **Rs.l5,78,331**	2,50,000 + 5,00,000 - 71,750 = **Rs.6,78,250**

Illustration 10: Elimination of Mutual Owings

The following balances are extracted from the Balance Sheets of X Ltd. and Y Ltd. -

Particulars	**X Ltd.**	**Y Ltd.**
Bills Payable	7,50,000	4,50,000
Trade Creditors	5,00,000	7,00,000
Bills Receivable	3,50,000	5,00,000
Trade Debtors	8,00,000	7,00,000
Contingent Liability for Bills Discounted	2,00,000	1,50,000

Additional Information –

1. X Ltd. is wholly owned subsidiary of Y Ltd.
2. Creditors of X Ltd. include Rs.2,50,000 due to Y for goods supplied by it for Rs.3,00,000. Debtors of X however shows a Debit balance of Rs.3,00,000 due from Y. Y had remitted Rs.50,000 by Demand Draft to X which was not received by X on the Balance Sheet date.
3. Bills payable of Y include Rs.3,00,000 drawn in favour of X Ltd. X had discounted bills worth Rs.1,20,000 with its bankers.

Determine how the above given balances will be disclosed in the Consolidated Balance Sheet of X Ltd.

Solution:

	Particulars	Bills Payable	Bills Receivable	Creditors	Debtors	Contingent Liabilities
X Ltd.		7,50,000	3,50,000	5,00,000	8,00,000	2,00,000
Y Ltd.		4,50,000	5,00,000	7,00,000	7,00,000	1,50,000
	Total before adj. Mutual Owings	**12,00,000**	**8,50,000**	**12,00,000**	**15,00,000**	**3,50,000**
Less:	Mutual Owings					
–	For goods supplied	–	–	(2,50,000)	(3,00,000)	–
–	Bills drawn in favour of Upul (Only to the extent not discounted is reduced) (30,000-12,000)	(1,80,000)	(1,80,000)	–	–	–
–	Bills discounted (Only mutual bills discounted is reduced)	–	–	–	–	(1,20,000)
	Balance for Cons. Balance Sheet	**10,20,000**	**6,70,000**	**9,50,000**	**12,00,000**	**2,30,000**

Note: *In addition to the above, in the Consolidated Balance Sheet, Rs.50,000 will be lown as "Remittance-in Transit" under Current Assets after Trade Debtors and Bills Receivable.*

Illustration 11: Consolidated Balance Sheet – Line to Line Addition

From the Balance Sheets and information given below, prepare Consolidated Balance Sheet of A Ltd. and K Ltd. as at 31st December, 2008 -

Liabilities	A	K	Assets		A	K
Equity Capital (Rs.10)	30,000	20,000	Fixed Assets		20,000	15,000
General Reserve	5,000	5,000	Investment in Shares of K		16,000	–
8% Debentures	10,000	5,000	Current Asset:	Stock in Trade	8,000	10,000
Creditors	5,000	5,000		Debtors	4,000	7,000
				Cash & Bank	2,000	3,000
Total	**50,000**	**35,000**	**Total**		**50,000**	**35,000**

A Ltd. holds 80% of Equity Shares in K since its incorporation. Prepare Consolidated Balance Sheet.

Solution:

1. Basic Information

Company Status		Dates	Holding Status	
Holding Co.	= A	**Acquisition:** K Incorporation	Holding Company	= 80%
Subsidiary	= K	**Consolidation:** 31st December	Minority Interest	= 20%

2. Analysis of General Reserves of K Ltd.

Balance as per Balance Sheet Rs.5,000

Balance on date of acquisition	Acquisition to Consolidation
Rs.NIL	(balancing figure) **Rs.50,000**
Capital Profit	**Revenue Reserve**

Note: *Since A holds shares in K since its incorporation, the entire Reserve balance will be Revenue.*

3. Analysis of Net Worth of K Ltd.

Particulars	Total	A 80%	Minority 20%
(a) Equity Share Capital	20,000	16,000	4,000
(b) Capital Profits	NIL	–	–
(c) Revenue Reserve (General Reserve)	5,000	4,000	1,000
Minority Interest			**5,000**

4. Cost of Control

	Particulars	Rs.
	Cost of Investment	16,000
Less:	Nominal Value of Equity Capital	(16,000)
Less:	Share of Capital Profits	NIL
	Goodwill / Capital Reserve	**NIL**

Note: *If shares are purchased and held from the date of incorporation of subsidiary, there will not be any Goodwill or Capital Reserve.*

5. Consolidation of Reserves

Particulars	Rs.
Balance as per Balance Sheet	5,000
Add: Share of Revenu Reerves	4,000
Consolidated Balance	**9,000**

6. Consolidated Balance Sheet of A Ltd. and its subsidiary K Ltd. as at 31st December

Liabilities	Rs.	Assets		Rs.
Share Capital: Equity Capital (Rs.10)	30,000	**Fixed Assets**	(20,000 + 15,000)	35,000
Reserves: General Reserve	9,000	**Current Assets:**		18,000
Minority Interest	5,000	Stock	(8,000 + 10,000)	11,000
Secured Loans:	15,000	Debtors	(4,000 + 7,000)	5,000
8% Debentures (10,000 + 5,000) **Current**		Cash & Bank	(2,000 + 3,000)	
Liabs: Creditors (5,000+5,000)	10,000			
Total	**69,000**	**Total**		**69,000**

Illustration 12: Consolidated Balance Sheet – Investment in Debentures – Line Addition

The Balance Sheets of B Ltd. and S Ltd. as at 31st December are given below –

Liabilities	B	S	Assets	B	S
Equity Capital (Rs.10)	60,00,000	30,00,000	Fixed Assets	60,00,000	35,00,000
General Reserve	10,50,000	10,00,000	Investment		
Profit and Loss Account	10,00,000	5,00,000	- in 24,000 Shares of S	26,00,000	–
8% Debentures (Rs.100)	20,00,000	10,00,000	- in 500 Debentures of S	6,00,000	–
Bills Payable	6,00,000	7,00,000	- in 1000 Debentures of B	–	9,50,000
Creditors	9,00,000	8,00,000	Current/asset Stock in Trade	10,00,000	12,00,000
			Debtors	15,00,000	10,00,000
			Cash & Bank	3,00,000	3,50,000
Total	**12,00,000**	**7,00,000**	**Total**	**120,00,000**	**70,00,000**

The investments in S Ltd. were made on the same day when S's General Reserve was Rs.5,00,000 and Profit and Loss Account balance showed Rs.2,00,000.

Prepare Consolidated Balance Sheet.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Co. = B Subsidiary = S	**Acquisition:** Not Given **Consolidation:** 31st December	Holding Company (240,000 ÷ 300,000) = 80% Minority Interest = 20%

2. Analysis of Reserves and Surplus of S Ltd.

(a) General Reserve

Balance as per Balance Sheet Rs. 10,00,000

Balance on date of acquisition **Rs.5,00,000** **Capital Profit**	Acquisition to Consolidation (balancing figure) **Rs.5,00,000** **Revenue Reserve**

(b) Profit and Loss A/c

Balance as per Balance Sheet Rs.5,00,000

Balance on date of acquisition **Rs.20,000** **Capital Profit**	Acquisition to Consolidation (balancing figure) **Rs.30,000** **Revenue Reserve**

3. Analysis of Net Worth of S Ltd.

Particulars		Total	B 80%	Minority 20%
(a) Share Capital	Equity Share Capital	**30,00,000**	24,00,000	6,00,000
(b) Capital Profits	General Reserve	5,00,000		
Profit and Loss Account		2,00,000		
Total		**7,00,000**	5,60,000	1,40,000
(c) Revenue Reserve	General Reserve	**5,00,000**	4,00,000	1,00,000
(d) Revenue Profits	Profit and Loss Account	**3,00,000**	2,40,000	60,000
Minority Interest				**9,00,000**

4. Cost of Control

	Particulars	Rs.
	Cost of Investment	26,00,000
Less:	Nominal Value of Equity Capital	(24,00,000)
Less:	Share of Capital Profits	(5,60,000)
	Capital Reserve on Consolidation	**(3,60,000)**

5. Gain or Loss on elimination of Intra-Group Debentures

	Particulars		Rs.
	Cost of Investment	B in S	6,00,000
		S in B	9,50,000
Less:	**Total Cost of Investment**	(50,000+ 10,00,000)	**15,50,000**
	Nominal Value of Debentures		(15,00,000)
	Loss on Elimination	(Adjusted against Group Reserves)	**50,000**

6. Consolidation of Reserves and Surplus

	Particulars	Gen. Res.	P&L A/c
	Balance as per Balance Sheet	1,50,000	10,00,000
Add:	Share of Revenue	4,00,000	2,40,000
Less:	Loss on Elimination of Debentures	–	(50,000)
	Consolidated Balance	**19,00,000**	**11,90,000**

7. Consolidated Balance Sheet of B Ltd. and its subsidiary S Ltd. as at 31s1 December

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Capital (Rs.10)	60,00,000	**Fixed Assets** (6,00 + 3,50)	95,00,000
Reserves: General Reserve	19,00,000	**Current Assets:**	
Profit and Loss A/c	11,90,000	Stock (1,00 + 1,20)	22,00,000
C/R on Consolidation	3,60,000	Debtors (1,50 + 1,00)	25,00,000
Minority Interest	9,00,000	Cash & Bank (30 + 35)	6,50,000
Secured Loans:			
8% Debentures (2,000 + 1,00 - 1,500 Mutual)	15,00,000		
Current Liabs: Bills Payable **(600 + 700)**	13,00,000		
Creditors (900 + 800)	17,00,000		
Total	**1,48,50,000**	**Total**	**1,48,50,000**

B. BONUS SHARES

Illustration 13: Bonus issue - Before and After

On 31.03.2003, R Ltd. acquired 1,05,000 Shares of S Ltd. for Rs.12,00,000. The Balance Sheet of S Ltd. on that date was as under - (Rs.000's)

Liabilities	Rs.	Assets	Rs.
1,50,000 Equity Shares of Rs.10 each fully paid	1,500	Fixed Assets	1,050
Pre-lncorporation Profits	30	Current Assets	645
Profit & Loss Account	60		
Creditors	105		
Total	**1,695**	**Total**	**1,695**

On 31.03.2009, the Balance Sheets of the two Companies were as follows - (Rs.000's

Liabilities	R	S	Assets	R	S
Equity Shares of Rs.10 each fully paid (before Bonus Issue)	4,500	1,500	Fixed Assets	7,920	2,310
			1,05,000 Equity Shares in	1,200	–
Securities Premium	900	–	S Ltd. at Cost		
Pre-lncorporation Profits	–	30	Current Assets	4,410	1,755
General Reserve	6,000	1,905			
Profit and Loss Account	1,575	420			
Creditors	555	210			
Total	**13,530**	**4,065**	**Total**	**13,530**	**4,065**

Directors of S Ltd. made a bonus issue on 31.03.2009 in the ratio of one Equity Share of Rs.10 each fully paid for every two Equity Shares held on that date.

Calculate as on 31.3.2009 (i) Cost of Control/Capital Reserve ; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account in each of the following cases: (1) Before issue of Bonus Shares; (2) Immediately after the issue of Bonus Shares. It may be assumed that Bonus Shares were issued out of Post-Acquisition Profits by using General Reserve.

Prepare a Consolidated Balance Sheet after the Bonus Issue.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = R Ltd. Subsidiary = S Ltd.	Acquisition: 31.03.2003 Consolidation: 31.03.2009	Holding Company = 70% Minority Interest = 30%

2. Analysis of Reserves and Surplus of S Ltd.

(a) Pre-lncorporation Profits = Rs. 30,000 **– Capital Profit**

(b) General Reserve

Before Bonus Issue		After Bonus Issue		
As on 31.3.2009	19,05,000	As on 31.3.2009	19,05,000	
		Bonus Issue	7,50,000	(15 Lacs x 1/2)
		Corrected Bal	11,55,000	
As on 01.04.03	Tfr between 01.04.03 & 31.3.2009	01.04.2003	Tfr between 1.4.03 & 3 1.3.09	
NIL	**19,05,000**	**NIL**	**11,55,000**	
Capital	**Revenue**	**Capital**	**Revenue**	

(c) Profit & Loss Account

As on 31.03.2009 Rs.4,20,000

As on 01.04.2003	60,000	Profits between 01.04.2003 & 31.03.2009	**3,60,000**
	Capital		**Revenue**

3. Analysis of Net Worth of S Ltd.

Particulars	Before Bonus Issue			After Bonus Issue		
	Total	**R**	**Minority**	**Total**	**R**	**Minority**
	100%	**70%**	**30%**	**100%**	**70%**	**30%**
(a) Share Capital	15,00,000			15,00,000		
Add: Bonus Issue	–			7,50,000		
	15,00,000	10.50,000	4,50,000	**22,50,000**	15,75,000	6,75,000
(b) Capital Profits						
Pre Incorporation Profits	30,000			30,000		
General Reserve	NIL			NIL		
Profit and Loss Account	60,000			60,000		
	90,000	63,000	27,000	**90,000**	63,000	27,000
(c) **Revenue Reserve:** Gen. Reserve	**19,05,000**	13,33,500	5.71,500	**11,55,000**	8,08,500	3,46,500
(d) **Revenue Profits:** P & L A/c	**3,60,000**	2,52,000	1,08,000	**3,60,000**	2,52,000	1,08,000
Minority Interest			**11,56,500**			**11,56,500**

4. Cost of Control

Particulars	Before Bonus Issue	After Bonus Issue
Cost of Investment	12,00,000	12,00,000
Less: (a) Nominal Value of Share Capital	(10,50,000)	(15.75,000)
(b) Share in Capital Profits	(63.000)	(63,000)
Goodwill / Capital Reserve on Consolidation	**87,000**	**(4,38,000)**

5. Consolidation of Reserves & Surplus

Particulars	Before Bonus Issue		After Bonus Issue	
	Gen. Res.	**P&L A/c**	**Gen. Res.**	**P&L A/c**
Balance as per Balance Sheet of R Ltd.	60,00,000	15,75,000	60,00,000	15,75,000
Add: Share of Revenue	13,33,500	2,52,000	8,08,500	2,52,000
Consolidated Balance	**73,33,500**	**18,27,000**	**68,08,500**	**18,27,000**

6. Consolidated Balance Sheet of R Ltd. and its subsidiary S Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	45,00,000	**Fixed Assets**	
Reserves & Surplus General Reserve	68,08.500	[79,20,000 + 23,10,000]	1,02,30,000
Profit & Loss Account	18,27,000	**Current Assets:**	
Securities Premium	9,00,000	[44,10,000 + 17,55,000]	61,65,000
Capital Reserve on Consolidation	4,38,000		
Minority Interest	11,56,500		
Current Liabilities: [5,55,000 + 2,10,000]	7,65,000		
Total	**1,63,95,000**	**Total**	**1,63,95,000**

Illustration 14: Bonus Issue - Unrealized Profits

On 31.03.2009 the Balance Sheets of H Ltd. and its subsidiary S Ltd. stood as follows (in Rs. Lakhs) -

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
Share Capital:			Land and Buildings	2,718	–
Authorised	15,000	6,000	Plant and Machinery	4,905	4,900
Issued and Subscribed:			Furniture and Fittings	1,845	586
Equity Shares (Rs.10) Fully Paid	12,000	4,800	Investments in shares in S Ltd.	3,000	–
General Reserve	2,784	1,380	Stock	3,949	1,956
Profit and Loss Account	2,715	1,620	Debtors	2,600	1,363
Bills Payable	372	160	Cash and Bank Balances	1,490	204
Sundry Creditors	1,461	854	Bills Receivable	360	199
Provision for Taxation	855	394	Sundry Advances	520	–
Proposed Dividend	1,200	–			
	21,387	**9,208**		**21,387**	**9,208**

The following information is also provided to you:

1. H Ltd. purchased 180 Lakhs shares in S Ltd. on 01.04.2008 when the balances to General Reserve and Profit and Loss Account of S Ltd. stood at Rs. 3,000 Lakhs and Rs.1,200 Lakhs respectively.
2. On 04.07.2008 S Ltd. declared a dividend @ 20% for the year ended 31.03.2008. H Ltd. credited the dividend received by it to its Profits and Loss Account.
3. On 01.01.2008 S Ltd. issued 3 fully paid-up shares for every 5 shares held as Bonus Shares out of balances in its General Reserve as on 31.03.2008.
4. On 31.03.2009 all the Bills Payable in S Ltd.'s Balance Sheet were acceptances in favour of H Ltd. But on that date, H Ltd. held only Rs.45 Lakhs of these acceptances in hand, the rest having been endorsed in favour of its Creditors.
5. On 31.03.2009 S Ltd.'s stock included goods which it had purchased for Rs.100 Lakhs from H Ltd. which made a profit @ 25% on cost.

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31.03.2009 bearing in mind the requirements of AS 21.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = H Subsidiary = S	Acquisition: 01.04.2008 Consolidation: 31.03.2009	Holding Company = 60% Minority Interest = 40%

Shareholding Pattern - % of Holding by H Ltd.

Date	Particulars	No. of Shares
01.04.2008	Original Purchase	180
01.01.2009	First Bonus Issue (3/5 x 1,80,000)	108
31.03.2009	Total Shares held by H Ltd. in S Ltd.	**288**
	Total Shares outstanding in S Ltd. (Rs.4,800 Lakhs / Rs.10)	**480**
	% of Holding (288 / 480)	**60%**

2. Analysis of Reserves and Surplus of S Ltd. (Rs. Lakhs)

(a) General Reserves

Balance as on 31.03.2009 Rs. 1,380

	Balance on 1.4.2008 (as oi. acqn. date)	Rs.3,000
Less:	Bonus Issue (108/60% x Rs. 10)	Rs. 1,800
	Balance **Capital Profit**	**Rs. 1,200**

Transfer during 2008-09 (upto Consolidation
(balancing figure) **Rs.180**
Revenue Reserve

(b) Profit and Loss Account

Balance as on 31.03.2009 Rs. 1,620

	Balance on 01.04.2008 (as on acqn. date)	Rs. 1,200
Less:	Dividend (Rs.3000 x 20%)	Rs. 600
	Balance **Capital Profit**	Rs. 600

Profit for 2008-09 (upto Consolidation)
(balancing figure) **Rs.1020**
Revenue Profit

3. Analysis of Net Worth of S Ltd. (Rs. Lakhs)

Particulars			**Total**	**H**	**Minority**
			100%	**60%**	**40%**
(a)	**Equity Capital**		**4,800**	2,880	1,920
(b)	**Capital Profits**	General Reserve	1,200		
		Profit and Loss Account	600		
		Total Capital Profits	**1,800**	1,080	720
(c)	**Revenue Res.**	General Reserve	**180**	108	72
(d)	**Revenue Profit**	Profit and Loss Account	**1,020**	612	408
	Minority Interest				**3,120**

4. Cost of Control

	Particulars	**Rs.Lakhs**	
	Cost of Investment		3,000
Less:	Pre-Acquisition Dividend Received (Rs. 1,800 x 20%)		360
	Adjusted Cost of Investment		2,640
Less:	Nominal Value of Share Capital	2.880	
	Share in Capital Profit of S Ltd.	1,080	(3,960)
	Capital Reserve on Consolidation		**1,320**

5. Consolidation of Reserves and Surplus (Rs.Lakhs)

	Particulars	**Gen. Res.**	**P&LA/c**
	Balance as per Balance Sheet of H Ltd.	2,784	2,715
Less:	Pre-Acquisition Dividend wrongly credited to P&L A/c		(360)
	Adjusted Cost of Investment	2,784	2,355
Add:	Share of Revenue from S Ltd.	108	612
	Consolidated Balance	2,892	2,967
Less:	Unrealized Profit on Closing Stock (Rs. 100 x 25%/125%)		(20)
	Adjusted Consolidated Balance	**2,892**	**2,947**

6. Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31.03.2009

Liabilities	Rs.Lakhs	Assets	Rs.Lakhs
Share Capital: Authorised	15,000	**Fixed Assets**	
Issued and Paid up	12,000	Land and Buildings	2,718
Reserves & Surplus		Plant & Machinery (4,905 + 4,900)	9,805
C/R on Consolidation	1,320	Furniture and Fittings (1,845 + 586)	2,431
Profit and Loss Account	2,947	**Current Assets**:	
General Reserve	2,892	Stock (3,949 + 1,956 - 20 Unrealized Pft)	5,885
Minority Interest	3,120	Trade Debtors (2,600 + 1,363)	3,963
Current Liabilities:		Cash and Bank (1,490 + 204)	1,694
Bills Payable (372 + 160 - 45 Mutual) (Set off)	487	Bills Receivable (360 + 199 - 45 Mutual) (Set off)	514
Sundry Creditors (1,461 +854)	2,315	Sundry Advances	520
Provision for Taxation (855 + 394)	1,249		
Proposed Dividend	1,200		
Total	**27,530**	**Total**	**27,530**

Illustration 15: Bonus Issue, Reverse Working for Bonus Amount - Investment in Debentures

Balance Sheet of P Ltd. and Q Ltd. as at 31.12.2008 is given below (Rs. in 000's)-

Liabilities	P	Q	Liabilities	P	Q
Equity Share Capital (Rs.10)	5,000	2,400	Goodwill	300	200
Securities Premium	200	140	Buildings	1,000	1,000
General Reserve	1,000	1,600	Machinery	4,000	2,440
Profit & Loss Account	900	600	Investment in Shares:		
8% Debentures	2,000	1,000	-1,92,000 Shares of Q Ltd.	1,500	
Trade Creditors	800	400	Investments in Debentures:		
Outstanding Expenses	300	150	- In Q Ltd. (Face Value Rs.4,00,000)	450	
			- In P Ltd. (Face Value Rs.2,00,000)		220
			Sundry Debtors	1,500	1,000
			Stock	1,000	1,000
			Cash and Bank	200	100
			Preliminary Expenses	100	50
			Outstanding Income	150	280
Total	**10,020**	**6,290**	**Total**	**10,200**	**6,290**

1. When the Shares were acquired, Q Ltd. had Rs.2.2 Lakhs in General Reserve and Rs.1,00,000 in Securities Premium, Rs.3,00,000 (Dr.) in Profit and Loss Account.
2. Two years after the date of acquisition Bonus Shares at 1 to 1 were issued out of General Reserve.
3. One year after the Bonus issue, Rights Shares were issued at 10% Premium at 1 for 5 held and P Ltd. purchased all the shares offered to it.
4. P Ltd. received Rs.1,92,000 dividend for the last year and Rs.96,000 interim dividend in the current year, i.e. 3 years after the Rights Issue.
5. For the current year 15% dividend (including Interim Dividend) has been proposed by Q Ltd., 10% by P Ltd., but no effect has yet been given in the accounts.
6. On the same day referred to in (5) above, Bonus Dividend has been declared at 1 to 2, but no effect has yet been given.
7. 50% of the shares originally purchased in Q Ltd. were paid for to the shareholders of Q Ltd. by 50,000 shares of P Ltd. issued at 10% premium.
8. Debenture Interest of both the Companies falls due on 31st December, but payments are made 2 or 3 days after.

Prepare Consolidated Balance Sheet as at 31.12.2008.

Solution:

1. Basic Information

Company Status		Dates		Holding Status	
Holding Company	= P	Consolidation:	31.12.2008	Holding Company	= 80%
Subsidiary	= Q			Minority Interest	= 20%

	Shares held as on 31.12.2008	1,92,000
Add:	Second Bonus Issue (1,92,000 xl/2)	96,000
	Actual Shareholding	2,88,000

DOA - 1 (Original Acquisition)	First Bonus Issue (1 : 1 as at DOA-1)	DOA - 2 Rights Issue	Second Bonus Issue (1 :2 as at DOA-2)
80,000	**80,000**	**32,000**	**96,000**
(balancing figure)	[(1,92,000 - 32,000) ÷ 2]	[1,92,000 x l ÷ (5 + 1)]	

40,000	40,000
For Cash	For Shares of P Ltd.

2. Analysis of Reserves & Surplus of Q Ltd.

(a) Securities Premium

Balance on 31.12.2008 Rs. 1,40,000

DOA-1	**Rs. 1,00,000** **Capital Profit**	Proceeds from Rights Issue	**Rs.40,000** **Capital**

(b) General Reserve

	Shares held as on 31.12.2008	16,00,000
Add:	Second Bonus Issue (24,00,000 x 1 / 2)	12,00,000
	Adjusted Balance	40,00,000

	DOA-1	Rs.22,00,000	Additions upto Consolidation
Less:	First Bonus	(Rs. 10,00,000) (80,000 Shares/80% x Rs. 10)	(balancing figure) **Rs. 4,00,000**
Less:	Second Bonus	(Rs. 12,00,000)	**Revenue Reserve**
	Capital Profit	**Rs. NIL**	

Note: In the absence of information in this regard, it is presumed that the second bonus issue has been made out of reserves as on the date of controlling acquisition.

(c) Profit & Loss Account

	Balance as on 31.12.2008	6,00,000	
Less:	Debenture Interest (10,00,000 x 8%)	(80,000)	
Add:	Debenture Interest from P (2,00,000 x 8%)	16,000	
Less:	Proposed Dividend (24,00,000 x 15% – Interim 1,20,000)	(2,40,000)	(See Note)
	Adjusted Balance	2,96,000	

DOA - 1	Additions to P&L A/c
(Rs. 3,00,000) Debit balance given	**Rs. 5,96,000**
Capital Profit	**Revenue Profit**

Note: *Interim Dividend received by Holding Company = Rs.96,000 for 80% holding. Hence, Total Interim Dividend paid by Subsidiary = Rs.96,000 ÷ 80% = Rs. 1,20,000*

3. Analysis of Net Worth of Q Ltd.

	Particulars		Total	P	Minority
			100%	**80%**	**20%**
(a)	**Equity Share Capital:**	(including Bonus Rs. 12,00,000)	**36,00,000**	28,80,000	7,20,000
(b)	**Capital Profits:**	Securities Premium Account	1,00,000		
	General Reserve		NIL		
	Profit & Loss Account		(3,00,000)		
	Preliminary Expenses		(50,000)		
			(2,50,000)	(2,00,000)	(50,000)
(c)	**Securities Premium** (after acquisition date)		**40,000**	32,000	8,000
(d)	**Revenue Reserves:**	General Reserve	**4,00,000**	3,20,000	80,000
(e)	**Revenue Profits:**	Profit & Loss A/c	**5,96,000**	4,76,800	1,19,200
(f)	**Proposed Equity Dividend**		**2,40,000**	1,92,000	48,000
Minority Interest					**9,25,200**

4. Cost of Control

	Particulars		Rs.
	Cost of Investment		15,00,000
Less:	(1) Nominal Value of Equity Capital	28,80,000	
	(2) Share in Capital Profit of Q Ltd.	(2,00,000)	(26,80,000)
	Capital Reserve on Consolidation		**(11,80,000)**

5. Gain / Loss on Consolidation of Debentures

	Particulars		Rs.
	Cost of Investment in Debentures:		
	Lavanya Ltd. in P Ltd.	2,20,000	
	Karunya Ltd. in Q Ltd.	4,50,000	6,70,000
Less:	Face Value of Debentures (Rs.20,000 + Rs.40,000)		(6,00,000)
	Loss on Consolidation of Debentures (Adjusted against Group Reserves)		**70,000**

6. Consolidation of Reserves & Surplus

	Particulars		Securities Premium	Gen. Res	P&L A/c
	Balance as per Balance Sheet of P Ltd.		2,00,000	10,00,000	9,00,000
Less:	Proposed Dividend	(Rs.50,00,000 x 10%)		–	(5,00,000)
Less:	Debenture Interest Due	(Rs.20,00,000 * 8%)	–	–	(1,60,000)
Add:	Share of Dividend from Q Ltd.	(Rs.2,40,000 x 80%)	–	–	1,92,000
Add:	Share of Debenture Int from Q	(Rs.4,00,000 x 8%)	–	–	32,000
	Adjusted Balance		**2,00,000**	**10,00,000**	**4,64,000**
Add:	Share of Reserves of Q Ltd.		32,000	3,20,000	4,76,800
Less:	Loss on Elimination of Debentures on Consolidation				(70,000)
	Consolidated Balance		**2,32,000**	**13,20,000**	**8,70,800**

7. Consolidated Balance Sheet of P Ltd. and its Subsidiary Q Ltd. as at 31.12.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	50,00,000	**Fixed Assets:**	
Reserves and Surplus:		Goodwill (3,00,000 + 2,00,000)	5,00,000
Securities Premium	23,2000	Building (10,00,000 + 10,00,000)	20,00,000
General Reserve	13,20,000	Machinery (40,00,000 + 24,40,000)	64,40,000
Profit & Loss Account	8,70,800		
Capital Reserve	11,80,000	**Current Assets:**	
Secured Loans		Sundry Debtors (15,00,000 + 10,00,000)	25,00,000
8% Debentures (20,00,000 + 10,00,000 -		Stock in Trade (10,00,000 + 10,00,000)	20,00,000
2,00,000 (held by Q) - 4,00,000	24,00,000	Cash in Hand (2,00,000 + 1,00,000)	3,00,000
(held by P)		Outstanding Income (1,50,000 + 2,80,000)	4,30,000
Debenture Interest accrued	1,92,000	**Misc. Expenditure (to the extent not**	
Minority Interest:	9,25,200	**w/off)**	1,00,000
Current Liabilities:		Preliminary Expenses	
Sundry Creditors [8,00,000 + 4,00,000]	12,00,000		
Outstanding Exp [3,00,000 + 1,50,000]	4,50,000		
Proposed Dividend (P Ltd.)	5,00,000		
Total	**1,42,70,000**	**Total**	**1,42,70,000**

Notes:

- ***It*** *is presumed that the Companies have not accounted for the inter company owings in respect of Debenture interest and proposed dividends.*
- *Interest due on Debenture has been shown under Secured Loans together with Debentures in accordance with Schedule VI to the Companies Act, 1956.*

C. REVALUATION OF ASSETS

Illustration 16: Bonus Issue, Asset Revaluation, Interest not recorded

X Ltd. acquired 80,000 Shares of Rs.100 each in Y Ltd. on 30.09.2008. The summarized two Companies as on 31.03.2009 were as follows -

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Share Capital (Rs.100)	3,00,00,000	1,00,00,000	**Fixed Assets**	1,50,00,000	1,44,70,000
Capital Reserve	–	55,00,000	Investments in Y Ltd.	1,70,00,000	–
General Reserve	30,00,000	5,00,000	Stock in Hand	40,00,000	20,00,000
Profit & Loss Account	38,20,000	18,00,000	Loan to X Ltd.	–	2,00,000
Loan from Y Ltd.	2,10,000		Debtors	25,00,000	1,08,00,000
Creditors	17,90,000		Bank	2,00,000	2,00,000
Bills Payable (including Rs.50,000	–	7,00,000	Bills Receivable (including	1,20,000	–
to X Ltd.)		1,70,000	Rs.5,000 from Y Ltd.)		
Total	**3,88,20,000**	**18,67,00,000**	**Total**	**3,88,20,000**	**18,67,00,000**

Contingent Liability (X Ltd.): Bills discounted of Rs.60,000.

Additional information:

1. Y Ltd. made a bonus issue on 31.03.2009 of one share for every two shares held, reducing the Capital Reserve equivalentlly, but the accounting effect to this has not been given in the above Balance Sheet.
2. Interest receivable for the year (Rs.10,000) in respect of the loan due by X Ltd. to Y Ltd. has not been credited in the accounts of Y Ltd.
3. The credit balance in Profit & Loss Account of Y Ltd. on 01.04.2008 was Rs.2,10,000.
4. The Directors decided on the date of the acquisition that the Fixed Assets of Y Ltd. were overvalued and should be written down by Rs.5,00,000. Consequential adjustments on depreciation are to be ignored.

Prepare the Consolidated Balance Sheet as at 31.03.2009, showing your workings.

Solution:

1. Basic Information

Company Status		Dates		Holding Status	
Holding Company	= X Ltd.	Acquisition:	30.09.2008	Holding Company	= 80%
Subsidiary	= Y Ltd.	Consolidation:	31.03.2009	Minority Interest	= 20%

2. Analysis of Reserves and Surplus of Y Ltd.

(a) General Reserve

Balance as per B/s Rs.5,00,000

As on 01.04.2008 (Date of previous B/s) **Rs.5,00,000**
Assumed that entire balance is available on this date
Capital Profit

01.04.2008 to 31.03.2009 (upto Consolidation)
Rs. NIL (balancing figure)
Revenue Reserve

(b) Profit and Loss Account

	Balance as on date of Consolidation	Rs.18,00,000
Add:	Interest on Loan to X (Given)	Rs. 10,000
	Corrected Balance	Rs.18,10,000

Balance on 01.04.2008
(Date of previous B/s)
Rs.2,10,000
Capital Profit
Capital Profit Rs.8,00,000

Profit for 2008-09 (balancing figure) **Rs. 16,00,000**

Upto date of acquisition 01.04.2004 to
30.09.2008 Rs.l6,00,000 x 6/12
Revenue Profit Rs.8,00,000

Acquisition to Consolidation 30.09.2008
to 31.03.2009 Rs.l6,00,000 x 6/ 12

Total Capital Profits: 2,10,000 + 8,00,000 = **Rs.10,10,000; Total Revenue Profits: Rs.8,00,000**

(c) Capital Reserve

	Balance as on date of Consolidation	Rs. 55,00,000	**Remarks**
Less:	Bonus Issue (Rs. 1,00,00,000 x 1/2)	Rs. 50,00,000	The entire balance is
	Adjusted Balance	Rs. **5,00,000**	considered **Capital Profits.**

(d) Revaluation of Assets: Loss (Rs.5,00,000) = **Capital Profit**

3. Analysis of Net Worth of Y Ltd.

Particulars	Total	X Ltd	Minority
	100%	**80%**	**20%**
(a) **Share Capital**	1,00,00,000		
Add: Bonus Issue [1/2 x 1,00,00,000]	50,00,000		
	1,50,00,000	**1,20,00,000**	**30,00,000**
(b) **Capital Profits:**			
General Reserve	5,00,000		
Profit & Loss Account	10,10,000		
Capital Reserve	5,00,000		
Loss on Revaluation of Assets	(5,00,000)		
(c) **Revenue Reserve:**	**15,10,000**	**12,08,000**	**3,02,000**
(d) **Revenue Profits:**	NIL		
Profit & Loss A/c	**8,00,000**	**6,40,000**	**1,60,000**
Minority Interest			**34,62,000**

4. Cost of Control

Particulars	Rs.	
Cost of Investment as per B/Sheet		
Less: (1) Nominal Value of Equity Capital	1,20,00,000	1,70,00,000
(2) Share in Capital Profit as calculated above	12,08,000	1,32,08,000
Goodwill on Consolidation		**37,92,000**

5. Consolidation of Reserves & Surplus

Particulars	Gen. Res.	P&LA/c
Balance as per Balance Sheet of X Ltd.	30,00,000	38,20,000
Add: Share of Revenue Reserve / Profit from Y Ltd.	NIL	6,40,000
Consolidated Balance	**30,00,000**	**44,60,000**

6. Consolidated Balance Sheet of X Ltd. and its Subsidiary Y Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	3,00,00,000	**Fixed Assets**	
Reserves & Surplus		Goodwill on Consolidation	37,92,000
General Reserve	30,00,000	Other Fixed Assets [1,50,00,000 + 1,44,70,000 - 5,00,000 (Revaluation Loss)]	2,89,70,000
Profit and Loss Account	44,60,000	**Current Assets**	
Minority Interest	34,62,000	Sundry Debtors [25,00,000 + 18,00,000]	43,00,000
Current Liabilities		Stock in Trade [40,00,000 + 20,00,000]	60,00,000
Sundry Creditors [17,90,000 + 7,00,000]	24,90,000	Cash at Bank [2,00,000 + 2,00,000]	4,00,000
B/P [1,70,000 - 50,000 (Mutual Owings)]	1,20,000	B/R [1,20,000 - 50,000 (Mutual Owings)]	70,000
Total	**4,35,32,000**	**Total**	**4,35,32,000**

Contingent Liability for Bills Discounted Rs.60,000

Note: *Fixed Assets have been revalued for the purpose of Consolidation and the depreciation on the revaluation loss has been ignored as its specifically stated in the problem.*

Illustration 17: Invt in PSC, Revaluation of Asset & Stock Reserve - Upstream & Downstream.

G Ltd. acquired control in S Ltd. a few years back when S Ltd. had Rs.25,000 in Reserve and Rs.14,000 (Cr.) in Profit & Loss Account. Plant Account (Book Value Rs.66,000) of S Ltd. was revalued at Rs.62,000 on the date of purchase. Equity Dividend of Rs.7,500 was received by G Ltd. out of pre-acquisition profit and the amount was correctly treated by G Ltd. Debenture Interest has been paid upto date.

Following are the Balance Sheets of G Ltd. and S Ltd. as at 31st December (Rs.000's) -

Liabilities	**G**	**S**	**Assets**	**G**	**S**
6% Preference Share Capital (Rs.100)	100	50	Goodwill	50	30
Equity Share Capital (Rs.10)	500	100	Land & Buildings	200	50
General Reserve	30	30	Plant & Machinery	105	100
Profit & Loss Account	40	12	Stock in Trade	130	100
6% Debentures	NIL	100	Sundry Debtors	90	50
Sundry Creditors	90	60	Bills Receivable	30	10
Due to S Ltd.	10	NIL	Due from G Ltd.,	NIL	12
Bills Payable	20	25	Bank	27	25
			Investments in S Ltd.		
			- 300 Preference Shares	28	NIL
			- 7,500 Equity Shares	85	NIL
			- Debentures (Face Value Rs.50,000)	45	NIL
Total	**790**	**377**	**Total**	**790**	**377**

Additional Information -

1. Cheque of Rs.2,000 sent by G Ltd., to S Ltd., was in transit.
2. Balance Sheet of S Ltd. was prepared before providing for 6 months dividend on Preference Shares, the first half being already paid.
3. Both the Companies have proposed Preference Dividend only, but no effect has been given in the accounts.
4. Stock of G includes Rs.6,000 stock purchased from S on which S made 20% profit on cost. Stock of S includes Rs.10,000 purchased from G on which G made 10% profit on selling price.
5. Since acquisition, S Ltd. has written off 30% of the book value of plant as on date of acquisition by way of depreciation.
6. Bills Receivable of S Ltd. are due from G Ltd.

Prepare Consolidated Balance Sheet as at 31st December.

Solution:

1. Basic Information

Company Status		**Dates**		**Holding Status**	
Holding Company	= G	Acquisition:	a few years back	Holding Company	= 75%
Subsidiary	= S	Consolidation:	31sl December	Minority Interest	= 25%

2. Analysis of Reserves & Surplus of S Ltd.

(a) General Reserve

Balance on date of consolidation (given) Rs.30,000

As on Date of Acquisition (given)
Rs. 25,000 Capital Profit

From date of acquisition to date of consolidation
(balancing figure) = **Rs.5,000 Revenue Reserve**

(b) Profit & Loss Account

	Balance on 31st December	Rs.	12,000
Less:	Proposed Preference Dividend (Rs.50.000 x 6% x 6 - 12)	Rs.	1,500
	Corrected Balance	Rs.	10,500

	As on date of acquisition	Rs. 14,000	From date of acquisition to date of consolidation (balancing figure) =
Less:	Equity Dividend for pre-acqn period	Rs. 10,000	
	(Reed, by G 7,500 - 75%)	**Rs. 4,000**	**Rs.6,500**
		Capital Profits	**Revenue Profits**

(c) Gain / Loss on Revaluation of Assets

• Loss on Revaluation of Machinery	= 62,000 - 66,000	**= (Rs.4,000)**	**Capital Profit**
• Depreciation Gain on Revaluation Loss	= 4,000 x 30%	**= Rs.1,200**	**Revenue Profit**

3. Analysis of Net Worth of S Ltd.

Particulars			Total 100%	G Ltd. (75%)	Minority Int (25%)
(a)	**Equity Share Capital**		**1,00,000**	**75,000**	**25,000**
(b)	**Preference Share Capital**		**50,000**	**30,000**	**20,000**
(c)	**Capital Profits:**	General Reserve	25,000		
		Profit & Loss Account	4,000		
		Loss on Revaluation of Assets	(4,000)		
			25,000	**18,750**	**6,250**
(d)	**Revenue Reserves:**	General Reserve	**5,000**	**3,750**	**1,250**
(e)	**Revenue Profits:**	Profit & Loss Account	6,500		
		Depreciation Gain on Revaluation	1,200		
			7,700	**5,775**	**1,925**
(f)	**Preference Dividend**		**1,500**	**900**	**600**
	Minority Interest before Stock Reserve Adjustment				**55,025**
Less:	Stock Reserve on Unrealised Profits i.e. Share of Minority Interest [6,000 x (20 - 120) x 25%]				**250**
	Minority Interest				**54,775**

Note: Unrealized profits on upstream transaction (i.e. Subsidiary to Holding Company) alone is eliminated from the Minority Interest, towards their share i.e. 25%. The balance of 75% (Holding Company's Share) will be reduced from the Reserves of G Ltd. Unrealized profits on downstream transaction, will be eliminated in full against reserves of G Ltd.

4. Cost of Control

Particulars			Rs.
	Cost of Investment in S Ltd.		1,13,000
	7,500 Equity Shares of S Ltd.	85,000	
	300 6% Preference Shares of S Ltd.	28,000	
Less:	(1) Nominal Value of Equity Capital	75,000	
	(2) Nominal Value of Preference Share Capital	30,000	
	(3) Share in Capital Profit of S Ltd.	18,750	(1.23,750)
	Capital Reserve on Consolidation		**(10,750)**

5. Gain or Loss on Elimination of Mutually held Debentures

Particulars		Rs.
	Cost of Investment	45,000
Less:	Nominal Value of Debentures	50,000
	Gain on Consolidation - Added to Group Profits	**5,000**

6. Consolidation of Reserves & Surplus

Particulars			Gen. Res	P&L A/C
	Balance as per Balance Sheet of S Ltd.		30,000	40,000
Less:	Proposed Preference Dividend	(Rs. 1,00,000 x 6%)	–	(6,000)
Add:	Share of Proposed Dividend from S Ltd.	(Rs.30,000 x 6% x 6/12)	–	900
	Adjusted Balance		**30,000**	**34,900**
Add:	Share of Revenue Profits / Reserves of S Ltd.		3,750	5,775
	Consolidated Balance		**33,750**	**40,675**
Less:	Unrealised Profits on Closing Stock of G Ltd. - Upstream transaction - Rs.6,000 x (20 - 120) x G Ltd.'s Share 75%		–	(750)
Less:	Unrealised Profits on Closing Stock of S Ltd. - Downstream transaction Rs. 10,000 x 10% - Fully adjusted against G Ltd.'s Reserves		–	(1,000)
Add:	Gain on elimination of mutually held Debentures			5,000
	Adjusted Consolidated Balance		**33,750**	**43,925**

7. Consolidated Balance Sheet of G Ltd. and its Subsidiary S Ltd. as at 31st December

Liabilities	Rs.	Assets	Rs.
Share Capital:		**Fixed Assets**	
Equity Share Capital (Rs.10)	5,00,000	Goodwill (50,000+ 30,000)	80,000
6% Preference Share Capital (Rs.100)	1,00,000	Land & Buildings (2,00,000 + 50,000)	2,50,000
Reserves & Surplus		Plant & Mcy. (105000 + 100000 - 4000 (Revln. Loss) + 1200 (Depn. Gain)l	2,02,200
General Reserve	33,750		
Profit & Loss Account	43,925	**Current Assets**	
Capital Reserve on Consolidation	10,750	Stock in Trade [1,30,000 + 1,00,000 - 2,000 (Stock Reserve)]	2,28,000
Minority Interest	54,775		
6% Debentures (1,00,000 - 50,000 held by G in S)	50,000	Trade Debtors [90,000 + 50.000]	1,40,000
		Bills Receivable [30,000 + 10,000 - 10,000 (Mutual Owings)]	30,000
Current Liabilities			
Creditors [90,000 + 60,000]	1.50.000	Cash at Bank [27,000 + 25,000]	52,000
Bills Payable [20,000 + 25,000 - 10,000 (Mutual Owings)]	35,000	Cheque in Transit	2,000
Proposed Preference Dividend (G Ltd.)	6,000		
Total	**9,84,200**	**Total**	**9,84,200**

Illustration 18: Asset Revaluation, Pre-acquisition Dividend

On 01.01.2006, H Ltd. acquired 8000 Shares of Rs.10 each of G Ltd. at Rs.90,000. The Balance Sheet of H Ltd., and G Ltd., as at 31.12.2008 are given below-

Liabilities	H Ltd.	G Ltd.	Assets	H Ltd.	G Ltd.
Equity Share Capital (Rs.10)	1,00,000	1,00,000	Fixed Assets	60,000	1,10,000
General Reserve	40,000	26,000	Investments	1,00,000	15,000
Profit & Loss Account	36,000	35,000	Debtors	25,000	20,000
Creditors	71,000	48,000	Stock	30,000	40,000
			Bank	32,000	24,000
Total	**2,47,000**	**2,09,000**	**Total**	**2,47,000**	**2,09,000**

1. At the time of acquiring shares, G Ltd. had Rs.24,000 in General Reserve and Rs. 15,000 (Cr.) in P & L A/c.
2. G Ltd. paid 10% dividends in 2006, 12% in 2007, 15% in 2008 for 2005, 2006 and 2007 respectively. All dividends received have been credited to the Profit & Loss Account of H Ltd.
3. Proposed dividend for both the Companies for 2008 is 10%.

4. One bonus share for five fully paid shares held has been declared by G Ltd. out of pre-acquisition reserve on 31.12.2008. No effect has been given to that in the above accounts.
5. On 01.01.2006, Building of G Ltd. which stood at Rs.50,000 was revalued at Rs.60,000 but no adjustment has been made in the books. Depreciation has been charged @ 10% p.a. on reducing balance method.
6. In 2008, H Ltd. purchased from G Ltd., goods for Rs.10,000 on which G Ltd. made a profit of 20% on Sales. 25% of such goods are lying unsold on 31.12.2008.

Prepare the Consolidated Balance Sheet as at 31.12.2008.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = H Ltd. Subsidiary = G Ltd.	Acquisition: 01.01.2006 Consolidation: 31.12.2008	Holding Company = 80% Minority Interest = 20%

Note: Number of Shares in G Ltd. after Bonus Issue = 10,000 + l/5in Bonus = 12,000 Shares. Holding by Ganpat in G Ltd. - Originally Acquired 8,000 Shares + Bonus at 1/5* = 9,600 Shares, out of 12,000 Shares = 80%.

2. Analysis of Reserves and Surplus of G Ltd.
(a) General Reserve

	Balance as on date of Consolidation	Rs.	26,000
Less:	Bonus Issue (l/5th of Rs. 1,00,000)	Rs.	20,000
	Adjusuted Balance	Rs.	6,000

	As on date of acquisition 01.01.2006	Rs.	24,000
Less:	Bonus Issue	Rs.	20,000
	Balance **Capital Profit**	Rs.	4,000

Transfer between 01.01.2006 and 31.12.2008 (acquisition to consolidation) **(balancing figure)** Rs.2,000 **Revenue Reserve**

(b) Profit & Loss Account

	Balance as on date of Consolidation	Rs.	35,000
Less:	Proposed Dividend for 2008 (10% of Rs. 1,00,000)	Rs.	10,000
	Adjusted Balance	**Rs.**	**25,000**

	Bal.on date of acquisition 1.1.06	Rs.	15,000
Less:	Pre-Acqn Dividend 2005 (10%)	Rs.	10,000
	Balance **Capital Profit**	**Rs.**	**5,000**

Profits for 2006, 2007 & 2008 (balancing figure) **Rs.20,000** **Revenue**

(c) Gain / Loss on Revaluation of Building

Gain on Revaluation = Rs. 60,000 - Rs. 50,000 = **Rs.10,000 - Capital Profit**

Depreciation Loss on Revaluation Gain

For 2006 - Rs.l 0,000 x 10%	Rs. 1,000		
For 2007 - Rs. 1,000 x 90%	Rs. 900		
For 2008 - Rs. 900 x 90%	Rs. 810	**(Rs.2,710)**	Revenue Profit

Alternatively, Depreciation gain can be derived as under -

Year	Depreciation on Rs.50,000 already provided		Depreciation on 60,000 (Required)		Additional Depreciation
2006	Rs.50,000 x 10% =	Rs.5,000	Rs.60,000 x 10% =	Rs.6,000	(1,000)
2007	Rs. 5,000 x 90% =	Rs.4,500	Rs. 6,000 x 90% =	Rs.5,400	(900)
2008	Rs. 4,500 x 90% =	Rs.4,050	Rs. 5,400 x 90% =	Rs.4,860	(810)
Total Additional Depreciation to be provided (Revenue Profit)					**(2,710)**

3. Analysis of Net Worth of G Ltd.

Particulars	Total 100%	H Ltd. 80%	Minority 20%
(a) **Equity Share Capital** (including Bonus Issue) Rs. 1,00,000 + 20%	**1,20,000**	96,000	24.000
(b) **Capital Profits:** General Reserve	4,000		
Profit & Loss Account	5,000		
Gain on Revaluation of Assets	10,000		
	19,000	15,200	3,800
(c) **Revenue Reserves:** General Reserve	**2,000**	1,600	400
(d) **Revenue Profits:** Profit & Loss Account	20,000		
Depreciation Gain on Revaluation	(2,710)		
	17,290	13,832	3,458
(e) **Proposed Dividend** 10% of Rs. 1,00,000	**10,000**	8,000	2,000
Minority Interest before Stock Reserve Adjustment			**33,658**
Less: Stock Reserve on Closing Stock (10,000 x 25% x 20%) x 20%			(100)
Minority Interest taken to B/Sheet			**33,558**

4. Cost of Control

Particulars		Rs.
Cost of Investment in G Ltd.		90,000
Less: Dividend out of Pre-acquisition profits (of 2005) of G (Rs.80,000 x 10%)		8,000
Adjusted Cost of Investment		**82,000**
Less: (1) Nominal Value of Equity Capital	96,000	
(2) Share in Capital Profit of G Ltd.	15,200	1,11,200
Capital Reserve on Consolidation		**(29,200)**

5. Consolidation of Reserves & Surplus

Particulars	Gen. Res	P&L A/c
Balance as per Balance Sheet of H Ltd.	40,000	36,000
Less: Dividend out of Pre-acquisition Profits (Rs.80,000 x 10%)	–	(8,000)
Less: Dividend Proposed for 2008 by H (Rs. 10% x 1,00,000)	–	(10,000)
Add: Share of Proposed Dividend of G Ltd. for 2008 (80% x Rs. 10000)	–	8,000
Adjusted Balance	**40,000**	**26,000**
Add: Share of Revenue Profits/Reserves of G Ltd.	1,600	13,832
Consolidated Balance	**41,600**	**39,832**
Less: Unrealised Profit on Closing Stock [20% x Rs. 10,000 x 25%] x 80%	–	(400)
Adjusted Consolidated Balance	**41,600**	**39,432**

6. Consolidated Balance Sheet of H Ltd. and its Subsidiary G Ltd. as at 31.12.2008

Liabilities	Rs.	Assets	Rs.
Share Capital:	1,00,000	**Fixed Assets:** (60000 + 110000 + 10000	1,77,290
Equity Share Capital (Rs.100 each)		(Revaln Gain) - 2710 (Depn. Loss)	
Reserves & Surplus		**Investments:** [1,00,000 + 15,000 -	25,000
General Reserve	41,600	90,000 (Held by H Ltd. in G Ltd.)]	
Profit and Loss Account	39,432	**Current Assets**	
Capital Reserve on Consolidation	29,200	Debtors [25,000 + 20,000]	45,000
Minority Interest	33,558	Stock [30000 + 40000 - 500 (Reserve)]	69,500
Current Liabilities		Bank [32,000 + 24,000]	56,000
Sundry Creditors [71,000 + 48,000]	1,19,000		
Proposed Dividend: Ganpat Ltd.	10,000		
Total	**3,72,790**	**Total**	**3,72,790**

D. INVESTMENT IN PREFERENCE CAPITAL

Illustration 19: Bonus Issue, Pre-acquisition Dividend, Preference Dividend

The following are the Balance Sheets of Sky Ltd. and Star Ltd. as on 31.03.2009 -

Liabilities	Sky	Star	Assets	Sky	Star
Share Capital:			**Fixed Assets:** Goodwill	60,000	40,000
Equity Shares of Rs.10 each	5,00,000	2,00,000	Machinery	1,00,000	60,000
12% Pref. Shares of Rs.100 each	1,00,000	50,000	Vehicles	1,80,000	70,000
Reserves: General Reserve	1,00,000	60,000	Furniture	50,000	30,000
Profit & Loss A/c	1,50,000	90,000	**Investment:** Shares of Sea (Cost)	3,80,000	–
Current Liabilities & Provisions:			**Current Assets:** Stock	70,000	1,40,000
Creditors	60,000	70,000	Debtors	1,00,000	1,65,000
Income Tax	70,000	60,000	Bank Balance	40,000	25,000
Total	**9,80,000**	**5,30,000**	**Total**	**9,80,000**	**5,30,000**

The following further information is furnished:

1. Sky Ltd. acquired 12,000 Equity Shares and 400 Preference Shares on 01.04.2008 at a cost of Rs.2,80,000 and Rs.1,00,000 respectively.
2. The Profit & Loss Account of Star Ltd. had a credit balance of Rs.30,000 as on 01.04.2008 and that of General Reserve on that date was Rs.50,000.
3. On 01.07.2008, Star Ltd. declared dividend out of its pre-acquisition profit, 12% on its Share Capital; Sky Ltd. credited the receipt of dividend to its Profit & Loss Account.
4. On 01.10.2008 Star Ltd. issued one Equity Share for every three shares held, as Bonus Shares, at a face value of Rs.100 per share out of its General Reserve. No entry has been made on the books of Sky Ltd. for the receipt of these bonus shares.
5. Star Ltd. owed Sky Ltd. Rs.20,000 for purchase of goods from Sky Ltd. The entire stock of goods is held by Sea Ltd. on 31.03.2009. Ocean Ltd. made a profit of 25% on cost.

Prepare a Consolidated Balance Sheet as at 31.03.2009.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = Sky Ltd. Subsidiary = Star Ltd	Acquisition: 01.04.2008 Consolidation: 31.03.2009	Holding Company = 80% Minority Interest = 20%

Shareholding Status: Shares held on 31.03.2009 = 1,200+ 1/3 x 1,200 (Bonus) = 1,600 out of 2,000 = 80%.

Note: Share distribution pattern can be determined as under –

Date	Particulars	Held by Sky Ltd.	% of Holding	Total Shares
01.04.2008	Opening Balance	1,200	NIL	1,500
01.10.2008	Bonus Shares (1 /3 x 1,200)	400	80%	500
31.03.2009	Closing Balance	1,600	80% (1,600/2,000)	2,000 (From Balance Sheet Given)

2. Analysis of Reserves & Surplus of Star Ltd.

(a) General Reserve

Balance on 31.03.2009 Rs.60,000

	Balance on 01.04.2008 (acquisition)	50,000	Transfer during 2008-09 (bal. fig)	60,000 Revenue Reserve
Less:	Bonus Issue (1/3 x 1,500 Shares x Rs. 100)	50,000		
	Capital Profit	**Nil**		

(b) Profit & Loss Account

Balance on 31.03.2009 Rs.90,000

	Balance on 01.04.2008 (acquisition)	30,000		Profit for 2008-09	Rs. 84,000
Less:	Dividend on pre-acquisition profit		**Less:**	Preference Dividend	Rs. 6,000
	(12% x 15,000 shares x Rs. 10 each)	(18,000)			**Rs.78,000**
Less:	Preference dividend (50,000 x 12%)	(6,000)			**Revenue Profit**
	Balance **Capital Profits**	Rs. 6,000			

3. Analysis of Net Worth of Star Ltd.

Particulars			Total	Sky Ltd	Minority
			100%	**80%**	**20%**
(a)	**Share Capital:**	Equity	**2,00,000**	1,60,000	40,000
		Preference	**50,000**	40,000	10,000
(b)	**Capital Profits:**	General Reserve	Nil		
		Profit & Loss Account	6,000		
			6,000	4,800	1,200
(c)	**Revenue Reserve:**		**60,000**	48,000	12,000
(d)	**Revenue Profit:**	Profit & Loss Account	**78,000**	62,400	15,600
(e)	Preference Dividend	of Star Ltd. for the year	**6,000**	4,800	1,200
	Minority Interest				**80,000**

4. Cost of Control

	Particulars		Rs.	
	Cost of Investment:	Equity Shares of Sea Ltd.		1,00,000
		Preference Shares of Sea Ltd.		2,80,000
	Total Cost of Investment			**3,80,000**
Less:	Dividend out of Pre-acquisition profits			
	Preference Shares	(40,000 Shares x Rs.100 each x 12%)	4,800	
	In Equity Shares	(15,000 Shares x Rs.10 each x 12%)	14,400	(19,200)
	Corrected Cost of Investment			**3,60,800**
Less:	(1) Nominal Value of Equity Share Capital		1,60,000	
	(2) Nominal Value of Preference Share Capital		40,000	
	(3) Share in Capital Profit of Star Ltd.		4,800	(2,04,800)
	Goodwill on Consolidation			**1,56,000**

5. Consolidation of Reserves & Surplus

	Particulars	Gen. Res	P&L A/c
	Balance as per Balance Sheet of Sky Ltd.	1,00,000	1,50,000
Add:	Share of Revenue Profits/ Reserves of Star Ltd.	48,000	62,400
Add:	Share of Preference Dividend from Star Ltd.	–	4,800
Less:	Dividend out of Pre-acquisition Profits (Rs.4,800 + Rs. 14,400)	–	(19,200)
Less:	Preference Dividend payable for the current year by Sky Ltd.	–	(12,000)
Less:	Stock Reserve on Closing Stock (20,000 x 25 /125)	–	(4,000)
	Adjusted Consolidated Balance	**1,48,000**	**1,82,000**

6. Consolidated Balance Sheet of Sky Ltd. and its Subsidiary Star Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	5,00,000	**Fixed Assets**	
12% Pref. Share Capital	1,00,000	Goodwill (Purchased as per B/s)	1,00,000
Reserves and Surplus:		Goodwill on Consolidation	1,56,000
General Reserve	1,48,000	Machinery (1,00,000 + 60,000)	1,60,000
P & L Account	1,82,000	Vehicles (1,80,000+ 70,000)	2,50,000
Minority Interest:	80,000	Furniture (50,000 + 30,000)	80,000
Current Liabilities:		**Current Assets, Loans & Advances**	
Creditors (60,000 + 70,000 - 20,000)	1,30,000	Stock (70,000 + 1,40,000 - Stock Res 4,000)	2,06,000
Income Tax (70,000 + 60,000)	1,30,000	Debtors (1,00,000 + 1,65,000 - 20,000 mutual)	2,45,000
Preferance Dividend Payable Sky Ltd.	12,000	Bank Balance (40,000 + 25,000)	65,000
Total	**12,62,000**	**Total**	**12,62,000**

Notes:

- Stock Reserve i.e. unrealized profits on Closing Stock have been eliminated in full against Holding Company's Profits, as it arose from downstream transaction (i.e. Holding to Subsidiary).
- Inter Company Owings have been eliminated in full.

Illustration 20: Bonus Issue Not Recorded / Debenture Interest

The following are the Balance Sheets of K Ltd. and P Ltd. as at 31.12.2005 - (Rs.000's)

Liabilities	K	P	Assets	K	P
Authorized Issued & Paid-up Capital:			**Fixed Assets:**	1,015	809
Equity Shares of Rs.100 each	800	400	Investments: In P Ltd.		
12% Preference Shares of Rs.100 each	—	200	3,000 Equity Shares	450	
Reserves & Surplus:			1,500 Preference Shares	180	
General Reserve	360	200	25 10% Debentures (Face Value)	25	
Profit & Loss Account	240	140	**Current Assets:**	260	480
Secured Loans:					
10% Debentures of Rs.1,000 each		50			
Current Liabilities & Provisions:					
Proposed Dividends on:					
- Equity Shares	120	60			
- Preference Shares	—	24			
Debenture Interest accrued	—	5			
Trade Creditors	410	210			
Total	**1,930**	**1,289**	**Total**	**1,930**	**1,289**

1. K Ltd. acquired its interest in P Ltd. on 01.01.2008, when the balance to the General Reserve Account of P Ltd. was Rs.1,80,000.
2. The balance in the Profit & Loss Account of P Ltd. as at 31.12.2008 was arrived at as under –

	Rs.	Rs.
Balance on 01.01.2008		40,000
Add: Current Profits (including Dividends)		2,04,000
Deduct: Transfer to: General Reserve	20,000	2,44,000
Proposed Dividends	84,000	1,04,000
Balance as on 31.12.2008		**1,40,000**

3. Balance to the P & L Account of P Ltd. as on 01.01.2008 was after providing for dividends on Preference Shares and 10% dividends on Equity Shares for the year ended 31.12.2008, these dividends were paid in cash by P Ltd. in May 2008.
4. No entries have been made in the books of K Ltd. for debenture interest due or for proposed dividends of P Ltd. for the year ended 31.12.2008.
5. Mutual indebtedness of Rs.24,000 is reflected in the balances shown in the Balance Sheets.
6. In October 2008, P Ltd. issued fully paid up Bonus Shares in the ratio of one share for every four shares held by utilizing its General Reserve. This was not recorded in the books of both the Companies.

From the above information, you are required to prepare the Consolidated Balance Sheet of K Ltd., and its subsidiary P Ltd. as at 31.12.2008.

Solution:

1. Basic Information

Company Status	Dates	Holding Status
Holding Company = K Ltd. Subsidiary = P Ltd.	Acquisition: 01.01.2008 Consolidation: 31.12.2008	Holding Company = 75% Minority Interest = 25%

2. Analysis of Reserves and Surplus of P Ltd.

(a) General Reserve

	Balance on 31.12.2008	Rs. 2,00,000
Less:	Bonus Issue (Rs.4,00,000 x 1 / 4)	Rs. 1,00,000
	Adjusted Balance	**Rs. 1,00,000**

	Balance on 01.01.2008 (acquisition)	Rs. 1,80,000	Transfer during 2008	**Rs.20,000**
Less:	Bonus Issue	Rs. 1,00,000	(balancing figure)	**Revenue Profit**
	Balance **Capital Profit**	**Rs. 80,000**		

(b) Profit and Loss Account

Balance on 31.12.2008 Rs. 1,40,000

Balance on 01.01.2008	**Rs. 40,000**	Profit for 2008	**Rs. 1,00,000**
	Capital Profit	(balancing figure)	**Revenue Profit**

3. Analysis of Net Worth of P Ltd.

Particulars		Total	K Ltd.	Minority
		100%	**75%**	**25%**
(a) **Share Capital:**	Equity (including Bonus Rs. 1,00,000)	**5,00,000**	3,75,000	1,25,000
	12% Preference Share Capital	**2,00,000**	1,50,000	50,000
(b) **Capital Profits**	General Reserve	80,000		
	Profit & Loss Account	40,000		
		1,20,000	90,000	30,000
(c) **Revenue Reserves:**	General Reserve	**20,000**	15,000	5,000
(d) **Revenue Profits:**	P & L Account	**1,00,000**	75,000	25,000
(e) **Proposed Dividend:**	Equity Dividend	**60,000**	45,000	15,000
	12% Preference Dividend	**24,000**	18,000	6,000
Minority Interest				**2,56,000**

4. Cost of Control

	Particulars		Rs.
	Cost of Investment: Equity Shares		4,50,000
	Preference Shares		1,80,000
	Total Cost of Investment		**6,30,000**
Less:	(1) Nominal Value of Equity Capital	3,75,000	
	(2) Nominal Value of Preference Capital	1,50,000	
	(3) Share in Capital Profit of P Ltd.	90,000	6,15,000
	Goodwill on Consolidation		**15,000**

Note: It has been presumed that K Ltd. has correctly recorded the receipt of pre-acquisition dividend to its investment account. If it is presumed that Pre-acquisition dividend have been wrongly taken to P & L Account, Capital Reserve on Consolidation will be Rs.33,000. Balance in P & L will be reduced by Rs.48,000.

5. Consolidation of Reserves & Surplus

	Particulars	Gen. Res.	P&LA/c
	Balance as per Balance Sheet of K Ltd.,	3,60,000	2,40,000
Add:	Share of Dividends declared for 2007 (75% of Rs.84,000)		63,000
Add:	Share of Debenture Interest [(25,000/50,000) x Rs.5,000]		2,500
	Adjusted Balance	**3,60,000**	**3,05,500**
Add:	Share of Revenue Profits / Reserves of Prasad Ltd.	15,000	75,000
	Consolidated Balance	**3,75,000**	**3,80,500**

6. Consolidated Balance Sheet of K Ltd. and its subsidiary P Ltd. as at 31.12.2008

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	8,00,000	**Fixed Assets:** Goodwill on Consolidation	15,000
Reserves and Surplus:		Other Fixed Assets	
General Reserve	3,75,000	(10,15,000 + 8,09,000)	18,24,000
Profit & Loss Account	3,80,500		
Secured Loans: 10% Debentures [50,000 - 25,000 (Held by K)]	25,000	**Current Assets:** [2,60,000 + 4,80,000 24,000 (Mutual Owings)]	7,16,000
Minority Interest:	2,56,000		.
Current Liabilities:			
Creditors [4,10,000 + 2,10,000 - 24,000 (Mutual)]	5,96,000		
Proposed Dividends: Equity	1,20,000		
Debenture Interest Accrued [Rs.5,000 - Rs.2,500 (Held by K)]	2,500		
Total	**25,55,000**	**Total**	**25,55,000**

F. ACQUISITION IN LOTS

Illustration 21: Purchase in Lots - Before Controlling Acqn. - Loss of Stock post-acquisition

The following are the Balance Sheets of L Ltd. and M Ltd. as at 31.03.2009 -

Liabilities	L Ltd.	M Ltd.	Assets	L Ltd.	M Ltd.
Equity Share Capital (Rs.10)	80,000	1,00,000	Shares in Monu Ltd	98,000	–
Profit & Loss Account Sundry	22,000	30,000	Cash	7,000	4,000
Creditors	3,000	8,000	Other Assets	–	1,34,000
Total	**1,05,000**	**1,38,000**	**Total**	**1,05,000**	**1,38,000**

1. Net Profit during 2008-09 included above were: L Ltd. Rs.18,000; M Ltd. Rs.12,000.
2. During 2008-09, M Ltd. credited Rs.3,000 to its P & L Account in settlement of a claim of loss of stock (costing Rs.5,400 - included in opening stock) by fire on 30.06.2008.
3. Rs. 250 p.m. expenses incurred by L Ltd. on behalf of M Ltd. has been debited to the Profit & Loss Account of L Ltd. and left unrecorded for in the books of M Ltd.
4. Both the Companies have proposed a dividend of 10% which is yet to be recorded.
5. On 01.04.2008, L Ltd., was formed and on the same day it acquired 4,000 Shares of M Ltd. at Rs.55,000.
6. On 31.07.2008, 10% dividend was received from M Ltd. and also Bonus Share at 1:4 was received. The dividend was credited to Profit & Loss Account.
7. On 31.8.2008, L Ltd. purchased another 3,000 Shares of M Ltd. at Rs.43,000.

   Draft a Consolidated Balance Sheet for the above Group.

Solution:

1. Basic Information

Company Status		Date of Acquisition		Holding Status	
Holding Company	= L Ltd.	Lot 1 = 4,000 Shares	= 01.04.2008	Holding Company	= 80%
Subsidiary	= M Ltd.	Bonus 1,000 Shares	= 31.07.2008	Minority Interest	= 20%
		Lot 2 = 3,000 Shares	= 31.08.2008		

Date of Consolidation = 31.03.2009

Notes:

- As per M's B/Sheet, number of Shares = 10,000, which is after Bonus Issue of 1:4. Hence, Number of Shares prior to Bonus Issue = 10,000 Less l/5^{lh} = 8,000 Shares.
- Lot 14,000 Shares do not constitute controlling acquisition. Hence, Date of Control = 31.08.2008. Shares held by Lalu Ltd. = 8,000 Shares out of 10,000 = 80% Holding.

2. Analysis of Profit & Loss Account of M Ltd.

Note:

1. Normal Operating Profit of M for 2008-09 = 12,000 (given) + 2,400 (abnormal loss item) = **Rs. 14,400.**
2. Presuming this to be earned uniformly, the Revenue Profits after date of controlling acquisition i.e. the period from 31.08.2008 to 31.03.2009 (i.e. 7 months) = Rs. 14,400 x 7/12 = **Rs.8,400.** Hence, amount relatable to pre-acquisition period = Rs. 14,400 - Rs.8,400 = Rs.6,000.

P & L balance on 31.03.2009 Rs. 30,000

Bal.in P&L last year	Rs. **46,000**		Profit from 31.08.2008 to 31.03.2009	8,400
Less: Bonus Issue	20,000	(Rs.80,000 x 1 /4)	(See **Note 2** above)	
Less: Dividend	8,000	(Rs.80,000 x 10%)	**Less:** Expenses by L Ltd. (Rs.250 x 7)	(1,750)
Less: Stock Loss	2,400		**Less:** 2008-09 Dividend (1,00,000x10%)	(10,000)
	15,600	(30,000- 14,400)		**(Rs.3,350)**
2008-09 Pft **(Note 2)**	6,000	(Rs.l4,400 x 5/12)	**Revenue Profit**	
Less: Exp. by L Ltd.	(1,250)	(Rs.250 x 5)		
	20,350	**Capital Profit**		

Note:

- The Opening Balance in P&L A/c Rs.46,000 is derived by reverse working. From this balance, M Ltd. should have declared bonus shares, paid dividend and written off the stock losses.
- The net balance of Capital and Revenue Profits = Rs.20,350 - Rs.3,350 = **Rs.17,000.** This is confirmed with the corrected balance of M's P&L Account i.e. Balance as given = Rs.30,000 **Less** Expenses incurred by L Ltd., now recorded = Rs.3,000 **Less** Dividend for 2008-09 = Rs. 10,000; Net Balance = Rs.17,000.

3. **Analysis of Net Worth of M Ltd.**

Particulars	Total 100%	L Ltd. (80%)	Minority 20%
(a) **Equity Share Capital**	1,00,000	80,000	20,000
(b) **Capital Profits:** Profit & Loss Account	20,350	16,280	4,070
(c) **Revenue Profits:** Profit & Loss Account	(3,350)	(2,680)	(670)
(d) **Proposed Dividend**	10,000	8,000	2,000
Minority Interest			**25,400**

4. Computation of Pre-acquisition Dividend of L Ltd.

Particulars	Total	1st Lot	2nd Lot
% of Holding on 31.03.2009	80%	50%	30%
Share of dividend	Rs.8,000	Rs.5,000	Rs.3,000
Period of holding during 2008-09	–	12 Months	7 Months
To be Credited to P&L A/c	Rs.6,750	Rs.5,000	Rs.1,750 (3,000x7/12)
To be Credited to Investment A/c (Pre-acquisition Dividend)	Rs. 1,250	NIL	Rs. 1,250 (3,000x5/12)

5. Cost of Control

	Particulars		Rs.
	Cost of Investment in M Ltd.		98,000
Less:	Dividend out of Pre-acquisition Profits (2007-08) of M Ltd. (Rs.8,000 x 50%)		(4,000)
Less:	Dividend out of Pre-acquisition Profits (2008-09) Working Note - 4 above		(1,250)
	Adjusted Cost of Investment		**92,750**
Less:	Nominal Value of Equity Capital	80,000	
	Share in Capital Profit of M Ltd.	16,280	96,280
	Capital Reserve on Consolidation		**(3,530)**

6. Consolidation of Profit and Loss Account

	Particulars		Rs.
	Balance as per Balance Sheet		22,000
Less:	Proposed Dividend	(Rs.80,000 x 10%)	(8,000)
Add:	Expenses incurred on behalf of M Ltd. by L Ltd.	(Rs.250 x 12 months)	3,000
Less:	Dividend out of Pre-acquisition Profits (2007-08)	(Rs.8,000 x 50%)	(4,000)
Add:	Share of Proposed Dividend for FY 2008-09	(WN4)	6,750
	Adjusted Balance		**19,750**
Less:	Share of Revenue Loss of M Ltd.		(2,680)
	Consolidated Balance		**17,070**

7. Consolidated Balance Sheet of L Ltd. and its Subsidiary M Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	80,000	**Other Assets**	1,34,000
Reserves & Surplus		**Current Assets:** Cash [7,000 + 4,000]	11,000
Profit and Loss Account	17,070		
Capital Reserve on Consolidation	3,530		
Minority Interest	25,400		
Current Liabilities:			
Sundry Creditors [3,000 + 8,000]	11,000		
Proposed Dividend [shareholders of L Ltd.]	8,000		
Total	**1,45,000**	**Total**	**1,45,000**

Illustration 35: Purchase in Lots - Before Controlling Acqn. - Ex-Dividend & Ex-Bonus

The Balance Sheets of G Ltd. and M Ltd. as on 31.03.2009 are as follows -

Liabilities	G	M	Assets	G	M
Share Capital (Rs.100 Shares)	1,60,000	2,00,000	Investment: Shares in Maurya	–	–
Profit & Loss Account	50,000	60,000	Debtors	1,96,000	1,20,000
Creditors		16,000	Stock in Trade		80,000
			Cash at Bank		70,000
			Cash in Hand	14,000	6,000
Total	**2,10,000**	**2,76,000**	**Total**	**2,10,000**	**2,76,000**

Particulars of Gupta Ltd. -

1. This Company was formed on 1.4.2008.
2. It acquired the shares of M Ltd. as under –

Date of Acquisition	No. of Shares	Cost Rs.
1.4.2007	800	1,10,000
31.7.2007	600	86,000

3. The shares purchased on 31.07.2008 are ex-dividend and ex-bonus from existing holders.
4. On 31.07.2008 dividend at 10% was received from Maurya and was credited to Profit & Loss Account.
5. On 31.07.2008 it received Bonus Shares from Maurya in the ratio of One Share on every Four Shares held.
6. Gupta incurred an expenditure of Rs.500 per month on behalf of Maurya Ltd. and this was debited to the Profit and Loss Account of Gupta Ltd, but nothing has been done in the books of Maurya Ltd.
7. The balance in Profit & Loss A/c as on 31.03.2009 included Rs.36,000 being the net profit made during the year.
8. Dividend proposed for 2008-08 at 10% was not provided for yet.

Particulars of Maurya Ltd. -

1. The balance in the Profit & Loss A/c as on 31.03.2009 is after the issue of Bonus Shares made on 31.07.2008.
2. The Net Profit made during the year is Rs.24,000 including Rs.6,000 received from Insurance Company in settlement of the claim towards loss of stock by fire on 30.06.2008 (Cost Rs.10,800 included in Opening Stock)
3. Dividend proposed for 2008-09 at 10% was not provided for in the accounts.

Prepare the Consolidated Balance Sheet as at 31.03.2009.

Solution:

1. Basic Information

Company Status	Dates of Acquisition	Holding Status
Holding Company = Gupta	Lot 1 800 Shares 01.04.2008	Holding Company = 80%
Subsidiary = Maurya	Lot 2 600 Shares 31.07.2008	Minority Interest = 20%

Consolidation: 31.03.2009

Shareholding Status: 800 (Lot 1 on 01.04.2007) + 600 (Lot 2 on 31.07.2008) + 200 (Bonus Issue 1/4th x 800 shares) = 1,600 Shares out of Total 2,000 Shares = 80%

2. Analysis of Profit & Loss Account of M Ltd.

Balance on 31.03.2009 Rs.60,000

Balance on 01.04.08	36,000		Profit for 2008-09 (Upto consolidation)	24,000
(60,000 - 24,000)		**Less:**	Expenses incurred by G Ltd. (Rs.500 x 12)	(6,000)
Less: Dividend adjusted	(2,000)	**Add:**	Abnormal Item - Loss of Stock Rs. 10,800	
(20,000 Less 18,000)		**Less:**	Insurance Claim Rs.6,000	4,800
Balance Capital Profit	**34,000**		Profit for the year before Dividend	22,800

	01.04.2008 to 31.07.2008 (upto acquisition)		01.07.2008 to 31.03.2009 (upto consolidation)	
	Rs.22,800x4/12=	7,600	Rs.22,800 x 8/12 =	15,200
Less:	Abnormal Item	4,800	**Less:** Dividend 10% x 2,00,000	6,800
	Profit after stock loss	2,800	restricted to profits available	
Less:	Balance Dvd Rs.4,800		Revenue Profit	NIL
	(20,000 - 15,200) adj.	(2,800)		
	to the extent of Profit			
	Balance Capital Profit	NIL		

3. Analysis of Net Worth of M Ltd.

Particulars	Total 100%	G Ltd. 80%	Minority 20%
(a) Equity Share Capital	2,00,000	1,60,000	40,000
(b) Capital Profits: Profit & Loss Account	34,000	27,200	6,800
(c) Revenue Profits: Profit & Loss Account	NIL	–	–
(d) Proposed Dividend	20,000	16,000	4,000
Minority Interest			**50,800**

4. Cost of Control

	Particulars	Rs.
	Cost of Investment in M Ltd.	1,96,000
Less:	Dividend out of Pre-acquisition profits (2007-08) (800 Shares x Rs. 10 x 10%)	(8,000)
	FY 2007-08 Rs.2,000 x 80% x 1,000 Shares * 1,600 Shares	(1,000)
	Adjusted Cost of Investment	**1,87,000**
Less:	(1) Nominal Value of Equity Capital	(1,60,000)
	(2) Share in Capital Profit of M Ltd.	(27,200)
	Capital Reserve on Consolidation	**(200)**

Note: *Out of the Dividend for the year declared, Rs.2,000 is from Profits prior to the date of acquisition. Holding Company's share of pre-acquisition dividend Rs.800 (Rs.2,000 x 80% x 800 Shares ÷ 1,600 Shares) (to the extent of 1,000 Shares including bonus of 200 Shares only) should be adjusted against Investment Account. The balance dividend should be credited to Profit and Loss Account only because –*

- For the first lot of 800 Shares, dividends for the preceding year 2007-08 alone should be reduced from Investment Account.
- Second Lot of 600 Shares were purchased ex-dividend and ex-bonus and therefore the entire dividend received on them should be credited to Profit and Loss Account.

5. Consolidation of Profit and Loss Account

Particulars		Rs.
	Balance as per Balance Sheet of G Ltd.	50,000
Less:	Proposed Dividend (Rs. 1,60,000 x 10%)	(16,000)
Add:	Expenses incurred by M Ltd., (Rs.500 x 12)	6,000
Less:	Dividend out of Pre-acquisition Profits (FY 2007-08 8,000 + FY 04-05 1,000)	(9,000)
Add:	Share of Proposed Dividend for FY 2007-08 (1,600 Shares x Rs. 10 x 10%)	16,000
	Adjusted Balance as at 31.3.2008	**47,000**
Add:	Share of Revenue Profits of M Ltd.,	–
	Consolidated Balance	**47,000**

6. Consolidated Balance Sheet of G Ltd. and its Subsidiary M Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	1,60,000	**Fixed Assets**	NIL
Reserves and Surplus:		**Current Assets**	
Profit & Loss A/c	47,000	Trade Debtors	1,20,000
Capital Reserve on Consolidation	200	Stock in Trade	80,000
Minority Interest:	50,800	Cash at Bank	70,000
Current Liabilities: Trade Creditors	16,000	Cash in Hand (14,000 + 6,000)	20,000
Proposed Dvnd.	16,000		
Total	**2,90,000**	**Total**	**2,90,000**

Illustration 22: Purchase in Lots – Treatment of Pre-acquisition Dividend

Following are the Balance Sheets of M Ltd. and N Ltd. as at 31.03.2009 -

Liabilities	M Ltd.	N Ltd.	Assets	M Ltd.	N Ltd.
Equity Share Capital of Rs.100 each fully paid	6,00,000	1,00,000	Land & Building	2,00,000	1,00,000
			Machinery	2,80,000	50,000
General Reserve	50,000	30,000	7000 Shares in N	1,00,000	–
Profit & Loss Account	80,000	40,000	Stock in Trade	70,000	40,000
Sundry Creditors	1,00,000	40,000	Debtors	1,50,000	20,000
Bills Payable	10,000	15,000	Bills Receivable	10,000	–
			Cash at Bank	30,000	15,000
Total	**8,40,000**	**2,25,000**	**Total**	**8,40,000**	**2,25,000**

Prepare Consolidated Balance Sheet as at 31st March, 2009 from the following additional Information -

1. All the Bills Receivable of M Ltd. including those discounted were accepted by N Ltd.
2. When M Ltd. had acquired 600 Shares in N Ltd., the latter had Rs.20,000 in General Reserve and Rs.5,000 Credit Balance in Profit and Loss Account.
3. At the time of acquisition of further 100 Shares by N Ltd., the latter had Rs. 25,000 General Reserve and Rs. 28,000 Credit Balance in Profit and Loss Account, from which 20% dividend was paid by N Ltd.
4. The dividends received by M Ltd. on these shares were credited to Profit & Loss Account.
5. Stock of N Ltd. includes goods valued at Rs.20,000 purchased from M Ltd. which has made 25% profit on cost.
6. For the financial year ending 31.03.2009, M Ltd. had proposed a dividend of 10% and N Ltd. has proposed a dividend of 15%, but no effect has yet been given in the above Balance Sheets.

Solution:

1. Basic Information

Company Status		Date of Acquisition		Holding Status	
Holding Company	= M Ltd.	Lot 1 = 600 Shares	= DOA - 1	Holding Company	= 70%
Subsidiary	= N Ltd.	Lot 2 = 100 Shares	= DOA - 2	Minority Interest	= 30%

Date of Consolidation = 31.03.2009

2. Analysis of Reserves & Surplus of Kaurava Ltd.

(a) General Reserve as per B/s = Rs.30,000

As on DOA-1	For the period DOA-1 to DOA-2 (Lot 2 date)	From DOA-2 to B/s Date
(Lot 1 date)	Rs.25,000 - Rs.20,000 = Rs.5,000	(upto Consolidation)
Rs.20,000	For 600 Shares (Lot 1): **Revenue**	**Rs.5,0000)** (bal. figure)
Capital	For 100 Shares (Lot 2): **Capital**	**Revenue**

Total Capital Profits = Rs.20,000; Total Revenue Reserves = Rs. 10,000 **(See Note)**

Note: *Addition to Reserves of Rs.5,000 between DOA-1 and DOA-2 have been considered as Revenue Reserves in full, only for the purpose of determining the share of Minority Interest. After allocating for Minority Interest, the revenue portion of Rs.500 (i.e. 10% Shares x Rs.5,000) will be added to Capital Profits.*

(b) Profit & Loss Account

	P & L A/c Balance as per B/s	= Rs. 40,000
Less:	Proposed Dividend = 1,00,000 x 15%	= Rs. 15,000
	Adjusted Balance of N Ltd.'s Profits	= Rs. 25,000

As on DOA-1	For the period DOA-1 to DOA-2 (Lot 2 date)	From DOA-2 to B/s Date
(Lot 1 date)	Rs.28,000 - Rs.5,000 = Rs.23,000	(upto Consolidation)
Rs.5,000	**Less:** Dividend out of this = Rs.20,000	**Rs.17,000** (bal. figure)
	Net Balance = **Rs. 3,000**	
Capital	For 600 Shares (Lot 1): **Revenue**	**Revenue**
	For 100 Shares (Lot 2): **Capital**	

Total Capital Profits = Rs.5,000; Total Revenue Reserves = Rs.5,000 **(See Note)**

Note: *Addition to P&L A/c Rs.3,000 between DOA-1 and DOA-2 have been fully considered as Revenue only for the purpose of determining the share of Minority Interest. After allocating for minority Interest, the revenue portion of Rs.300 (i.e. 10% Shares x Rs.3,000) will be added to Capital Profits.*

3. Analysis of Net Worth of N Ltd.

	Particulars	Total	M Ltd.	Minority
	% of share Holding on Consolidation Date	**100%**	**70%**	**30%**
(a)	**Equity Share Capital**	**1,00,000**	70,000	30,000
(b)	**Capital Profits:** General Reserve	20,000		
	Profit & Loss Account	5,000		
		25,000	17,500	7,500
Add:	Capital Items [Res Rs.5000 + P&L A/c Rs.3,000] x 10%		800	
	Net Share in Capital Profit		18,300	
(c)	**Revenue Reserves:** General Reserve	**10,000**	7,000	3,000
Less:	Capital Item included in Revenue [Rs.5,000 x 10%]		(500)	
	Net Share in Revenue Reserves		6,500	
(d)	**Revenue Profits:** Profit & Loss A/c	**20,000**	14,000	6,000
Less:	Capital Item included in Revenue [Rs.3,000 x 10%]		(300)	
	Net Share in Revenue Profit		13,700	
(e)	**Proposed Dividend**	**15,000**	10,500	4.500
	Total Minority Interest			**51,000**

4. Cost of Control

	Particulars		Rs.
	Cost of Investment in Equity Shares of N Ltd.		1,00,000
Less:	Dividend out of Pre-acquisition profits of N Ltd. (Only for Lot 2 - 1000 Shares) - (Rs. 10,000 x 20%)		2,000
	Adjusted Cost of Investment		98,000
Less:	(1) Nominal Value of Equity Capital	70,000	
	(2) Share in Capital Profit of N Ltd.	18,300	88,300
	Goodwill on Consolidation		**9,700**

5. Consolidation of Reserves & Surplus

	Particulars		Gen. Res	P&L A/c
	Balance as per Balance Sheet of M Ltd.		50,000	80,000
Less:	Dividend out of Pre-acquisition Profits	(Rs.20,000 x 10%)	–	(2,000)
Less:	Proposed Dividend	(Rs.6,00,000 x 10%)	–	(60,000)
Add:	Share of Dividend from N Ltd.	(Rs. 15,000 x 70%)	–	10,500
	Adjusted Balance		**50,000**	**28,500**
Add:	Share of Revenue Profits/Reserves of N Ltd.		6,500	13,700
	Consolidated Balance		**56,500**	42,200
Less:	Unrealised Profits on Closing Stock Rs.20,000 x 25 / 125		–	(4,000)
	Adjusted Consolidated Balance		**56,500**	**38,200**

6. Consolidated Balance Sheet of M Ltd. and its Subsidiary N Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	6,00,000	**Fixed Assets**	
Reserves & Surplus		Goodwill on Consolidation	9,700
General Reserve	56,500	Land & Building (2,00,000 + 1,00,000)	3,00,000
Profit & Loss Account	38,200	Plant & Machinery (2,80,000 + 50,000)	3,30,000
Minority Interest	51,000	**Current Assets**	
Current Liabilities		Stock in Trade [70,000 + 40,000 - 4,000 (Stock Reserve)]	1,06,000
B/P [10,000 + 15,000 - 10,000 (Mutual)]	15,000		
Trade Creditors [1,00,000 + 40,000]	1,40,000	Trade Debtors [1,50,000 + 20,000]	1,70,000
Proposed Dividend (M Ltd.)	60,000	B/R [10,000 - 10,000 (Mutual Owings)]	NIL
		Cash at Bank [30,000 + 15,000]	45,000
Total	**9,60,700**	**Total**	**9,60,700**

Notes:

- *Balance Sheet items have been consolidated on line-by-line addition basis.*
- *Stock Reserve i.e. unrealized profits on Closing Stock have been eliminated in full from Group reserves as it relates to downstream transaction (i.e. Holding to Subsidiary).*
- *Inter-Company Owings have been eliminated in full.*

Illustration 23: Purchase in Multiple Lots - Asset sold by Holding Co. to Subsidiary Co.

Z Ltd. acquired 60% of shares of P Ltd. as on 30th June, 2005. As on 31st December, 2007, Balance Sheet of P Ltd. shows a balance in General Reserves Rs.2,00,000 and in Profit and Loss Account Rs.20,000. Subsequently Hema Ltd. purchased another 10% shares of P Ltd. on 30th September, 2008. Finally Z Ltd. purchased another 20% Shares as on 30th November, 2008. Given below the Balance Sheets of Z Ltd. and P Ltd. as on 31st December, 2008 -

Liabilities	Z Ltd.	P Ltd.	Assets	Z Ltd.	P Ltd.
Share Capital	10,00,000	6,00,000	**Fixed Assets**	16,00,000	10,00,000
General Reserve	4,00,000	1,00,000	(-) Accumulated Depreciation	4,00,000	2,00,000
P & L Account	2,00,000	1,00,000	**Net Block**	12,00,000	8,00,000
Loans	3,00,000	4,00,000	Investments	6,00,000	2,00,000
Sundry Creditors	4,00,000	2,00,000	Current Assets		
Provision for Tax	1,00,000	80,000	Stock	4,00,000	3,00,000
Proposed Dividend	2,00,000	1,20,000	Debtors	3,00,000	2,00,000
			Cash & Bank	1,00,000	1,00,000
Total	**26,00,000**	**16,00,000**	**Total**	**26,00,000**	**16,00,000**

Other Information's:

1. The initial of investment in P Ltd. was made by Z Ltd. for Rs.3,00,000. The second phase of Investment was made by Z Ltd. for Rs. 80,000 and the last phase of investment was made for Rs.1,50,000.
2. P Ltd. declared and paid Bonus Shares at one for every two Shares held. For this purpose the book closure date was 15th July to 31st July, 2008.
3. Z Ltd. sold a machinery costing Rs.4,00,000 to P Ltd. on 15th September, 2008 on which the former made a profit of Rs.1,00,000. P Ltd. charged depreciation at 20% on the plant on time proportion basis.

Prepare a Consolidated Balance Sheet for Z Ltd. and its subsidiary P Ltd. as on 31.12.2008.

Solution:

1. Basic Information

Company Status	Date of Acquisition	Holding Status
Holding Company = Z Ltd. Subsidiary = P Ltd.	Lot 1 = 60% Shares = 30.06.2008 Lot 2 = 10% Shares = 30.09.2008 Lot 3 = 20% Shares = 30.11.2008	Holding Company = 90% Minority Interest = 10%

Date of Consolidation = 31.12.2008

2. Analysis of Reserves & Surplus of P Ltd.

(a) General Reserve

Balance on 31.12.2008 Rs. 1,00,000

Balance on 1.1.2008	2,00,000	Transfer during 2008 (balancing figure)	**Rs. 1,00,000**
Less: Bonus Issue	2,00,000		
Capital Profit	**Nil**		

	Upto 30.6.08	1.7.08 to 30.9.08	1.10.05 to 30.11.08	1.12.08 to 31.12.08
	6 Months	3 Months	**2 Months**	**1 Month**
	100000 x 6/12	100000 x 3/12 =	100000 x 2/12 =	00000 x 1/12 =
	=	**Rs. 25,000**	**Rs.16,667**	**Rs. 8,333**
Capital Profit for	**Rs.50,000**	30%	20%	–
Revenue Reserve for	90%	60%	70%	90%
Total Holdings by Z Ltd.		90%	90%	90%

Total Capital Profits: **Rs. 50,000;** Total Revenue Profits: **Rs. 50,000**

Note: *Additions to General Reserve Account are fully considered as revenue only for the purpose of determining Minority Interest. After allocating the Minority Interest the respective Capital Portion will be transferred to Capital Profits.*

(b) Profit & Loss Account

Balance on 31.12.2008 Rs. 1,00,000

Balance on 1.1.2008	**20,000**	Profit earned during 2008 (b/f)	**Rs.80,000**
	Capital Profit	**Add:** Depreciation on Machinery	Rs.29,167
		(Rs.5 Lakhs x 3.5 Months / 12 x 20%)	**Rs.1,09,167**

	Upto 30.6.08	**1 1.7.08 to 30.9.08**	**1.10.08 to 30.11.08**	**1.12.08 to 31.12.08**
	6 Months	3 Months	2 Months	1 Month
	109167 x 6/12 =	109167 x 3/12 =	109167 x 2/12 =	109167 x 1/12 =
	Rs.54,584	**Rs.27,292**	**Rs.18,195**	**Rs.9,096**
Less: Depreciation	–	Rs.4,167	Rs. 16,667	Rs.8,333
	–	(29167 x 0.5/3.5)	(29167 x 2.0/3.5)	(29167 x 1.0/3.5)
	Rs. 54,584	**Rs.23,125**	**Rs.1,528**	**Rs.763**
Capital Profit for	90%	30%	20%	–
Revenue Profit for	–	60%	70%	90%
Total Holdings by Z Ltd.		90%	90%	90%

Total Capital Profits: Rs. 54,584 + Rs.20,000 = **Rs.74,584; Total Revenue Profits: Rs. 25,416**

Note:

- *Profits are assumed to have been evenly spread out throughout the year.*
- *Additions to the P&L A/c after 30.06.2008 are fully considered as revenue only for the purpose of determining Minority Interest. After allocating the Minority Interest the respective Capital Portion will be transferred to Capital Profits.*

3. Computation of amount to be transferred from Revenue Profits to Capital Profits

Period	% of holding considered as Capital	P&L A/c	General Reserve
30.6.2008-30.9.2008	30%	23,125 x 30% = Rs.6,938	25,000 x 30% = Rs. 7,500
30.9.2008-30.11.2008	20%	1,528 x 20% = Rs. 306	16,667 x 20% = Rs. 3,333
		Rs.7,244	Rs. 10,833

4. Analysis of Net Worth of S Ltd.

Particulars			Total	Z Ltd.	Minority
			100%	90%	10%
(a) **Equity Share Capital**			**6,00,000**	5,40,000	60,000
(b) **Capital Profits:**		General Reserve	50,000		
		Profit & Loss Account	74,584		
			1,24,584	1,12,126	12,458
	Add:	Capital Items (7,244 + 10,833)		18,077	
				1,30,203	
(c) **Revenue Reserve:**		General Reserve	**50,000**	45,000	5,000
	Less:	Capital Item included in Revenue		(10,833)	
				34,167	
(d) **Revenue Profits:**		Profit & Loss Account	**25,416**	22,874	2,542
	Less:	Capital Item included in Revenue		(7,244)	
				15,630	
(e) **Proposed Dividend**			**1,20,000**	1,08,000	12,000
Minority Interest					**92,000**

5. Cost of Control

	Particulars		Rs.
	Cost of Investment in Equity Shares of P Ltd.		5,30,000
Less:	Pre-acquisition Dividend		(65,000)
	Adjusted Cost of Investment		
Less:	(1) Nominal Value of Equity Capital	5,40,000	4,65,000
	(2) Share in Capital Profit of P Ltd.	1,30,203	6,70,203
	Capital Reserve on Consolidation		**(2,05,203)**

6. Computation of Pre-acquisition Dividend

Particulars	Pre-Acquisition Dividend	Post Acquisition Dividend
Lot 1 - 60% - Acqd. on 30.6.2008	1,20,000 x 6/12 x 60% = Rs.36,000	1,20,000 x 6/12 x 60% = Rs.36,000
Lot 2 - 80% - 01.07.08 to 30.09.08	1,20,000 x 3/12 x 80% = Rs.24,000	1,20,000 x 3/12 x 20% = Rs. 6,000
Lot 3 - 90% - 30.09.08 to 30.11.08	1,20,000 x 2/12 x 90% = Rs. 18,000	1,20,000 x 1/12 x 10% = Rs. 1,000
Total	**Rs.65,000**	**Rs.43,000**

7. Consolidation of Reserves and Surplus

	Particulars		P&L A/c	Gen. Res.
	Balance as per Balance Sheet of Z Ltd.		2,00,000	4,00,000
Add:	Proposed Dividend from P Ltd.		43,000	–
Add:	Share of Revenue Profits / Reserves of P Ltd.		15,630	34,167
Less:	Unrealized Profit on Machinery sold			
	Profit on Sale of Machinery	1,00,000		
Less:	Depreciation on Profit (1,00,000 x 20% x 3.5/12)	(5,833)	(94,167)	–
	Consolidated Balance		**1,64,463**	**4,34,167**

8. Consolidated Balance Sheet of Z Ltd. and its subsidiary P Ltd. as at 31.12.2008

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	10,00,000	**Fixed Assets:** (12,00,000 + 8,00,000 - Unrealised Profits 94,167)	19,05,833
Reserves and Surplus.			
– General Reserve	4,34,167	**Investments**	
– Profit & Loss Account	1,64,463	(6,00,000 - 5,30,000 - 2,00,000)	2,70,000
– Capital Reserve on Consolidation	2,05,203	**Current Assets**	
Minority Interest:	92,000	Sundry Debtors (3,00,000 + 2,00,000)	5,00,000
Loan Funds : (3,00,000 + 4,00,000)	7,00,000	Stock in Trade (4,00,000 + 3,00,000)	7,00,000
Current Liabilities:		Cash at Bank (1,00,000 + 1,00,000)	2,00,000
Sundry Creditors (4,00,000 + 2,00,000)	6,00,000		
Provision for Tax (1,00,000 + 80,000)	1,80,000		
Proposed Dividend (Hema Ltd.)	2,00.000		
Total	**35,75,833**	**Total**	**35,75,833**

Note: *Unrealised Profit on Sale of Machinery has been eliminated fully from Group Reserves as it relates to Downstream Activity (i.e. Holding to Subsidiary).*

G. CHAIN HOLDINIG

Illustration 24 : Chain Holding - Multiple Subsidiaries - 100% Subsidiary

P Ltd. purchases its raw materials from H Ltd. and sells goods to Q Ltd. In order to ensure regular supply of raw materials and patronage for finished goods, P Ltd. through its wholly owned subsidiary, G Ltd. acquires on 31.03.2009, 51% of Equity Capital of H Ltd. for Rs.15 Crores and 76% of Equity Capital of Q Ltd. for Rs.30 Crores. G Ltd. was floated by P Ltd. in 2000 from which date it was wholly owned by P Ltd.

The following are the Balance Sheets of the four companies as at 31.3.2009 (Rs.Crores) -

Particulars			P Ltd.	G Ltd.	H Ltd.	Q Ltd.
	SOURCES OF FUNDS					
1.	Shareholders Funds:	Equity (Fully paid) Rs.10 each	25	5	10	15
		Reserves and Surplus	75	20	15	20
			100	25	25	35
2.	Loan Funds:	Secured Loans	15	–	5	20
		Unsecured Loans	10	50	10	15
			25	50	15	35
	Total Sources of Funds		**125**	**75**	**40**	**70**
	APPLICATION OF FUNDS:					
1.	Fixed Assets: Cost		60	–	15	30
	Less: Depreciation		35	–	7	17
			25	–	8	13
2.	Investments at Cost in Fully paid Equity Shares of:					
	Giri Ltd.		5	–	–	–
	Hari Ltd.		–	15	–	–
	Pari Ltd.		–	30	–	–
	Other Companies (Market Value Rs.116 Crores)		–	29	–	–
3.	Net Current Assets:	Current,Assets	5	74	–	–
	Less:	Current Liabilities	105	1	96	200
			10		64	143
			95	1	32	57
	Total Application of Funds		**125**	**75**	**40**	**70**

There are no inter-company transactions outstanding between the Companies. Prepare Consolidated Balance Sheet as at 31.03.2009.

Solution:

1. Basic Information (for Consolidation on 31.03.2005)

Company Status		Dates		Holding Status			
Holding Company	= P	Acquisition:				**Holding**	**Minority**
Subsidiary	= G	P in G 2001		a.	G Ltd.	(P)100%	Nil
Sub-Subsidiary 1	= H	G in H:	31.03.2009	b.	H Ltd.	(G) 51%	49%
Sub-Subsidiary 2	= Q	G in Q:	31.03.2009	c.	Q Ltd.	(G) 76%	24%

2. Analysis of Reserves and Surplus of Subsidiary Companies

Giri Ltd. is wholly owned subsidiary from the beginning and therefore the entire amount of Reserves represents Revenue Portion. H Ltd. and Q Ltd. were acquired only on 31.03.2009 which is also the date of consolidation and hence, entire balance in Reserves and Surplus represents Capital Profits.

3. Analysis of Net Worth of Subsidiaries (Rs. Crores)

Particulars		**P Ltd.**			**Minority Interest**	
		100%				
		G Ltd. →	**H Ltd.** 76% →	**Q Ltd.**	**H Ltd.** **49%**	**Q Ltd.** **24%**
(a)	**Share Capital**	5.00	10.00	15.00		
Less:	Minority Interest	NIL	4.90	3.60	4.90	3.60
	Holding Co's Share	**5.00**	**5.10**	**11.40**		
(b)	**Capital Profits** Reserves & Surplus	–	15.00	20.00	7.35	4.80
	Tfr of G Share in H & Q	7.65	(7.65)	(15.20)		
		15.20	[15 x 51%]	[20 x 76%]		
		22.85	**7.35**	**4.80**		
Less:	Minority Interest	–	(7.35)	4.80 [20 x		
			[15 x 49%]	24%]		
	Holding Co's Share	**22.85**	**NIL**	**NIL**		
c)	**Revenue Profits:** Reserves & Surplus	**20.00**	**NIL**	**NIL**	**NIL**	**NIL**
	Minority Interest				**12.25**	**8.40**

4. Cost of Control

	Particulars		**Rs. Crores**
	Cost of Investment: P Ltd. in G Ltd.		5.00
	G Ltd. in H Ltd.		15.00
	G Ltd. in Q Ltd		30.00
	Total Cost of Investment		**50.00**
Less:	(a) Nominal Value of Share Capital in: - G Ltd.	5.00	
	- H Ltd.	5.10	
	- Q Ltd.	11.40	(21.50)
	(b) Share in Capital Profits of G Ltd.		(22.85)
	Goodwill on Consolidation		**5.65**

5. Consolidated Balance Sheet of P Ltd. and its subsidiaries G, H and Q, as at 31.03.2009

Liabilities	**Rs.Crores**	**Assets**	**Rs.Crores**
Share Capital: Equity Capital	25.00	**Fixed Assets:** Goodwill on Consolidation	5.65
Reserves and Surplus:	95.00	Other Fixed Assets Cost (60 + 15 + 30) 105	
(75.00 + 20.00 Share in Revenue of		**Less:** Depreciation (35 + 7 + 17) 59	46.00
G Ltd.)		**Investments:** Other Co's [MV Rs.116 Crores]	
Minority Interest: (a) H Ltd.	12.25	**Current Assets, Loans & Advances:**	29.00
(b) Q Ltd.	8.40	(105 + 1 +96 + 200)	402.00
Secured Loans (15 + 5 + 20)	40.00		
Unsecured Loans (10 + 50 + 10 + 15)	85.00		
Current Liabilities: (10 + 64 + 143)	217.00		
Total	**482.65**	**Total**	**482.65**

Illustration 25: Chain Holding - Direct & Indirect Method — Abnormal Loss, Dividend

You are given the following Balance Sheets as on 31.12.2008 (Rs.000s)

Liabilities	A Ltd.	B Ltd.	C Ltd.	Assets	A Ltd.	B Ltd.	C Ltd.
Share Capital (Rs.100)	2,000	1,000	800	Fixed Assets	**1,500**	900	970
General Reserve	600	300	200	Current Assets	**450**	300	300
Securities Premium	200	50	NIL	Investments	**1,300**	580	NIL
Profit & Loss A/c	250	180	120	B Ltd. Balance	**70**	NIL	NIL
Creditors	300	200	140	C Ltd. Balance	**30**	NIL	NIL
A Ltd. Balance		50	30	Preliminary Expenses	**NIL**	NIL	20
Total	**3,350**	**1,780**	**1,290**	**Total**	**3,350**	**1,780**	**1,290**

A Ltd. had acquired 8000 Shares in B Ltd. at a total cost of Rs.11,00,000 on 01.07.2007. On 01.01.2008, A Ltd. purchased respectively 1,000 and 5,000 Shares in C Ltd. at Rs.116 per Share.

Particulars about General Reserve and the Profit & Loss Account are as given below (Rs.000's)

Particulars	A Ltd.	BLtd.	CLtd.
General Reserve: As on 1.1.2007	550	250	200
Profit & Loss A/c: As on 1.1.2007	50	40	20
Profit for 2007	170	100	100
Dividend paid in August 2008 in respect of 2007	10%	12%	10%

A Ltd. and B Ltd. have credited the dividends received by them to their Profit & Loss Accounts. Increase in Reserves were made in 2008. On 31.12.2008, C Ltd. sold goods costing Rs.20,000 to B Ltd. for Rs.25,000, these were immediately sold for Rs.28,000 to A Ltd. Prepare the Consolidated Balance Sheet of the Group as at 31.12.2008.

Solution:

1. Basic Information

Company Status	Dates	Holding Status		
Holding Company = A Ltd.	**Acquisition:**	a. Holding Co.	**B Ltd.**	**C Ltd.**
Subsidiary = B Ltd.	A in B: 01.07.2007		(A Ltd.) 80%	(A) 12.5%
Sub-Subsidiary = C Ltd.	A in C: 01.01.2008		–	(B) 62.5%
	B in C: 01.01.2008	b. Minority Int.	20%	25%
	Consolidation 31.12.2008			

Note: *The Shareholding Pattern is analysed as under–*

Co.	Held by A Ltd	Held by B Ltd	Total Holdings	Minority Int.	Total Shares
B Ltd.	8,000 (80%) acquired on 01.07.2007	N.A.	8,000 (80%)	2,000 (20%)	10,000 (100%)
C.Ltd.	1,000 (12.5%) acquired on 01.01.2008	5,000 (62.5%) acquired on 01.01.2005	6,000 (75%)	2,000 (25%)	8,000 (100%)

2. Analysis of Reserves and Surplus of Subsidiary Companies

(a) General Reserve

B Ltd.

31.12.2008 3,00,000

1 1 01.01.2007	Tfr in 2007	1 Tfr in 2008
Rs.2,50,000	NIL	Rs.50,000
Capital	**Capital**	**Revenue**

C Ltd.

31.12.2008 2,00,000

01.01.2007	Tfr in 2007	Tfr in 2008
Rs.2,00,000	NIL	**NIL**
Capital	**Capital**	**Revenue**

(b) Profit & Loss Account C Ltd.

Balance as given on 31.12.2008 Rs. 1,20,000

1.1.2007	Profit for 2007	Dividend for 2007	Profit for 2008
Rs.20,000	Rs. 1,00,000	Rs.8 Lacs x 10% = (Rs.80,000)	(b/f) Rs.80,000
Capital	**Capital**	**Capital**	**Revenue**

Total Capital Profit: 20,000 + 1,00,000 - 80,000 = **Rs.40,000; Total Revenue Profit: Rs.80,000**

B Ltd.

	Balance as given on 31.12.2008	1,80,000
Less:	Pre-Acquisition Dividend from C Ltd. (80,000 x 5 / 8)	50,000
	Adjusted Balance	**1,30,000**

01.01.2007	Profit for 2007	Dividend for 2007	Profit for 2008
Rs.40,000	Rs. 1,00,000	Rs.10 Lacs x 12% = (Rs. 1,20,000)	**Rs.1,10,000**
Capital			**Revenue** (bal. figure)

1.1.2007 to 1.7.2007	1.7.2007 to 31.12.2007	From Opg Bal. (bal. figure)	From Profit for 1.1.07 to 1.7.07	From Profit 1.1.07 to 31.12.07
Rs.50,000	Rs.50,000	**(Rs.20,000)**	(Rs.50,000)	(Rs.50,000)
Capital	**Capital**	**Capital**	**Capital**	**Revenue**

Total Capital Profit: 40,000 + 50,000 - 20,000 - 50,000 = **Rs.20,000;**

Total Revenue Profit: 1,10,000 + 50,000 - 50,000 = **Rs.1,10,000**

Note: • ***It*** *has been assumed that the Profits arose evenly throughout the year.*

- *Dividend declared for 2007 = Rs. 1,20,000, but profit for 2007 is Rs. 1,00,000. So it is presumed* ***that*** *Rs.20,000 declared from opening reserve.*

(c) Securities Premium: B Ltd. = Rs. 50,000 – Capital Profit

(d) Preliminary Expenses: C Ltd. = (Rs.20,000) – Capital Profit

3. Analysis of Net Worth of Subsidiary Companies

Particulars	Indirect Method				Direct Method			
	A Ltd. 80% 12.5%		**Minority Interest**		**A Ltd.** 80% 12.5%		**Minority Interest**	
	B Ltd. 62.5% →	**C Ltd.**	**B Ltd.**	**CLtd**	**B Ltd.** 62.5% →	**C Ltd**	**Bharat**	**India**
			20%	**25%**			**20%**	**25%**
(a) Share Capital	**10,00,000**	**8,00,000**	2,00,000	2,00,000	**10,00,000**	**8,00,000**	2,00,000	2,00,000
Less: Minority Interest	(2,00,000)	(2,00,000)			(2,00,000)	(2,00,000)		
	8,00,000	**6,00,000**			**8,00,000**	**6,00,000**		
(b) Capital Profits					50,000	2,00,000		
Securities Premium	50,000				2,50,000	40,000		
General Reserve	2,50,000	2,00,000			20,000	(20,000)		
Profit & Loss Account	20,000	40,000						
Preliminary Expenses	–	(20,000)						
	3,20,000	**2,20,000**			**3,20,000**	**2,20,000**		
Transfer of B's Share in C (62.50% x Rs. 2,20,000)	1,37,500	(1,37,500)	25%		NOT APPLICABLE		25%	
Less: Minority Interest	20% **4,57,500**	**82,500**			**3,20,000**	**2,20,000**		
	91,500)	(55,000)	91,500	55,000	(64,000)	(55,000)	64.000	55,000
	3,66,000	**27,500**			**2,56,000**	**1,65,000**		
(c) Revenue Reserve	20% **50,000**	**NIL**			**50,000**	**NIL**		
Less: Minority Interest	10,000	**NIL**	10,000	NIL	10,000	NIL	10,000	NIL
	40,000	**NIL**			**40,000**	**NIL**		
(d) Revenue Profit	**1,10,000**	**80,000**			**1,10,000**	**80,000**		
Transfer of B's Share in C (62.50% x Rs. 80,000)	50,000	(50,000)	25%		50,000	(50,000)	25%	
	20% **1,60,000**	**30,000**			**1,60,000**	**30,000**		
Less: Minority Interest	(32,000)	(20,000)	32,000	20,000	(32,000)	(20,000)	32,000	20,000
	1,28,000	**10,000**			**1,28,000**	**10,000**		
Minority Interest Before Adjustment			**3,33,500**	**2,75,000**			**3,06,000**	**2,75,000**
Less: Stock Reserve (28,000 - 20,000) * 20%			1,600	–			1,600	–
Minority Interest after Stock Reserve			**3,31,900**	**2,75,000**			**3,04,400**	**2,75,000**

Note: *In B Ltd. as the entire stock was immediately sold, no Stock Reserve arises.*

4. Cost of Control

	Particulars	Indirect Method		Direct Method	
	Cost of Investment: A Ltd. in B Ltd.		11,00,000		11,00,000
	A Ltd. in C Ltd.		1,16,000		1,16,000
	B Ltd. in C Ltd.		5,80,000		5.80.000
	Total Cost of Investment		**17,96,000**		**17,96,000**
Less:	**Pre acquisition Dividend**				
	From B to A [20,000 + 50,000) x 80%]	56,000		56,000	
	From C to A [80,000 x 12.5%]	10,000		10,000	
	From C to B [80,000 x 62.5%]	50,000	(1,16,000)	50,000	(1,16,000)
	Adjusted Cost of Investment		**16,80,000**		**16,80,000**
Less:	(a) Nominal Value of Capital: B Ltd.	8,00,000		8,00,000	
	C Ltd.	6,00,000	(14,00,000)	6,00,000	(14,00,000)
	(b) Share in Capital Profit of: B Ltd.	3,66,000		2,56,000	
	C Ltd.	27,500	(3,93,500)	1,65,000	(4,21,000)
	Capital Reserve on Consolidation		**(1,13,500)**		**(1,41,000)**

5. Consolidation of Reserves & Surplus

	Particulars	Indirect Method		Direct Method	
		Gen. Res.	P&L A/c	Gen. Res.	P&L A/c
	Balance as per Balance Sheet of A Ltd.	6,00,000	2,50,000	6,00,000	2,50,000
Less:	Pre Acquisition Dividend				
	From B to A [20,000 + 50,000) x 80%]	–	(56,000)	–	(56,000)
	From C to A [80,000 x 12.5%]	–	(10,000)	–	(10,000)
	Adjusted Balance	**6,00,000**	**1,84,000**	**6,00,000**	**1,84,000**
Add:	Share of Revenue Reserves/Profits from: B Ltd.	40,000	1,28,000	40,000	1,28,000
	C Ltd.	NIL	10,000	NIL	10,000
	Consolidated Balance	**6,40,000**	**3,22,000**	**6,40,000**	**3,22,000**
Less:	Stock Reserve (28000 - 25000) + (25000 - 20000) x 80%		(6,400)		(6,400)
	Adjusted Consolidated Balance	**6,40,000**	**3,15,600**	**6,40,000**	**3,15,600**

6. Consolidated Balance Sheet of A Ltd. anc its Subsidiaries B Ltd. and C Ltd. as at 31.12.2008

Liabilities	Indirect	Direct	Assets	Indirect	Direct
Equity Share Capital	20,00,000	20,00,000	**Fixed Assets**	33,70,000	33,70,000
Reserves & Surplus			(1500 + 900 + 970)		
Securities Premium	2,00,000	2,00,000			
General Reserve	6,40,000	6,40,000	**Invts:** (1300000 + 580000	84,000	84,000
Profit & Loss Account	3,15,600	3,15,600	-1796000 Inter Co)		
C/R on Consolidation	1,13,500	1,41,000	**Current Assets** (450000 +		
Minority Interest			300000 + 300000 - 8000	10,62,000	10,62,000
(a) B Ltd.	3,31,900	3,04,400	(Stock Res.) + 20000		
(b) C Ltd.	2,75,000	2,75,000	(Chq in Transit)		
Current Liabilities:					
(300 + 200 + 140)	6,40,000	6,40,000			
Total	**45,16,000**	**45,16,000**	**Total**	**45,16,000**	**45,16,000**

Notes:

- *Stock Reserve i.e. unrealized profits on Closing Stock have been eliminated to the extent of Holding Company's Share in P& L and balance in Minority Interest.*
- *Inter Company Owings have been eliminated in full.*

Illustration 26: Chain Holding - Direct & Indirect Method

Balance Sheets of 3 Companies A Ltd., B Ltd., and C Ltd. as at 31.12.2008 is given below -

Liabilities	A Ltd.	B Ltd.	C Ltd.	Assets	A Ltd.	B Ltd.	C Ltd.
Share Capital	2,50,000	2,00,000	1,20,000	Fixed Assets	56,000	1,10,000	75,000
Reserves	36,000	20,000	14,400	Investments at Cost			
Profit & Loss A/c	32,000	4,000	10,200	- In Shares of B Ltd.	1,70,000	—	—
Chand Balance	6,600	—	—	- In Shares of C Ltd.	36,000	1,06,000	—
Arun Balance	—	14,000	—	Stock in Trade	24,000	—	—
Sundry Creditors	14,000	10,000	—	Sundry Debtors	36,600	32,000	63,000
				B Ltd.	16,000		
				A Ltd.	—	—	6,600
Total	**3,38,600**	**2,48,000**	**1,44,600**	**Total**	**3,38,600**	**2,48,000**	**1,44,600**

Additional Information:

1. Share Capital of all the Companies is divided in to Shares of Rs.100 each.
2. A Ltd. held 1,500 Shares of B Ltd. and 300 Shares of C Ltd., B Ltd. held 800 shares of C Ltd.
3. All investments were made on 30.06.2008.
4. On 01.01.2008, B Ltd.'s books showed a Reserves Balance of Rs.18,000 and Profit & Loss Account stood at Rs.2,000 (Cr.). On the same date, books of C Ltd. reflected the following balances: Reserves - Rs.12,000; and P&L A/c - Rs.1,680 (Cr.).
5. Dividends have not been declared by any Company during the year, nor are any proposed.
6. B Ltd. sold goods costing Rs.8,000 to A Ltd. at the price of Rs.8,800. These goods were still unsold on 31.12.2008.
7. A Ltd. remitted Rs.2,000 to B Ltd. on 30.12.2008, but the same was not received by B Ltd. as at the Balance Sheet date.

Prepare Consolidated Balance Sheet of the Group.

Solution:

1. Basic Information

Company Status	Dates	Holding Status		
Holding Company = A Ltd.	Acquisition: 30.06.2008		**B** Ltd.	**C** Ltd.
Subsidiary = B Ltd.	Consolidation: 31.12.2008	a. Holding Co.	(A Ltd.) 75%	(A Ltd.) 25%
Sub-Subsidiary = C Ltd.			–	(B Ltd.) 67%
		b. Minority Int.	25%	8%

***Note:** Shareholding Pattern is as under-*

Company	Held by A Ltd.	Held by B Ltd.	Total Holdings	Minority Interest	Total No. of Shares
Balu	1,500 (75%)	N.A.	1,500 (75.00%)	500 (25.00%)	2,000 (100%)
Chand	300 (25%)	800 (66.67%)	1,100 (91.67%)	100 (8.33%)	1,200 (100%)

2. Analysis of Reserves and Surplus of Subsidiory Companies

(a) General Reserve

B Ltd.

On B/s date Rs.20,000

1.1.08 **Rs.18,000** Tfr in 2008 **Rs.2,000**

Prev B/s **Capital**

1.1.08 to DOA **Rs.1,000** **Capital**

DOAtoDOC **Rs.1,000** **Revenue**

Capital Profit-**Rs.19,000**; Revenue Reserve-**Rs. 1,000**

C Ltd.

On B/s date Rs.14,400

1.1.08 **Rs.12,000** Tfr in 2007 **Rs.2,400**

Prev B/s **Capital**

1.1.08 to DOA **Rs.1,200** **Capital**

DOAtoDOC **Rs.1,200** **Revenue**

Capital Profit-**Rs.13,200**; Revenue Reserve -**Rs.1,200**

(b) Profit & Loss Account

B Ltd.

On B/s date Rs.20,000

1.1.08 **Rs.2,000** Prev B/s **Capital**

Pft in 2008 **Rs.2,000**

1.1.08 to DOA **Rs.1,000** **Capital**

DOA to DOC **Rs.1,000** **Revenue**

Capital Profit-**Rs.3,000**; Revenue Reserve-**Rs.1,000**

C Ltd.

On B/s date Rs.10,200

1.1.08 **Rs.1,600** Prev B/s **Capital**

Pft in 2008 **Rs.8,520**

1.1.08 to DOA **Rs.4,260** **Capital**

DOA to DOC **Rs.4,260** **Revenue**

Capital Profit-**Rs.5,940**; Revenue Reserve - **Rs.4,260**

Note: *It has been assumed that the Profits arose evenly throughout the year.*

3. Analysis of Net Worth of Subsidiary Companies

Particulars	Indirect Method				Direct Method			
	A Ltd. 75%	25%	Minority Interest		A Ltd. 75%	25%	Minority Interest	
	B Ltd.	66.67% C Ltd.	B Ltd. 25%	C Ltd. 8.33%	B Ltd.	66.67% C Ltd.	B Ltd. 25%	C Ltd. 8.33%
(a) Share Capital	**2,00,000**	**1,20,000**			**2,00,000**	**1,20,000**		
Less: Minority Interest	(50,000)	(10,000)	50,000	10,000	(50,000)	(10,000)	50,000	10,000
	1,50,000	**1,10,000**			**1,50,000**	**1,10,000**		
(b) Capital Profits								
General Reserve	19,000	13,200			19,000	13,200		
Profit & Loss Account	3,000	5,940			3,000	5,940		
	22,000	**19,140**			**22,000**	**19,140**		
Transfer of B Ltd.'s Share in	12,760	(12,760)			NOT			
C Ltd. (66.67% x Rs. 19,140)			8.33%		APPLICABLE			
25%	**34,760**	**6,380**			**22,000**	**19,140**		
Less: Minority Interest	(8,690)	(1,595)	8,690	1,595	(5,500)	(1,595)	5,500	1,595
	26,070	4,785			**16,500**	**17,545**		
(c) Revenue Reserves	**1,000**	**1,200**			**1,000**	**1,200**		
Transfer of B Ltd.'s Share in	800	(800)			800	(800)		
C Ltd. (66.67% x Rs. 1,200)			8.33%				8.33%	
25%	**1,800**	**400**			**1,800**	**400**		
Less: Minority Interest	(450)	(100)	450	100	(450)	(100)	450	100
	1,350	**300**			**1,350**	**300**		
(d) Revenue Profits	**1,000**	**4,260**			**1,000**	**4,260**		
Transfer of B Ltd.'s Share in	2,840	(2,840)			2,840	(2,840)		
C Ltd. (66.67% x Rs. 4,260)			8.33%				8.33%	
25%	**3,840**	**1,420**			**3,840**	**1,420**		
Less: Minority Interest	(960)	(355)	960	355	(960)	(355)	960	355
	2,880	**1,065**			**2,880**	**1,065**		
Minority Interest			**60,100**	**12,050**			**56,910**	**12,050**
Less: Stock Reserve (8,800 - 8,000) * 25%			200				200	
Minority Interest to CBS			**59,900**	**12,050**			**56,710**	**12,050**

4. Cost of Control

	Particulars		Indirect Method		Direct Method	
	Cost of Investment: A Ltd. in B Ltd.			1,70,000		1,70,000
	A Ltd. in C Ltd.			36,000		36,000
	B Ltd. in C Ltd.			1,06,000		1,06,000
	Total Cost of Investment			3,12,000		3,12,000
Less:	(a) Nominal Value of Share Capital:	B Ltd.	1,50,000		1,50,000	
		C Ltd.	1,10,000	(2,60,000)	1,10,000	(2,60,000)
	(b) Arun's Share in Capital Profit of:	B Ltd.	26,070		16,500	
		C Ltd.	4,785	(30,855)	17,545	(34,045)
	Goodwill on Consolidation			**21,145**		**17,955**

5. Consolidation of Reserves & Surplus

	Particulars		Indirect Method		Direct Method	
			Gen. Res.	P&L A/c	Gen. Res.	P&L A/c
	Balance as per Balance Sheet of A Ltd.		36,000	32,000	36,000	32,000
Add:	Share of Revenue Reserves/Profits from	B Ltd.	1,350	2,880	1,350	2,880
		C Ltd.	300	1,065	300	1,065
	Consolidated Balance		**37,650**	**35,945**	**37,650**	**35,945**
Less:	Stock Reserve (Rs.8,800 - Rs. 8,000) x 75%			(600)		(600)
	Adjested Consolidated Balance		**37,650**	**35,345**	**37,650**	**35,345**

6. Consolidated Balance Sheet of A Ltd. and its subsidiaries B Ltd. and C Ltd. as at 31.12.2008

Liabilities	Indirect	Direct	Assets	Indirect	Direct
Equity Share Capital	2,50,000	2,50,000	**Fixed Assets**		
Reserves & Surplus			Goodwill on Consolidation	21,145	17,955
General Reserve	37,650	37,650	Other FA (56 + 110 + 75)	2,41,000	2,41,000
Profit & Loss Account	35,345	35,345	**Current Assets**		
Minority Interest			Stock (24,000 - 800 Resve)	23,200	23,200
(a) B Ltd.	59,900	56,710	Drs (36600 + 32000 + 63000)	1,31,600	1,31,600
(b) C Ltd.	12,050	12,050	Cheque in Transit	2,000	2,000
Current Liabilities:					
Crs (14,000 + 10,000)	24,000	24,000			
Total	**4,18,945**	**4,15,755**	**Total**	**4,18,945**	**4,15,755**

Notes:

- *Stock Reserve i.e. unrealized profits on Closing Stock have been eliminated to the extent of holding company's share in P & L A/c and balance adjusted towards Minority Interest.*
- *Inter Company Owings have been eliminated in full.*

Illustration 27: Triangle Holding - Trfr of Shares by Holding Company to its Subsidiary

K Ltd. acquired 15,000 Equity Shares out of 20,000 Equity Shares of Rs.10 each of G Ltd. on 01.04.2008 for Rs.2,40,000. As on 01.07.2008, it transferred 5,000 Shares to its Subsidiary M Ltd. for Rs.90,000. Balance Sheets of K Ltd., M Ltd., and G Ltd. as on 31.03.2009 were as follows - (Rs.000's)

Liabilities	K Ltd.	M Ltd.	G Ltd.	Assets	K Ltd.	M Ltd.	G Ltd.
Share Capital (Rs 10 each)	1,000	500	200	Fixed Assets	1,000	500	300
General Reserve	500	200	40	Investments			
Profit & Loss A/c	100	40	20	- In Sonu Ltd.	400	–	–
14% Loans	100	100	100	- In Tinu Ltd.	160	90	–
Sundry Creditors	150	80	40	- Others	100	50	20
Proposed Dividends	200	100	40	Inventories	100	50	50
				Debtors	100	200	40
				Loan to Sonu Ltd.	100	-	-
				Loan to Tinu Ltd.	50	50	-
				Cash & Bank	40	80	30
Total	**2,050**	**1,020**	**440**	**Total**	**2,050**	**1,020**	**440**

K Ltd. acquired 60% shares of M Ltd. on 01.04.2008. As on that date, balances in M Ltd.'s General Reserve and P & L were Rs.1,00,000 and Rs.10,000 respectively.

As on 01.04.2008, G Ltd.'s books showed General Reserve Rs.10,000 and Profit and Loss Account Rs.2,000. Interest on Inter-Corporate Loans within the group has not been accounted for.

Prepare Consolidated Balance Sheet of K Ltd. and its Subsidiary M Ltd. and G Ltd. as on 31.03.2009.

Solution:

1. Basic Information

Company Status	Dates	Holding Status		
Holding Company = K Ltd.	Acquisitions 1.04.2008		**M Ltd.**	**G Ltd.**
Subsidiary = M Ltd.	Consolidation: 31.03.2009	a. Holding Co.	(K Ltd.) 60%	(K Ltd.) 50%
Sub-Subsidiary = G Ltd.			–	(M Ltd.) 25%
		b. Minority Int.	40%	25%

Note: *Shareholding Pattern is as under–*

Company	Held by K Ltd.	Held by M Ltd.	Total Holdings	Minority Interest	Total number of shares
Sonu Ltd.	30,000 (60%)	–	30,000 (60%)	20,000 (40%)	50,000
Tinu Ltd.	10,000 (50%)	5,000 (25%)	15,000 (75%)	5,000 (25%)	20,000

3. Analysis of Reserves and Surplus of G Ltd.

(a) General Reserve

Balance on 31.3.2009 Rs. 40,000

Balance on 1.4.2008 (Acquisition date)	**10,000** **Capital Profit**	Transfer during 2008-09 (bal. fig)	**Rs.30,000** **Revenue Reserve**

(b) Profit & Loss Account

	Balance on 31.03.2009	Rs. 20,000
Less:	Loan Interest (Rs. 1,00,000 x 14%)	Rs. 14,000
	Corrected Balance	**Rs. 6,000**

Balance on 1.4.2008 (Acquisition date)	**Rs.2,000** **Capital Profits**	Profit for 2008-09 (balancing figure)	**Rs.4,000** **Revenue Profits**

4. Analysis of Reserves & Surplus of M Ltd.

(a) General Reserve

Balance on 31.3.2009 Rs.2,00,000

Balance on 1.4.2008 (Acquisition date)	**1,00,000** **Capital Profit**	Transfer during 2008-09 (bal. fig)	**1,00,000** **Revenue Reserve**

(b) Profit & Loss Account

	Balance on 31.03.2009	Rs. 20,000
Add:	Dividend from G Ltd. (40,000 x 25% x 9/12)	Rs. 7,500
Add:	Loan Interest receiced from G Ltd. (50,000 x 14%)	Rs. 7,000
Less:	Loan Interest (Rs. 1,00,000 x 14%)	Rs. 14,000
	Adjusted Balance	**Rs. 40,500**

Balance on 1.4.2008 (Given Acqn Date)	**Rs.10,000** **Capital Profit**	Profit for 2008-09 (balancing figure)	**Rs.30,500** **Revenue Profit**

Total Capital Profits: Rs. 10,000; Total Revenue Profits: Rs.30,500

Note: *Proposed Dividend from G Ltd. is considered only to the extent of period of holding by M Ltd. The balance dividend for 3 months will be reduced from Cost of Investments as it relates to pre-acquisition period.*

5. Computation of Minority Interest

Particulars	K Ltd.		Minority	Interest
	60%	50%	M Ltd.	G Ltd.
	M Ltd.	25% → G Ltd.	40%	25%
(a) Share Capital	5,00,000	2,00,000		
Less: Minority Interest	(2,00,000)	(50,000)	2,00,000	50,000
	3,00,000	**1,50,000**		
(b) Capital Profits General Reserve	1,00,000	10,000		
Profit & Loss A/c	10,000	2,000		
	1,10,000	**12,000**		
Transfer of M's Share in G (12000 x 25% x 9/12)	2,250	(2,250)		
	40% **1,12,250**	**9,750** 25%		
Less: Minority Interest	(44,900)	(3,000)	44,900	3,000
	67,350	**6,750**		
(c) Revenue Reserve:	**1,00,000**	**30,000**		
Transfer of M's Share in G (30,000 x 25% x 9/12)	5,625	(5,625)		
	40% **1,05,625**	24,375 25%		
Less: Minority Interest	(42,250)	(7,500)	42,250	7,500
	63,375	**16,875**		
(d) Revenue Profits:	**30,500**	**4,000**		
Transfer of M's Share in G (4,000 x 25% x 9/12)	750	(750)		
	40% **31,250**	**3,250** 25%		
Less: Minority Interest	(12,500)	(1,000)	12,500	1,000
	18,750	**2,250**		
(e) Proposed Dividend:	1,00,000	40,000		
Less: Minority Interest	(40,000)	(10,000)	40,000	10,000
	60,000	**30,000**		
Total Minority Interest			**3,39,650**	**71,500**

For G Ltd.: *Capital Reserve, Revenue Reserve & Revenue Profits are to be considered only from the period of holding of M Ltd.*

4. Cost of Control

	Particulars			Rs.
	Cost of Investment in Equity Shares	K Ltd. in M Ltd.		4,00,000
		K Ltd. in G Ltd.		1,60,000
		M Ltd. in G Ltd.		90,000
	Total Cost of Investment			**6,50,000**
Less:	Dividend out of Pre-acquisition profits in M Ltd. (40,000 x 25% x 3/12)		2,500	
Less:	Unrealized Profit on sale of Investment by K to M [90,000 - (240000/15,000 x 5,000)		10,000	12,500
	Adjusted Cost of Investment			**6,37,500**
Less:	Nominal Value of Equity Capital:	M Ltd.	3,00,000	
		G Ltd.	1,50,000	
	Share in Capital Profit:	M Ltd.	67,350	
		G Ltd.	“6,750	(5,24,100)
	Goodwill on Consolidation			**1,13,400**

5. Consolidation of Reserves and Surplus

Particulars			Gen. Res.	P&L A/c
	Balance as per Balance Sheet of K Ltd.		5,00,000	1,00,000
Add:	Proposed Dividends	From G Ltd. (Rs.40,000 x 50/100)		20,000
		From M Ltd. (Rs. 1,00,000 x 60/100)		60,000
Add:	Interest on Loans [Rs. 1,00,000 to M + Rs.50,000 to G) x 14%]			21,000
Add:	Share of Revenue Profits / Reserves:	M Ltd.	63,375	18,750
		G Ltd.	16,875	2,250
Less:	Unrealized Profit on Sale of Investment to M			(10,000)
	Consolidated Balance		**5,80,250**	**2,12,000**

6. Consolidated Balance Sheet of K Ltd. and its subsidiaries M Ltd. & G Ltd. as at 31.03.2009

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Share Capital	10,00,000	**Fixed Assets**	
Reserves and Surplus:		Goodwill on Consolidation	1,13,400
General Reserve	5,80,250	Others (10,00,000 + 5,00,000 + 3,00,000)	18,00,000
Profit & Loss Account	2,12,000	**Investments** (1,00,000 + 50,000 + 20,000)	1,70,000
Minority Interest: (a) M Ltd.	3,39,650		
(b) G Ltd.	71,500	**Current Assets, Loans & Advances:**	
Loan Funds: (1,00,000 + 1,00,000	1,00,000	Debtors (1,00,000 + 2,00,000 + 40,000)	3,40,000
+ 1,00,000 - 1,50,000 - 50,000)		Inventories (1,00,000 + 50,000 + 50,000)	2,00,000
Current Liabilities		Cash & Bank (40,000 + 80,000 + 30,000)	1,50,000
Creditors (1,50,000 + 80,000 + 40,000)	2,70,000		
Proposed Dividend	2,00,000		
Total	**27,73,400**	**Total**	**27,73,400**

Notes:

- *Interest on Loan taken from Others (Outsiders) is assumed to have been paid.*
- *Inter Company Owings have been eliminated in full.*
- *Under Direct Method, Capital Profits in M Ltd. will be Rs.66,000; Minority Interest in M will be Rs.3,38,750 and Goodwill on Consolidation will be Rs.l,12,500.*

Illustration 28: Chain Holding /Unrealized Profits on Upstream Transaction

A Ltd. is a holding Company and B Ltd. and C Ltd. are subsidiaries of A Ltd. Their Balance Sheets as on 31.12.2008 are given below-

Liabilities	A Ltd.	B Ltd.	C Ltd.	Assets	A Ltd.	B Ltd.	C Ltd.
Share Capital	1,00,000	1,00,000	60,000	Fixed Assets	20,000	60,000	43,000
Reserves	48,000	10,000	9,000	Investments in:			
Profit & Loss A/c	16,000	12,000	9,000	- Shares of B Ltd.	95,000	—	—
C Ltd. Balance	3,000	—	—	- Shares of C Ltd.	13,000	53,000	—
Sundry Creditors	7,000	5,000	—	Stock in Trade	12,000	—	—
A Ltd. Balance	—	7,000	—	B Ltd. Balance	8,000	—	—
				Sundry Debtors	26,000	21,000	32,000
				A Ltd. Balance	—	—	3,000
Total	**1,74,000**	**1,34,000**	**78,000**	**Total**	**1,74,000**	**1,34,000**	**78,000**

The following particulars are given:

1. The Share Capital of all Companies is divided into shares of Rs.10 each.
2. A Ltd. held 8,000 shares in B Ltd. and 1,000 shares of C Ltd.
3. B Ltd. held 4,000 shares of C Ltd.
4. All these investments were made on 30.6.2006.
5. On 31.12.2007, the position was as shown below: (Amount in Rs.)

Particulars	Reserve	P&LA/c	Creditors	Fixed Assets	Stock	Debtors
B Ltd.	8,000	4,000	5,000	60,000	4,000	48,000
C Ltd.	7,500	3,000	1,000	43,000	35,500	33,000

6. 10% Dividend is proposed by each Company.
7. The whole of stock in trade of B Ltd. as on 30.06.2008 (Rs.4,000) was later sold to A Ltd. for Rs.4,400 and remained unsold by A Ltd. as on 31.12.2008.
8. Cash in transit from B Ltd. to A Ltd. was Rs.1,000 as at the close of business. You are required to prepare the Consolidated Balance Sheet of the group as at 31.12.2008.

Solution:

1. Basic Information

Company Status	Dates	Holding Status		
Holding Company = A Ltd.	Acquisition: 30.06.2007		**B Ltd.**	**C Ltd.**
Subsidiary = B Ltd.	Consolidation: 31.12.2008	a. Holding Co.	(A) 80%	(A) 16.67%
Sub–Subsidiary = C Ltd.			–	(B) 66.66%
		b. Minority Int.	20%	16.67%

Note: *The Shareholding Pattern is as under*

Company	Held by A	Held by B	Total Holdings	Minority Interest	Total No. of Shares
B Ltd.	8,000 (80%)	N. A.	8,000 (80%)	2,000 (20%)	10,000 (100%)
C Ltd.	1,000 (16.67%)	4,000 (66.67%)	5,000 (83.33%)	1,000 (16.67%)	6,000 (100%)

2. Analysis of Reserves and Surplus of Subsidiary Companies

(a) General Reserve

B Ltd.	C Ltd.
Balance on 31.12.2008 Rs. 10,000	31.12.2006 Rs. 9,000
1.1.08 Prev. B/s Tfr in 2008 Rs.2,000	1.1.08 Prev. B/s Tfr in 2008 Rs.1,500
8,000 Capital	**7,000 Capital**
1.1.06 to DOA DOA to DOC	1.1.08 to DOA DOA to DOC
Rs.1,000 **Rs.1,000**	**Rs.750** **Rs.750**
Capital **Revenue**	**Capital** **Revenue**
Capital Profit - **Rs.9,000**; Revenue Reserve - **Rs.1,000**	**Capital Profit - Rs.8,250; Revenue Reserve - Rs.750**

(b) Profit & Loss Account

B Ltd.

	Balance on 31.12.2008	12,000
Less:	Proposed Dividend (10%* 100000)	(10,000)
Add:	Dividend from C Ltd.	2,000
	(6/12 x 6,000 x 66.67%)2,000	
	Adjusted Balance	**4,000**

1.1.08 Prev. B/s	Profit in 2008 NIL
4,000 Capital	

C Ltd.

	Balance on 31.12.2008	9,000
Less:	Proposed Dividend (10x60,000)	6,000
	Adjusted Balance	**3,000**

1.1.08 Prev. B/s	Profit in 2008
3,000 Capital	**NIL Revenue**

3. Analysis of Net Worth of Subsidiary Companies (Indirect Method)

	Particulars	**A Ltd.**		**Minority Interest**	
		80%	**16.67%**	**B Ltd.**	**C Ltd.**
		B 66,67% C		**20%**	**16.67%**
(a)	**Share Capital**	**1,00,000**	**60,000**		
Less:	Minority Interest	(20,000)	(10.000)	20,000	10,000
	Holding Co's Share	**80,000**	**50,000**		
(b)	**Capital Profits**				
	General Reserve	9,000	8,250		
	Profit & Loss Account	4,000	3,000		
		13,000	**11,250**		
Trfr.	B's share in C (66.67% x Rs.l 1,250)	7.500	(7,500)		
		20,500	3,750	16.67%	
Less:	Minority Interest	20% (4,100)	(1,875)	4,100	1,875
	Holding Co's Share	**16,400**	**1,875**		
(c)	**Revenue Reserve:**	1,000	750		
Trfr.	B's share in C (66.67% x Rs.750)	500	(500)		
		1,500	250	16.67%	
Less:	Minority Interest	20% (300)	(125)	300	125
Holding Co.'s Share		**1,200**	**125**		
(d)	**Revenue Profits**	**NIL**	**NIL**	–	–
(e)	**Proposed Dividend**	10,000	6,000		
Less:	Minority Interest	(2,000)	(1,000)	2,000	1,000
	Holding Co's Share	**8,000**	**5,000**		
	Minority Interest Before Stock Reserve Adjustment			**26,400**	**13,000**
Less:	Share of Minority Interest of B in Unrealized Profits (4,400 - 4,000) x 20%			(80)	–
	Minority Interest			**26,320**	**13,000**

4. Cost of Control

	Particulars			Rs.
	Cost of Investment:	A Ltd. in B Ltd.	95,000	
		A Ltd. in C Ltd.	13,000	
		B Ltd. in C Ltd.	53,000	**1,61,000**
Less:	Dividend out of Pre-acqn. Pfts	(For 01.01.2005 to 30.06.2005)		
	From B Ltd.	(8000 Shares x Rs.10 x 10% x 6/12]	4,000	
	From C Ltd.	(5000 Shares x Rs.10 x 10% x 6/12)	2,500	**6,500**
	Adjusted Cost of Investment			**1,54,500**
Less:	(a) Nominal Value in Share Capital of:	B Ltd.	80,000	
		C Ltd.	50,000	(1,30,000)
	(b) Share in Capital Proffits	B Ltd.	16,400	
		C Ltd.	1,875	**(18,275)**
	Goodwill on Consolidation			**6,225**

5. Consolidation of Reserves and Surplus

	Particulars		Gen. Res.	P & L A/c
	Balance as per Balance Sheet of A Ltd.		48,000	16,000
Less:	Proposed Dividend	(Rs. 1,00,000 x 10%)	–	(10,000)
Add:	Share of Proposed Dividend	(01.07.2008 to 31.12.2008) from		
		B (8000 Shares x Rs.10 x 10% x 6/12)	–	4,000
		C (1000 Shares x Rs.10 x 10% x 6/12)	–	500
	Adjusted Balance		**48,000**	**10,500**
Add:	Share of Revenue from	B Ltd.	1,200	NIL
		C Ltd.	125	NIL
	Consolidated Balance		49,325	10,500
Less:	Stock Reserve [Rs.4,400 - Rs.4,000] x 80%		–	(320)
	Corrected Consolidated Balance		**49,325**	**10,180**

6. Consolidated Balance Sheet of A Ltd. and its Subsidiaries B and C as at 31.12.2008

Liabilities	Rs.	Assets	Rs.
Share Capital: Equity Capital	1,00,000	**Fixed Assets:**	
Reserves and Surplus:		Goodwill on Consolidation	6,225
General Reserve	49,325	Other Assets (20,000 + 60,000 + 43,000)	1,23,000
Profit & Loss Account	10,180	**Current Assets**	
Minority Interest: (a) B	26,320	Stock in Trade (12,000 - 400 Stock Reserve)	11,600
(b) C	13,000	Sundry Debtors [26,000 + 21,000 + 32,000]	79,000
Current Liabilities:		Cash-in-transit (8,000 + 3,000 - 7,000 - 3,000)	1,000
Sundry Creditors (7,000 + 5,000)	12,000		
Intercompany Borrowings	NIL		
Proposed Dividend	10,000		
Total	**2,20,825**	**Total**	**2,20,825**

Note: *Under Direct Method,*

(a) **Capital Profit** will **be:** (1) B Ltd. - Rs. 10,400; & (2) C Ltd. - Rs.9,375

(b) **Minority Interest** will be: (1) B Ltd. - Rs.24,820; & (2) C Ltd. - Rs. 13,000.

(c) **Goodwill on Consolidation:** Rs.4,725.

Illustration 29: Chain Holdings - Multiple Subsidiaries

Following are the Balance Sheets of R Ltd., S Ltd, T Ltd. and U Ltd. as at 31.12.2008 -

Particulars	R Ltd.	S Ltd.	T Ltd.	U Ltd.
Liabilities				
Share Capital (Rs.100 Face Value)	5,00,000	4,00,000	2,00,000	6,00,000
General Reserve	2,00,000	40,000	25,000	1,00,000
Profit & Luss Account	1,00,000	40,000	25,000	32,000
Sundry Creditors	30,000	10,000	5,000	8,000
Total	8,30,000	4,90,000	2,55,000	7,40,000
Assets				
Investments:				
3,000 Shares in S Ltd.	3,50,000	–	–	–
1,000 Shares in T Ltd.	1,10,000	–	–	–
500 Shares in T Ltd.	–	50,000	–	–
Shares in U Ltd. at Rs.120	3,60,000	1,80,000	60,000	–
Fixed Assets	–	2,00,000	1,50,000	7,00,000
Current Assets	10,000	60,000	45,000	40,000
Total	**8,30,000**	**4,90,000**	**2,55,000**	**7,40,000**

Balance in General Reserve A/c and P & L Account, when shares were purchased in different Companies were -

Particulars	R Ltd.	S Ltd.	T Ltd.	U Ltd.
General Reserve Account	1,00,000	20,000	10,000	60,000
Profit & Loss Account	60,000	20,000	5,000	6,000

Prepare the Consolidated Balance Sheet of the Group as at 31.12.2008.

Solution:

1. Basic Information

Company Status	Dates	Holding Status		
Holding Company = R Ltd.	Acquisition: Various dates		**Holding**	**Minority**
Subsidiary = S Ltd.	Consolidation 31.12.2008	a. S	(R)75%	25%
Sub-Subsidiary 1 = T Ltd.		b. T	(R)50%+(S)25%	25%
Sub-Subsidiary 2 = U Ltd.		c. U	(R)50%+(S)25%+(T)8.3%	16.7%

Note: *The Slareholding Pattern is as under -*

Company	Held by R	Held by S	Held by T	Total Holdings	Minority Interest	Total Shares
S Ltd.	3,000 (75%)	N.A.	—	3,000 (75%)	1,000 (25%)	4,000 (100%)
T Ltd.	1,000(50%)	5,000 (25%)	N.A.	1,500 (75%)	500 (25%)	2,000 (100%)
U Ltd.	3.6 Lacs/120 = 3,000 (50%)	1.8 Lacs/ 120 = 1,500(25%)	0.6 Lacs/ 120 = 5.00 (8.33%)	5,000 (83.33%)	1,000 (16.67%)	6,000 (100%)

2. Analysis of Reserves & Surplus of Subsidiary Companies

(a) Saran Ltd

General Reserve

Balance on 31.12.08 40,000

DOA	**20,000** **Capital**	Transfer between DOA & DOC	**20,000** **Revenue**

Profit & Loss Account

Balance on 31.12.08 40,000

DOA	**20,000** **Capital**	Profit between DOA & DOC	**20,000** **Revenue**

(b) T Ltd.

General Reserve			
Balance on 31.12.08 25,000			
DOA	**10,000** **Capital**	Transfer between DOA & DOC	**15,000** **Revenue**

Profit & Loss Account			
Balance on 31.12.08 25,000			
DOA	**5,000** **Capital**	Profit between DOA & DOC	**20,000** **Revenue**

(c) U Ltd.

General Reserve			
Balance on 31.12.08 1,00,000			
DOA	**60,000** **Capital**	Transfer between DOA & DOC	**40,000** **Revenue**

Profit & Loss Account			
Balance on 31.12.08 32,000			
DOA	**6,000** **Capital**	Profit between DOA & DOC	**26,000** **Revenue**

3. Analysis of Net Worth of Subsidiary Companies

Particulars	**Share of R**			**Minority Interest**		
	75%	**50%**	**50%**	**S**	**T**	**U**
	S 25%	25% **T** 8.33%	**U**	**25%**	**25%**	**16.67%**
(a) Share Capital	4,00,000	2,00,000	6,00,000			
Less: Minority Interest	(1,00,000)	(50,000)	(1,00,000)	1,00,000	50,000	1,22,002
Holding Co.'s Share	**3,00,000**	**1,50,000**	**5,00,000**			
(b) Capital Profits						
General Reserve	20,000	10,000	60,000			
Profit & Loss Account	20,000	5,000	6,000			
	40,000	**15,000**	**66,000**			
Trfr. T 's share in U (6,60,000 x 8.33%)	NIL	5,498	(5,498)			
Trfr. Saran's share in U (6,60,000 x 25%)	16,500	NIL	(16,500)			
	56,500	**20,498**	**44,002**			
Trfr. Saran's share in T (20,498 x 25%)	5,125	(5,125)	NIL			
	61,625	**15,373**	**44,002**			
Less: Minority Interest	(15,406)	(5,125)	(11,002)	15,406	5,125	11,002
Holding Co.'s Share	**46,219**	**10,248**	**33,000**			
(c) Revenue Reserves						
General Reserve	20,000	15,000	**40,000**			
Trfr. T's share in U (40,000 x 8.33%)	NIL	3,333	(3,333)			
Trfr. S's share in U (40,000 x 25%)	10,000	NIL	(10,000)			
	30,000	**18,333**	**26,667**			
Trfr. S's share in T (18,333 x 25%)	4,583	(4,583)	NIL			
	34,583	**13,750**	**26,667**			
Less: Minority Interest	(8,646)	(4,583)	(6,667)	8,646	4,583	4,445
Holding Co.'s Share	**25,937**	**9,167**	**20,000**			

(d)	**Revenue Profits**						
	Profit & Loss Account	20,000	20,000	26,000			
Trfr.	T's share in U (2,60,000 x 8.33%)	NIL	2,167	(2,167)			
Trfr.	S's share in U (2,60,000 x 25%)	6,500	NIL	(65,000)			
		26,500	**22,167**	**1,733**			
Trfr.	S's share in T (2,21,667x25%)	5,542	(5,542)	NIL			
		32,042	16,625	17,333			
Less:	Minority Interest	(8,010)	(5,547)	(4,333)	8,010	5,542	4,333
	Holding Co's Share	**24,032**	**11,083**	**13,000**			
	Minority Interest				**1,32,062**	**65,250**	**1,41,782**

4. Cost of Control

	Particulars		Rs.	
	Cost of Investments:	R Ltd. in S Ltd.	3,50,000	
		R Ltd. in T Ltd.	1,10,000	
		R Ltd. in U Ltd.	3,60,000	
		S Ltd. in T Ltd.	50,000	
		S Ltd. in U Ltd.	1,80,000	
		T Ltd. in U Ltd.	60,000	**11,10,000**
Less:	(a) Paid up Value of Share Capital	- S Ltd.	3,00,000	
		- T Ltd.	1,50,000	
		- U Ltd.	5,00,000	(9,50,000)
	(b) Share in Capital Profits of	- S Ltd.	46,218	
		- T Ltd.	10,249	
		- U Ltd.	33,000	(89,467)
	Goodwill on Consolidation			**70,533**

5. Consolidation of Reserves and Surplus

	Particulars		Gen. Res.	P & L A/c
	Balance as per Balance Sheet of R Ltd.		2,00,000	1,00,000
Add:	Share of Revenue from	- S Ltd.	25,938	24,031
		- T Ltd.	9,167	11,083
		- U Ltd.	20,000	13,000
	Consolidated Balance		**2,55,105**	**1,48,114**

6. Consolidated Balance Sheet of Rajan and its subsidiaries Saran, Tripti and Upanya as at 31.12.2008

Liabilities		Rs.	Assets	Rs.
Share Capital: Equity Capital		5,00,000	**Fixed Assets:**	
Reserves & Surplus:	P & L A/c	2,55,105	Goodwill on Consolidation	70,533
	General Res.	1,48,114	Other Assets [NIL + 20,00 + 15,00 + 70,00]	10,50,000
Minority Interest:	S Ltd.	1,32,062	**Current Assets** [1,00 + 6,00 + 4,50 + 4,00]	1,55,000
	T Ltd.	65,250		
	U Ltd.	1,22,002		
Curr. Liabs.: [3,00 + 1,00 + 50 + 80]		53,000		
Total		**12,75,533**	**Total**	**12,75,533**

Note: *Under Direct Method -*

(a) Capital Profit will be (1) S - Rs.3,00,000; (2) T - Rs. 1,12,500; (3) U - Rs.5,50,000.

(b) Minority Interest will be (1) S - Rs.12,66,562; (2) T - Rs.6,38,750; (3) U - Rs. 12,00,000.

(c) Capital Reserve on Consolidation Rs.6,37,500

3.4 Preparation of Group Cash Flow Statement:

The actual cash paid for the subsidiary is shown under the heading 'Acquisitions and Disposals'. It is possible that the purchase consideration will include other forms of payments such as the issue of shares or loan stock and there is no cash flow effect in these cases.

In exchange for the purchase consideration, the group acquires the individual net assets of the subsidiary and goodwill is recognized on acquisition.

The net assets in the closing consolidated Balance Sheet will include those of the newly acquired subsidiary. The preparation of the group cash flow statement must recognize that the movement from opening to closing positions is increased in party by the net assets of the new subsidiary and the amounts relating to that subsidiary are therefore excluded from the cash flow statement.

Foe example, additions to fixed assets are represented by purchases during the year plus fixed assets of the acquired subsidiary. This is broken down as follows:

Opening + cash purchases + fixed assets of – disposals- depreciation=closing

NBV for additions acquired subsidiary NBV

Only cash purchase for additions are included in the cash flow statement under 'inventive activities'.

Problem:
A Ltd. acquires 80% of the shares of B Ltd. on 31st March 19x3. The fair values of B Ltd. assets at that date are

	Rs in '000
Tangible fixed assets	60
Stocks	20
Cash	10
	90

The purchase consideration consists of 50,000 at Re.1 ordinary shares valued at par and Rs.50, 000 cash. The summary consolidated Balance Sheet as at 31st December 19x2 and 19x3 the Profit and Loss accounts for the year are as follows:

3.5 Statement of Cash Flows

"The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period." - SFAS 95 Statement of Cash Flows, Financial Accounting Standards Board, US

LEARNING OBJECTIVES

After learning this Chapter, you will be able to understand that—

- When a company earns profit that may not be available in cash. Cash profit and accounting profit are different.
- What is the meaning of 'cash and cash equivalent'?
- How to classify cash flow from operational activities, financing activities and investment activities?
- How to reconcile cash balance of a company? and

Importance of Cash flows

Cash flows are crucial to business decisions. Cash is invested in the business and the rationality of such investment is evaluated taking into account the future cash flows it is expected to generate. Economic value of an asset is derived on the basis of its ability to generate future cash flows. Economic value of an asset is given by the present value of future cash flows expected to be derived from the asset.

Profit is an accounting concept. Profit is derived on accrual assumption. Profit and cash flows from operational activities are not the same. Dividend decision is taken on the basis of profit, although it is to be paid in cash. Similarly, debt servicing capacity of a company is determined on the basis of cash flows from operations before interest. Ploughing back of profit is a much talked about source of financing modernisation, expansion and diversification. Unless retained profit is supported by cash, ploughing back is not possible. Thus cash flows analysis is an important basis for making several management decisions.

Meaning of Cash and Cash Equivalent

A cash flow statement explains the reasons for change in the cash and cash equivalent between two financial statement dates. Before we introduce the technique of cash flow analysis, let us learn the meaning of the term 'cash and cash equivalent'.

Cash means cash in hand and balance of foreign currency. Cash equivalent implies bank balance and other risk-free short term investments, and advances which are readily encashable. Cash equivalent means short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. An investment of short maturity, say three months or less from the date of acquisition is generally considered as cash equivalent. Equity investments are not considered as cash equivalent because of high market risk. Investments in call money market, money market mutual funds, repo transactions, badla transactions, etc., are usually classified as cash equivalents.

Types of Cash flow

Cash Flow Statement explains cash movements under three different heads, namely

- Cash flow from operating activities;
- Cash flow from investing activities;
- Cash flow from financing activities.

Sum of these three types of cash flow reflects net increase or decrease of cash and cash equivalents.

Operating activities are the principal revenue - producing activities of the enterprise and other activities that are not investing and financing. Operating activities include all transactions that are not defined as investing or financing. Operating activities generally involve producing and delivering goods and providing services.

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

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

Elements of operating cash flow

Given below are elements of operating cash flow:

Description of elements of operating cash flow • Cash receipts from sale of goods and rendering services.
• Cash receipts from royalty, fees, commissions and other revenue.
• Cash payments to suppliers for goods and services.
• Cash payments to and on behalf of employees.
• Cash receipts and cash payments by an insurance enterprise for premiums and claims, annuities and other policy benefits.
• Cash payments and refunds of income taxes unless these are specifically identified as cash flow from financing or investment.
• Cash receipts and payments relating to contracts held for dealing or trading purposes.
• Cash flow arising from dealing in securities when an enterprise holds securities for such purpose.
• Cash advances and loans made by financial institutions including all contracts held for trading purposes which may range from sale licence, export-import quota, any other operating contract. This may not necessarily be a contract relating to derivative instruments.

Elements of cash flow from investment activities

Given below are eight elements of investment cash flow:

Elements of cash flow from investment activities:
1. Cash payments for acquisition of fixed assets including intangibles.
2. Cash receipts from disposal of fixed assets.
3. Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint venture.

	This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
4.	Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint venture.
	This does not include an item covered in cash equivalents and items held for dealing or trading purposes.
5.	Cash advances and loans made to third parties.
	This does not include loans and advances made by financial institutions as these fall under operating cash flow.
6.	Cash receipts from repayments of advances and loans made to third parties. This does not include loans and advances made by financial institutions as these fall under operating cash flow.
7.	Cash payments for future, forward, option and swap contracts.
	This does not include contracts held for dealing or trading purposes or contracts which are classified as financing activities.
8.	Cash receipts from future, forward, option and swap contracts.
	This does not include contracts held for dealing or trading purposes or contracts which are classified as financing activities.

Classification of derivative transactions –

Derivative Transactions which are for Heading	**Speculative contracts**
• Of Operating transactions like oil future, currency forward relating to sale or purchase of goods or services, commodity futures or options that relates to raw materials and finished goods: Should be classified as operating cash flow. • Of investment transactions like stock index futures to protect value investment in shares, T- bill futures or options to protect value of in vestment debt instruments Should be classified as investment cash flow. • Of financing activities like swaps against foreign currency loans and floating rate interest: Should be classified as financing cash flow.	• Of dealers - Operating activities. • Of others - Investment activities.

Elements of cash flow from financing activities

Given below are five elements illustrated cash flow from financing activities:

Elements of cash flow from financing activities
1. Cash proceeds from issuing shares or other equity instruments.
2. Cash payments to owners to acquire or redeem the enterprise's shares.
3. Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, and other short term and long term borrowings.

4.	Cash repayments of amounts borrowed.
5.	Cash payments by a lease for the reduction of the outstanding liability relating to a finance lease.

Cash Flow from Operating Activities

Operating cash flows can be derived either in pursuance of a direct method or indirect method. Under direct approach major classes of cash receipts and payments are disclosed. Whereas under indirect approach net profit or loss adjusted to derive operating cash flow. Although direct method is not appropriate, the SEBI requires computation of cash flow from operating activities using indirect method.

Direct Method

Cash flow from operating activities is computed taking into account the following items:

Cash Receipts	Cash Payments
• Cash sales and cash collection = Sales + Opening Balance of Receivables — Closing Balance of Receivables.	• Cash purchase of raw materials and spares for manufacturing activities = [Raw material consumed + Closing stock - Opening Stock] + [Opening creditors - Closing creditors] • Cash purchase of finished goods for trading [Goods sold + Closing stock - Opening Stock] + [Opening creditors - Closing creditors]. • Payment to and on behalf of employees Wages & Salaries + Closing outstanding balance -Opening outstanding balance. • Payment of expenses = Expenses incurred + Opening balance of outstanding - Closing balance of outstanding.

Notes:

(1) Figures of cash sales may be directly available from cash book. Then Cash collection can be derived taking Credit sales + Opening balance of debtors - closing balance of debtors.

(2) Similarly figures of cash purchases can also be obtained from cash books.

(3) Interest and dividend are investment cash inflow and, therefore, to be excluded.

(4) Interest expense is financing cash outflow.

(5) Tax provision is not cash expense, advance tax paid should be treated as tax cash outflow.

Indirect Method

Under this method operating cash flow is derived indirectly by making adjustments for non-cash items, cash flow of different types included in the profit and working capital adjustments. Starting from profit before tax adjustments can be made to arrive at operating cash flow.

Profit Before Tax

Add: Depreciation and Amortisation being non-cash item

Interest - being financing cash outflow

Lease rental of finance lease - being financing cash outflow

Less : Interest and dividend received - being investment cash inflow

Lease rental received of finance lease - being investment cash inflow

Advance tax paid to the extent relates to operating cash flow (Tax paid for financing cash flow and investment cash flow should be separated)

Add/Less : Working Capital Adjustments

Increase in current assets like receivables, inventories (-)

Decrease in current assets like receivables, inventories (+)

Increase in current liabilities (+)

Decrease in current liabilities (-)

3.6 Illustrations on Cash Flow Statement

Given below is Profit and Loss Account of ABC Ltd. and relevant Balance Sheet information :

Profit and Loss Account of ABC Ltd. for the year ended 31-03-2010	
	Rs. in lacs
Revenue	
Sales	4150
Interest and dividend	100
Stock adjustment	20
Total	**4270**
Expenditure	
Purchases	2400
Wages and salaries	800
Other expenses	200
Interest	60
Depreciation	100
Total	**3560**
Profit before tax	710
Tax Provision	200
Profit after tax	**510**
Balance of Profit & Loss Account	50
Profit available for distribution	560
Appropriation	
Transfer to General Reserve	200
Proposed dividend	300
Distribution tax	30
Total	**530**
Balance	30

Relevant Balance Sheet information	*31-03-2010*	*31-03-2009*
	Rs. in lacs	Rs. in lacs
Debtors	400	250
Inventories	200	180
Creditors	250	230
Outstanding wages	50	40
Outstanding expenses	20	10
Advance tax	195	180
Tax provision	200	180
Assessed tax liability		180

Let us now study the technique of direct method of calculating operating cash flow:

Computation of cash flow from Operating		
Activities		
Direct Method		
Cash Receipts		
Cash sales & Collection from debtors		
Sales+Opening Debtors - Closing Debtors	4150+250-400	4000
Cash Payments		
Cash purchases & Payment to creditors		
Purchases+ Opening Creditors - Closing creditors	2400+230-250	2380
Wages & salaries paid	800+40-50	790
Cash Expenses	200+10-20	190
Taxes paid - Advance tax		195
		3555
Cash Flow from Operating Activities		**445**
Indirect Method		
Profit before tax		710
Add : Non-cash items : Depreciation		100
Add : Interest : Financing cash outflow		60
Less : Interest and Dividend : Investment		
Cash inflow		-100
Less : Tax paid		-195
Working Capital Adjustments		
Debtors	250-400	-150
Inventories	180-200	-20
Creditors	250-230	20
Outstanding wages	50-40	10
Outstanding expenses	20-10	10
Cash Flow from Operating Activities		**445**

Illustration 2.

MZ Ltd.

Profit and Loss account for the year ended 31st March, 2010

Income		
Sales		10,000
Stock adjustment		
Closing stock	4,000	
Less opening stock	3,000	1,000
Other Income:		
Income from Investments		1,200
		12,200
Expenditure		
Raw Materials Consumed:		
Opening stock	2,000	
Add : Purchases	5,000	
	7,000	
Less : Closing stock	1,500	5,500
Salaries and Contribution to Retirement		
Benefit Schemes		2,500
Other Expenses		2,000
Depreciation		500
		10,500
Profit Before Interest and Tax Interest		1,700
Interest		800
Profit Before Tax		900
Tax Provision		100
Profit After Tax		800
Balance from last year		100
		900
Appropriations		
Transfer to General Reserve		250
Proposed Dividend		600
Balance c/d		50
		900

Balance Sheet as at 31-03-2010

(*Rs. in lacs*)

			31-03-10	**31-03-10**
Sources				
Share capital			4,000	3,000
General Reserve			1,000	750
P & L A/c			50	100
Secured Loans			6,000	4,000
			11,050	7,850
Applications				
Fixed Assets				
Gross Block		8,000		6,000
Less : Accumulated Depn.		1,500		1,000
		6,500		5,000
Invesment		1,500		1,000
Current Assets and Loans & Advance				
Inventories	5,500		5,000	
Sundry Debtors	2,000		1,500	
Cash & Bank Balances	500		600	
Advance Tax	100		150	
	8,100		7,250	
Less : Current liabilities and provisions				
Sundry Creditors	4,200		4,650	
Tax Provision	100		150	
Other provision	150		150	
Proposed Dividend	600		450	
	5,050		5,400	
New Current Assets		3,050		1,850
		11,050		7,850

Consider the above Profit and Loss account and Balance Sheet and derive Cash flows from operating activities using direct and indirect method.

Solution:

Computation of cash flows from operating activities by direct method:

	Rs. in lacs	*Rs. in lacs*
Cash inflows		
Sales	10,000	
Add : Opening S/Debtors	1,500	
	11,500	
Less : Closing S/Debtors	2,000	9,500
Cash outflows		
Creditors :		
Opening balance	4,650	
Add : Purchases	5,000	
Less : Closing balance	4,200	5,450
Salaries and Contributions to retirement Benefit Schemes		2,500
Other Expenses		2,000
		9,950
Cash flow from operating activities		(450)
Less : Advance tax paid		(100)
Cash flow from after tax operating activities		(550)

- Figures within bracket indicate cash outflows.

Notes :

- Cash inflows from sale of goods and services are given by cash sales plus collection from debtors.
- Cash outflows on account of purchase of materials are given by cash purchases plus payment to creditors.
- It may be noted that income from investments is classified as cash flows from investment activities and interest payment on long term loans is classified as cash flows for financing activities. Dividend payment also falls under the category of cash flows for financing activities.

Computation of Operating Cash Flow using Indirect Method:

		Rs. in lacs
Increase in General Reserve		250
Decrease in P & L A/c		(50)
Tax provision		100
Proposed Dividend		600
Interest		800
Depreciation		500
		2,200
Less : Income from Investments		1,200
		1,000
Working Capital Adjustments :		
Inventories	(500)	
Sundry Debtors	(500)	
Sundry Creditors	(450)	(1,450)
Cash from operating activities		(450)
Less : Advance tax paid		(100)
Cash flow from after tax operating activities		(550)

Working Capital Adjustments : Increase in current asets like inventories, debtors, prepayments blocks the cash flows, whereas decrease in current assets releases cash. Although there was profit before interest and depreciation amounting to Rs. 1000 lacs, such profit was not represented by cash since it was blocked in inventories and debtors.

Similarly, any increase in current liabilities means withholding cash payments. In other words, increase in current liabilities means increase in cash flows from opening activities. On the other hand, decrease in current liabilities means additional cash outflows which further reduces cash flows from operating acitivies.

After the working capital adjustments, it appears that there was net cash outflows from operating activities.

However, under both the direct and indirect methods cash flows from operating activities can be derived at a same level.

Reconciliation : In case indirect method is followed, it is better to have a reconciliation of cash flows and PAT.

		Rs. in lacs
Cash flows from operating activities		(450)
Add : Working Capital adjustments		1450
		1000
Less : Depreciation		(500)
Less : Interest		(800)
		(300)

		Rs. in lacs
Add : Income from investments		1200
PBT		900
Less : Tax Provision		100
PAT		800

Illustration 2 (a) Taking the data given in Illustration 2, and using the following additional information derive cash flow from investment activities :

Take 10% of the investments given in the Balance Sheets as risk-free and readily encashable and remaining of the investments as long term investments.

Cash flow from Investment Activities

			Rs. in lacs
Purchase of fixed assets			
Increase in gross block			(2,000)
Purchase of long term investments			
	31-3-08	31-3-09	
	1,000	1,500	
Less : Cash equivalents	100	150	
	900	1,350	450
			(2,450)
Income from Investments			1,200
			(1,250)

Thus there was net cash outflows for investing activities.

Illustration 2 (b) : Take the information given in Illustration 2. & 2.(a) and derive cash flow from financing activities :

Cash flows from financing activities	(Rs. in lacs)
Issure of shares	1,000
Loans	2,000
Interest	(800)
Dividend	(450)
	1,750

Thus there was net cash inflows from financing activities.

Illustration 2 (c): Use the data given in Illustration 2 & 2.(a) and find out change in cash and cash equivalents:

Rs. in lacs

	31-03-09	31-03-10	Increase/ (Decrease)
Cash and bank Balances	600	500	(100)
Risk-free and readily encashable			
Investments	100	150	50
	700	650	(50)

There was a decrease in Cash and Cash equivalents by Rs. 50 lacs.

Illustration 2 (d) : Now using data given in Illustration 2-2.(c), prepare a cash flow statements :

Cash Flow Statement	*Rs. in lacs*
Cash flows from operating activities	(550)
Cash flows from investment activities	(1250)
Cash flows from financing activities	1750
Decrease in cash and cash equivalents :	(50)

Cash flows statement is largely used fro management decisions. However, there is global trend in favour of inclusion of cash flows statement as a part of corporate financial statements. In India, the SEBI has already issued a notification requiring the listed companies to include a cash flow statement in the annual report. The Institute of Chartered Accountants of India has also issued Accounting Standard 3 (AS-3) Cash Flow Statement. It has now become part of the financial statements of the listed companies.

Illustration 3. Given below is the Balance Sheets of Alkrit Sugar Ltd. as at 31-03-10 and 31-03-09. You are required to prepare a Cash Flow Statement for the year 2009-10.

(Rs. in thousand)

Balance Sheet		**31-03-10**		**31-03-09**
Equity share capital	1500		1000	
General Reserve	3200		2700	
Profit & Loss Account	300		200	
Share Premium Account	500			
Shareholders' Funds		55000		3900
Secured Loans	800		1000	
Unsecured Loans	1600		1200	
Loan Funds		2400		2200
Sources		7900		6100
Fixed Assets				
Gross Block	7000		5000	
Accumulated Depreciation	1100		800	
Net Block		5900		4200
Investments		1100		800
Current Assets, Loans & Advances				
Inventories	1650		1670	
Debtors	760		450	
Cash & Bank Balances	240		120	
Loans	400		200	
Advance Tax	500		400	
	3550		2480	

Balance Sheet		31-03-10		31-03-09
Creditors	1470		970	
Outstanding expenses	200		110	
Tax Provision	500		400	
Proposed Dividend	600		400	
	2770		1880	
Net Current Assets		780		960
Miscellaneous Expenditure		120		140
Applications		7900		6100

Other Information:

(1) Fixed assets costing Rs. 40,000, accumulated depreciation Rs. 2,000 were sold for Rs. 30,000.

(2) Actual tax liability for 2008-09 was Rs. 4,00,000.

(3) Loans represent long term loans given to group companies.

(4) Interest on loan funds for 2009-10 was Rs. 3,48,000 and interest and dividend income were Rs. 1,95,000.

Solution: (*Rs. in thousand*)

Cash Flow from Operating Activities		
Change in general reserve	500	
Change in profit and loss account	100	
Proposed dividend	600	
Provision for tax	500	
Profit Before tax		1700
Add : Depreciation	302	
Add : Misc. Expn.	20	
Add/(Less) Loss (profit) on sale of fixed assets	8	
Funds flow from operations	2030	
Add : Interest paid	348	
Less : Interest and Dividend Received	-195	
Add/Less Working Capital Adjustment		
Inventories	20	
Debtors	-310	
Creditors	500	
Outstanding expenses	90	300
Cash Flow from Operating Activities (Before tax)		2483
Less: Advance tax for 2009-10		500
Cash flow from Operating Activities (After Tax)		1983

Cash flow Financing Activities		
Issue of shares		
Face value	500	
Premium	500	1000
Repayment of Secured Loans	-200	
Raising of Unsecured Loans	400	
Net loan		200
Interest payment		-348
Dividend payment for 2009-10		-400
		452
Cash flow from Investment Activities		
Purchase of Fixed Assets	-2040	
Sale of Fixed Assets	30	
Fixed Assets (Net)		-2010
Purchase of Investments		-300
Loans		-200
Interest & Dividend Income		195
		-23 15
Cash Flow Statement		
Cash flow from Operating Activities (After Tax)		1983
Cash flow Financing Activities		452
Cash How from Investment Activities		-2315
Increase/decrease in Cash & Bank Balance		120

Illustration 4. Given below are Balance Sheets of Calcutta Jute Ltd. as at 31-03-10 and 31-03-09. You are required to prepare Cash Flow Statement for the year 2009-10.

(Rs. in thousand)

Balance Sheet	**31-03-10**		**31-03-09**	
Equity share capital	5500		4000	
General Reserve	5100		4200	
Profit & Loss Account	450		400	
Share Premium Account	1500			
Shareholders' Funds		12550		8600
Secured Loans	1800		3400	
Unsecured Loans	2300		1200	
Loan Funds		4100		4600
Sources		16650		13200

Balance Sheet	**31-03-10**		**31-03-09**	
Fixed Assets				
Gross Block	15000		12000	
Accumulated Depreciation	1800		1300	
Net Block		13200		10700
Capital Work-in-progress		1200		700
Investments		1700		1400
Current Assets, Loans & Advances				
Inventories	2510		2600	
Debtors	1090		1200	
Cash & Bank Balances	240		340	
Loans	1700		200	
Advance Tax	850		700	
	6390		5040	
Creditors	1050		1200	
Outstanding expenses	2100		1540	
Tax Provision	850		700	
Proposed Dividend	2200		1600	
	6200		5040	
Net Current Assets		190		0
Miscellaneous Expenditure		360		400
Applications		16650		13200

Other Information :

(1) Fixed assets costing Rs. 1,20,000, accumulated depreciation R. 60,000 were sold for Rs. 70,000.

(2) Actual tax liability for 2009-10 was Rs. 7,00,000.

(3) Loans represent long term loans given to group companies.

(4) Interest on loan funds for 2009-10 was Rs. 5,94,500 and interest and divider income were Rs. 4,42,000.

(5) Investments costing Rs. 6,00,000 were sold for Rs. 7,00,000.

Solution: *(Rs. in thousand)*

Cash flow from operating activities		
Change in general reserve	900	
Change in profit and loss account	50	
Proposed dividend	2200	
Provision for tax	850	
Profit Before tax		4000

Add: Depreciation	560	
Add: Misc. Expn.	40	
Add/(Less) Loss (profit) on sale of fixed assets	-10	
Add/(Less) Loss (profit) on sale of Investments	-100	
Funds flow from operations		4490
Add: Interest paid		594.5
Less : Interest and Dividend Received		-442
Add/Less Working Capital Adjustment		
Inventories	90	
Debtors	110	
Creditors	-150	
Outstanding expenses	560	610
Cash Flow from Operating Activities (Before tax)		5252.5
Less Advance tax for 2009-10		850
Cash flow from Operating Activities (After Tax)		4402.5
Cash flow Financing Activities		
Issue of shares		
Face value	1500	
Premium	1500	3000
Repayment of Secured Loans	-1600	
Raising of Unsecured Loans	1100	
Net loan		-500
Interest payment		-594.5
Dividend payment for 2008-09		-1600
		305.5
Cash flow from Investment Activities		
Purchase of Fixed Assets	-3120	
Sale of Fixed Assets	70	
Capital WIP	-500	
Fixed Assets (Net)		-3550
Purchase of Investments	-900	
Sale Proceeds of Investments	700	
Investments (Net)		-200
Loans		-1500
Interest & Dividend Income		442
		-4808
Cash Flow Statement		
Cash flow from Operating Activities (After Tax)		4402.5
Cash flow Financing Activities		305.5
Cash flow from Investment Activities		-4808
Increase/decrease in Cash & Bank Balance		-100

Illustration 5. Deepak Chemicals presents the following Balance Sheets as at 31-03-10 and 31-03-09. You are required to prepare cash flow statement.

(Rs. in thousand)

Balance Sheet		**31-03-10**		**31-03-09**
Equity share capital	8500		7000	
General Reserve	3800		4000	
Profit & Loss Account	0		250	
Share Premium Account	1500		750	
Shareholders' Funds		13800		12000
Secured Loans	4800		500	
Unsecured Loans	5350		4000	
Loan Funds		10150		9000
Sources		23950		21000
Fixed Assets				
Gross Block	22400		21000	
Accumulated Depreciation	3450		3200	
Net Block		18950		17800
Capital Work-in-progress		1860		0
Investments		1650		2320
Current Assets, Loans & Advances				
Inventories	2150			
Debtors	1090			
Cash & Bank Balances	120			
Loans	1700			
Advance Tax	0			
Creditors	1050		1200	
Outstanding expenses	30		0	
Tax Provision	0		500	
Proposed Dividend	3400		2800	
	4480		4500	
Net Current Assets		940		280
Miscellaneous Expenditure		550		600
Applications		23950		21000

Other Information:

(1) Fixed assets costing Rs. 4,00,000, accumulated depreciation Rs. 3,00,000 were sold for Rs. 1,50,000.

(2) Actual tax liability for 2008-09 was Rs. 5,00,000.

(3) Loans represent long term loans given to group companies.

(4) Interest on loan funds for 2008-09 was Rs. 14,21,000 and interest and dividend income were Rs. 4,02,000.

(5) Investments costing Rs. 20,00,000 were sold for Rs. 25,00,000.

Solution: (*Rs. in thousand*)

Cash flow from operating activities		
Change in general reserve	-200	
Change in profit and loss account	-250	
Proposed dividend	3400	
Provision for tax	0	
Profit Before tax		2950
Add : Depreciation	550	
Add : Misc.Expn.	50	
Add/(Less) Loss (profit) on sale of fixed assets	-50	
Add/(Less) Loss (profit) on sale of Investments	-500	
Funds flow from operations		3000
Add: Interest paid		1421
Less Interest and Dividend Received		-402
Add/Less Working Capital Adjustment		
Inventories	90	
Debtors	110	
Creditors	-150	
Outstanding expenses	30	80
Cash Flow from Operating Activities (Before tax)		4099
Less Advance tax for 2009-10		0
Cash flow from Operating Activities (After Tax)		4099
Cash flow Financing Activities		
Issue of shares		
Face value	1500	
Premium	750	2250
Repayment of Secured Loans	-200	
Raising of Unsecured Loans	1350	
Net loan		1150
Interest payment		-1421
Dividend payment for 2008-09		-2800
		-821
Cash flow from Investment Activities		
Purchase of Fixed Assets	-1800	
Sale of Fixed Assets	150	
Capital WIP	-1860	

Fixed Assets (Net)		-3510
Purchase of Investments	-1330	
Sale Proceeds of Investments	2500	
Investments (Net)		1170
Loans		-1500
Interest & Dividend Income		402
		-3438
Cash Flow Statement		
Cash flow from Operating Activities (After Tax)		4099
Cash flow from Financing Activities		-821
Cash flow from Investment Activities		-3438
Increase/decrease in Cash & Bank Balance		-160

Illustration 6. Given below are summarised Balance Sheets of Harsh Chemicals Ltd. as at 31-03-09 and 31-03-10. The company issued one bonus share for every 4 shares held. The company also acquired machinery amounting to Rs. 30,00,000 from Levenz of France on deferred credit basis. You are required to prepare the cash flow statement.

(*Rs. in thousand*)

Balance Sheet		**31-03-10**		**31-03-09**
Equity share capital	8500		4000	
General Reserve	7000		7600	
Profit & Loss Account	1200		1000	
Share Premium Account	1500		750	
Shareholders' Funds		18200		13350
Secured Loans	4800		5400	
Unsecured Loans	5350		4000	
Deferred Credit	3000		0	
Loan Funds		13150		9400
Sources		31350		22750
Fixed Assets				
Gross Block	22400		17000	
Accumulated Depreciation	3450		3200	
Net Block		18950		13800
Capital Work-in-progress		8200		3000
Investments		1650		2320
Current Assets, Loans & Advances				
Inventories	4000		3200	
Debtors	1090		2200	
Cash & Bank Balances	540		750	
Loans	1700		200	

Balance Sheet		**31-03-10**		**31-03-09**
Advance Tax	1600		1400	
	8930		7750	
Creditors	1050		1600	
Outstanding expenses	880		120	
Tax Provision	1600		1400	
Proposed Dividend	3400		1600	
	6930		4720	
Net Current Assets		2000		3030
Miscellaneous Expenditure		550		600
Applications		31350		22750

Other Information:

(1) Fixed assets costing Rs. 4,00,000, accumulated depreciation Rs. 3,00,000 were sold for Rs. 1,50,000.

(2) Actual tax liability for 2008-09 was Rs. 14,00,000.

(3) Loans represent long term loans given to group companies.

(4) Interest on loan funds for 2009-10 was Rs. 18,41,000 and interest and dividend income were Rs. 4,02,000.

(5) Investments costing Rs. 20,00,000 were sold for Rs. 25,00,000.

Solution: (*Rs. in thousand*)

Cash flow from operating activities		
Change in general reserve	400	
Change in profit and loss account	200	
Proposed dividend	3400	
Provision for tax	1600	
Profit before tax		5600
Add : Depreciation	550	
Add : Misc. Expenses	50	
Add/(Less) Loss (profit) on sale of fixed assets	-50	
Add/(Less) Loss (profit) on sale of Investments	-500	
Funds flow from operations		5650
Add : Interest paid		1841
Less : Interest and Dividend Received		-402
Add/Less Working Capital Adjustment		
Inventories	-800	

Debtors	1110	
Creditors	-550	
Outstanding expenses	760	520
Cash Flow from Operating Activities (Before tax)		7609
Less : Advance tax for 2009-10		1600
Cash flow from Operating Activities (After Tax)		6009
Cash flow Financing Activities		
Issue of shares		
Face value	3500	
Premium	750	4250
Repayment of Secured Loans	-600	
Raising of Unsecured Loans	1350	
Net loan		750
Interest payment		-1841
Dividend payment for 2008-09		-1600
		1559
Cash flow from Investment Activities		
Purchase of Fixed Assets	-5800	
Sale of Fixed Assets	150	
Capital WIP	-2200	
Fixed Assets (Net)		-7850
Purchase of Investments	-1330	
Sale Proceeds of Investments	2500	
Investments (Net)		1170
Loans		-1500
Interest & Dividend Income		402
		-7778
Cash Flow Statement		
Cash flow from Operating Activities (After Tax)		6009
Cash flow from Financing Activities		1559
Cash flow from Investment Activities		-7778
Increase/decrease in Cash & Bank Balance		-210

Illustration 7.

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2010 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.03.2010

	Rs. '000		**Rs. '000**
Balance on 1.4.2000	50	Payment to Suppliers	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from Customers	2,800	Overhead expense	200
Sale of Fixed Assets	100	Wages and Salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.3.2001	150
	3,250		3,250

Solution:

X Ltd.
Cash Flow Statement for the year ended 31st March, 2010
(Using the direct method)

	Rs. '000	**Rs. '000**
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payment to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flows from investing activities		
Payment for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 8.

(a) Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS 3:

	Rs. (in lacs)	**Rs.(in lacs)**
Net Profit		60,000
Add: Sale of Investments		70,000
Depreciation on Assets		11,000
Issue of Preference Shares		9,000
Loan raised		4,500
Decrease in Stock		12,000
		1,66,500
Less: Purchase of Fixed Assets	65,000	
Decrease in Creditors	6,000	
Increase in Debtors	8,000	
Exchange gain	8,000	
Profit on sale of investments	12,000	
Redemption of Debenture	5,700	
Dividend paid	1,400	
Interest paid	945	1,07,045
		59,455
Add: Opening cash and cash equivalent		12,341
Closing cash and cash equivalent		71,796

(b) P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

(c) Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being Rs.7,00,000. The economic life of the machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays Rs.3,00,000. Guaranteed Residual Value (GRV) is Rs. 22,000 on expiry of the lease. Implicit Rate of Return (IRR) is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machine to be considered by Lessee Ltd. and the interest (Finance charges) in each year.

Solution:

(a) **Cash Flow Statement**

Cash flows from operating activities		*(Rs. in lacs)*
Net profit		60,000
Less: Exchange gain		(8,000)
Less: Profit on sale of investments		(12,000)
		40,000
Add: Depreciation on assets		11,000
Change in current assets and current liabilities		51,000
(-) Increase in debtors	(8,000)	
(+) Decrease in stock	12,000	
(-) Decrease in creditors	(6,000)	(2,000)
Net cash from operating activities		49,000
Cash flows from investing activities		
Sale of investments	70,000	
Purchase of fixed assets	(65,000)	
Net cash from Investing activities		5,000
Cash flows from financing activities		
Issue of preference shares	9,000	
Loan raised	4,500	
Redemption of Debentures	(5,700)	
Interest paid	(945)	
Dividend paid	(1,400)	
Net cash from financing activities		5,455
Net increase in cash & cash equivalents		59,455
Add: Opening cash and cash equivalents		12,341
Closing cash and cash equivalents		71,796

Illustration 9.

The following information is available in respect of ABC Ltd.:

(1) Materials are purchased and received one month before being used and payment is made to suppliers two months after receipt of materials.

(2) Cash is received from customers three months after finished goods are sold and delivered to them.

(3) No time lag applies to payments of wages and expenses.

(4) The following figures apply to recent and future months:

Month	Materials received Rs.	Sales Rs.	Wages and Expenses Rs.
January	20,000	30,000	9,500
February	22,000	33,000	10,000
March	24,000	36,000	10,500
April	26,000	39,000	11,000
May	28,000	42,000	11,500
June	30,000	45,000	12,000
July	32,000	48,000	12,500
August	34,000	51,000	13,000

(5) Cash balance at the beginning of April is Rs. 10,000.

(6) All the products are sold immediately they have been made and that materials used and sums spent on wages and expenses during any particular month relate strictly to the sales made during that month.

Prepare cash flow forecast month by month from April to July, profit and loss forecast for four months (April-July) and a movement of funds statement for the four months period (April-July).

Solution:

Cash forecast from April to July

Amount in Rs.

	April	May	June	July
Opening Balance	10,000	7,000	4,500	2,500
Collections from debtors	30,000	33,000	36,000	39,000
	40,000	40,000	40,500	41,500
Payments:				
Wages and Expenses	11,000	11,500	12,000	12,500
Payment to suppliers	22,000	24,000	26,000	28,000
	33,000	35,500	38,000	40,500
Closing balance	7,000	4,500	2,500	1,000

Profit and Loss forecast for 4 months April-July

.		Rs
Sales (April to July)		1,74,000
Closing Stock (July Purchase)		32,000
	2,06,000	
Less: Opening stock- (March purchase)	24,000	
Purchases (April to July)	1,16,000	
Wages and Expenses (April to July)	47,000	
	1,87,000	
Profit for the 4 months period		19,000

Movement of Funds Statement

Stock (Opening)	April	March purchase		24,000
Receivables (Opening)	April	Credit allowed 3 months		
		January Sales	30,000	
		February Sales	33,000	
		March Sales	36,000	
				99,000
Creditors (Opening)	April	Credit received 2 months		
		February Purchase	22,000	
		March Purchase	24,000	
				46,000
Closing stock (end of July), July Purchase				32,000
Receivable (end of July), May to July Sales				1,35,000
Creditors (end of July), June and July Purchase				62,000

Now movement of funds statement can be worked out as :

Sources:		**Rs.**
Profit earned during 4 months	19,000	
Add: Increase in creditors (62,000 - 46,000)	16,000	
		35,000
Application:		
Less: Increase in receivables (1,35,000-99,000)	36,000	
Less: Increase in stock (32,000-24,000)	8,000	
		44,000
		(-)9,000
Opening Cash balance		10,000
Hence closing cash balance		1,000

Illustration 10.

Alcobex Metal Company (AMC) does business in three products P1, P2 and P3. Products P1 and P2 are manufactured in the company, while product P3 is procured from outside and resold as a combination with either product P1 or P2. The sales volume budgeted for the three products for the year 2009-2010 (April-March) are as under :

Products	**Rs. in lakhs**
P1	1,200
P2	500
P3	400

Based on the budgeted sales value, the cash flow forecast for the company is prepared based on the following assumptions:

(1) Sales realisation is considered at:

50% Current month

25% Second month

25% Third month

(2) Production Programme for each month is based on the sales value of the next month.

(3) Raw material consumption of the company is kept at 59% of the month's production.

(4) 81% of the raw materials consumed are components.

(5) Raw material and components to the extent, at 25% are procured through import.

(6) The Purchases budget is as follows:

   (i) Indigenous raw materials are purchased two months before the actual consumption.

   (ii) Components are procured in the month of consumption.

   (iii) Imported raw materials and components are brought three months prior to the month of consumption.

(7) The company avails of the following credit terms from suppliers:

   (i) Raw materials are paid for in the month of purchases;

   (ii) Company gets one month's credit for its components;

   (iii) For imported raw material and components payments are made one month prior to the dates of purchases.

(8) Currently the company has a cash credit facility of Rs. 140.88 lakhs

(9) Expenses are given below and are expected to be constant throughout the year:

Wages and Salaries	Rs. 312 lakhs
Administrative Expenses	Rs. 322 lakhs
Selling and Distribution Expenses	Rs. 53 lakhs

(10) Dividend of Rs. 58.03 lakhs is to be paid in October.

(11) Tax of Rs. 23.92 lakhs will be paid in equal installments in four-quarters: i.e., January, April, July and October.

(12) The term-loan of Rs. 237.32 lakhs is repayable in two equal installments half-yearly. i.e June/ December.

(13) Capital expenditure of Rs. 292.44 lakhs for the year is expected to be spread equally during the 12 months period.

You are required to prepare a Cash Flow Statement (Cash Budget) for the period of June-November, 2010.

Solution:

Alcobex Metal Company

Cash Flow statement (cash budget) for the period of June –November, 2010

(Rs. in lakhs)

	June	July	August	September	October	November	Total cash flow
Opening Balance	(140.88)	(273.98)	(294.40)	(310.35)	(326.31)	(405.03)	(140.88)
(Refer to Assumption)							
Collection from customers	166.67	166.67	169.17	170.42	171.67	171.67	1,016.27
(Refer to working note 1)							
Total	25.79	(107.31)	(125.23)	(139.93)	(154.64)	(233.36)	875.39
Payment to supplier	99.49	101.70	103.5	104.76	104.76	104.76	618.97
(Refer to working note 4)							
Wages and Salaries	26	26	26	26	26	26	56.00
Administrative expenses	26.83	26.83	26.83	26.83	26.83	26.83	160.98
Selling and Distribution	4.42	4.42	4.42	4.42	4.42	4.42	26.52
Dividend					58.03		58.03
Tax	-	5.98	-	5.98	-	-	11.96
Capital Expenditure	24.37	24.37	24.37	24.37	24.37	24.37	146.22
Repayment of term loan	118.66						118.66
Total	**299.77**	**189.30**	**185.12**	**186.38**	**250.39**	**186.38**	**1,297.34**
Closing balance	(273.98)	(294.40)	(310.35)	(326.31)	(405.03)	(419.74)	(421.95)

Assumptions:

1. Since the opening cash balance as on June, 2010 is not given, it is assumed that the credit facility enjoyed by the company of Rs. 140.88 lakhs is its opening balance.
2. Since the question does not provide relevant information regarding purchase price and payment terms to the suppliers in respect of Product P3 which is procured from outside and sold as a combination with either Product P1 or P2. It is assumed that the Product P3 is manufactured within the company and its production programme and production costs are same as to the manufacturing of Products P1 or P2.
3. In the working notes some of the calculations are taken from December for the sake of completeness otherwise they are not required.

Working Notes :

1. Collection from debtors:

	Sales	Product P2	Product P3	Total Sales	Current month collection	2nd month collection	3rd month collection	Total collection
	(i)			(ii)	(iii)	(iv)	(v)	(vi)=(ii)+(iii)+(iv)
December	100	41.67	20	161.67	80.83	0	0	80.83
January	100	41.67	20	161.67	80.83	40.42	0	121.25
February	100	41.67	20	161.67	80.83	40.42	40.42	161.67
March	100	41.67	20	161.67	80.83	40.42	40.42	161.67
April	100	41.67	25	166.67	83.33	40.42	40.42	164.17
May	100	41.67	25	166.67	83.33	41.67	40.42	165.42
June	100	41.67	25	166.67	83.33	41.67	41.67	166.67
July	100	41.67	25	166.67	83.33	41.67	41.67	166.67
August	100	41.67	30	171.67	85.83	41.67	41.67	169.17
September	100	41.67	30	171.67	85.83	42.92	41.67	170.42
October	100	41.67	30	171.67	85.83	42.92	42.92	171.67
November	100	41.67	30	171.67	85.83	42.92	42.92	171.67
December	100	41.67	45	186.67	93.33	42.92	42.92	179.17
January	100	41.67	45	186.67	93.33	46.67	42.92	182.92
February	100	41.67	45	186.67	93.33	46.67	46.67	186.67
March	100	41.67	45	186.67	93.33	46.67	46.67	186.67
Total	**1600**	**666.67**	**480**	**2746.67**	**1373.33**	**640.00**	**593.33**	**2606.67**

2. Production Programme

Months	Sales value (Refer to working note (i) column (ii))	Total raw material consumption	Components	Other raw material	Imported raw material & components	Indigenous raw material & components	Indigenous raw material	Indigenous components
	(i)	(ii)=59% of (i)	(iii)=81% of (ii)	(iv)=(ii)-(iii)	(v)=25%of (ii)	(vi)=(ii)-(v)	(vii)=75% of (iv)	(viii)=75% of (iii)
December	161.67	95.38	77.26	18.12	23.85	71.54	13.59	57.95
January	161.67	95.38	77.26	18.12	23.85	71.54	13.59	57.95
February	161.67	95.38	77.26	18.12	23.85	71.54	13.59	57.95
March	166.67	98.38	79.65	18.68	24.58	73.75	14.01	59.74
April	166.67	98.33	79.65	18.68	24.58	73.75	14.01	59.74
May	166.67	98.33	79.65	18.68	24.58	73.75	14.01	59.74
June	166.67	98.33	79.65	18.68	24.58	73.75	14.01	59.74

Months	Sales value (Refer to working note (i) column (ii))	Total raw material consumption	Components	Other raw material	Imported raw material & components	Indigenous raw material & components	Indigenous raw material	Indigenous components
	(i)	(ii)=59% of (i)	(iii)=81% of (ii)	(iv)=(ii)-(iii)	(v)=25%of (ii)	(vi)=(ii)-(v)	(vii)=75% of (iv)	(viii)=75% of (iii)
July	171.67	101.28	82.04	19.24	25.32	75.96	14.43	61.53
August	171.67	101.28	82.04	19.24	25.32	75.96	14.43	61.53
September	171.67	101.28	82.04	19.24	25.32	75.96	14.43	61.53
October	171.67	101.28	82.04	19.24	25.32	75.96	14.43	61.53
November	186.67	110.13	89.21	20.93	27.53	82.60	15.69	66.91
December	186.67	110.13	89.21	20.93	27.53	82.60	15.69	66.91
January	186.67	110.13	89.21	20.93	27.53	82.60	15.69	66.91
February	186.67	110.13	89.21	20.93	27.53	82.60	15.69	66.91
Total	**2585.05**	**1525.15**	**1235.38**	**289.76**	**381.27**	**1143.86**	**217.29**	**926.57**

3. Purchase Programme

Months	Indigenous others (Refer to working note 2 above) (column vii)	Indigenous Components (Refer to working note 2 above) (column viii)	Imported others
	(i)	*(ii)*	*(iii)*
December	13.59	57.95	24.58
January	14.01	57.95	24.58
February	14.01	57.95	24.58
March	14.01	59.74	24.58
April	14.01	59.74	25.32
May	14.43	59.74	25.32
June	14.43	59.74	25.32
July	14.43	61.53	25.32
August	14.43	61.53	27.53
September	15.69	61.53	27.53
October	15.69	61.53	27.53
November	15.69	66.91	27.53
December	15.69	66.91	-
January	0.00	66.91	-
February	0.00	66.91	-

4. Payment to Suppliers (Rs. in lakhs)

Months	Indigenous others	Indigenous Components (Previous month paid now)	Imported others and components (Next month purchase advance payment)	Total Payment
December	13.59	0	24.58	13.59
January	14.01	57.95	24.58	96.54
February	14.01	57.95	24.58	96.54
March	14.01	57.95	25.32	96.54
April	14.01	59.74	25.32	99.07
May	14.43	59.74	25.32	99.49
June	14.43	59.74	25.32	99.49
July	14.43	59.74	27.53	101.70
August	14.43	61.53	27.53	103.50
September	15.69	61.53	27.53	104.76
October	15.69	61.53	27.53	104.76
November	15.69	61.53	0.00	104.76
December	15.69	66.91	0.00	82.60
January	0.00	66.91	0.00	66.91
February	0.00	66.91	0.00	66.91
March		66.91	0.00	66.91
		0.00	0.00	

Illustration 11.

XYZ Ltd. Company's Comparative Balance Sheet for June 2010 and June 2009 and the Company's Income Statement for the year June 30, 2010 are as follows:

XYZ Ltd.
Comparative Balance Sheet
June 2010 and June 2009

(*Rs. in crores*)

		2010		**2009**
Sources of funds:				
Shareholder's funds	140		140	
Share Capital	110	250	92	232
Loan funds		135		40
		385		272
Application of funds				
Fixed Assets				

		2010		2009
Plant and Equipment	430		309	
Less : Accumulated depreciation	(218)	212	(194)	115
Investments		60		75
Current Assets				
Inventory	205		160	
Accounts receivable	180		270	
Pre-paid expenses	17		20	
Cash	26	428	10	460
Less : Current liabilities and provisions				
Accounts payable	230		310	
Accrued liabilities	70		60	
Deferred income-tax provision	15	315	113	8
		378	82	
			385	272

XYZ Ltd.

Income Statement

For the year ended June 30, 2010

	(*Rs. in crores*)
Sales	1,000
Less : Cost of goods sold	530
Gross margin	470
Less : Operating expenses	352
Net operating income	118
Non-operating items:	
Loss on sale of equipment	(4)
Income before taxes	114
Less : Income-taxes	48
Net income	66

Additional information:

(i) Dividends of Rs.48 crores were paid in 2010.

(ii) The loss on sale of equipment of Rs.4 crore reflects a transaction in which equipment with an original cost of Rs.12 crore and accumulated depreciation of Rs.5 crore were sold for Rs.3 crore in cash.

Required:

Using the indirect method, determine the net cash provided by operating activities for 2010 and construct a statement of cash flows.

Solution:

Statement of net cash flows provided by operating activities by using indirect method for the year ended June 30, 2010

	(*Rs. in crores*)
Operating Activities	
Net Income	66
Adjustment to convert net income to a cash basis	
Depreciation and amortization charges	29
Decrease in accounts receivable	90
Increase in inventory	(45)
Decrease in pre-paid expenses	3
Decrease in accounts payable	(80)
Increase in accrued liabilities	10
Increase in deferred income tax	7
Loss on sale of equipment	4
Net cash provided by operating activities	84
Cash Flow from Investing Activities	
Additions to property, building & equipment	(133)
Decrease in long term investments	15
Proceeds from sale of equipment	3
Net cash used in investing activities	(115)
Cash Flows from Financing Activities	
Increase in bonds payable	95
Cash dividends paid	(48)
Net cash used in financing activities	47
Net increase in cash & cash equivalents	16
Cash & cash equivalents at the beginning of year	10
Cash & cash equivalents at the end of year	26

Illustration 12.

The following is the income statement XYZ Company for the year 2009-10:

			(Rs.)
Sales			1,62,700
Add: Equity In ABC Company's earning			6,000
			1,68,700
Expenses		Rs.	
Cost of goods sold		89,300	
Salaries		34,400	
Depreciation		7,450	
Insurance		500	
Research and development		1,250	
Patent amortisation		900	
Interest		10,650	
Bad debts		2,050	
Income tax :			
Current	6,600		
Deferred	1,550	8,150	
Total expenses			1,54,650
Net income			14,050

Additional informations are :

(i) 70% of gross revenue from sales were on credit.

(ii) Merchandise purchases amounting to Rs. 92,000 were on credit.

(iii) Salaries payable totaled Rs. 1,600 at the end of the year.

(iv) Amortisation of premium on bonds payable was Rs. 1,350.

(v) No dividends were received from the other company.

(vi) XYZ Company declared cash dividend of Rs. 4,000.

(vii) Changes in Current Assets and Current Liabilities were as follows:

	Increase (Decrease) **Rs.**
Cash	500
Marketable securities	1,600
Accounts receivable	(7,150)
Allowance for bad debt	(1,900)
Inventory	2,700
Prepaid insurance	700

	Rs.
Accounts payable (for merchandise)	5,650
Salaries payable	(2,050)
Dividends payable	(3,000)

Prepare a statement showing the amount of cash flow from operations.

Solution:

Statement showing cash flow from Operations

	Rs.	Rs.
Cash flow from operations		
Cash sales (30% 1,62,700)	48,810	
Collection from debtors	1,20,890	
Total cash from operations		1,69,700
Uses of cash from operations		
Payment to suppliers	86,350	
Salaries expense	36,450	
Payment for insurance	1,200	
Research and development	1,250	
Interest payment	12,000	
Income tax payment	6,600	
Total operating cash payment	1,43,850	
Net cash flow from operations	25,850	

Notes:

(1) Collection from debtors	Rs.
Credit sales (70%× 1,62,700)	1,13,890
Less : Bad debts (2,050 less 1,900)	150
	1,13,740
Add : decrease in accounts receivables	7,150
Collection from debtors on credit sales	1,20,890

(2) Dividends earned Rs 6,000 on equity of ABC Company has not been considered as it has not been received in cash.

	Rs.	
(3) Payment to suppliers		
Cost of goods sold	89,300	
Add: Increase in inventory	2,700	
Purchases	92,000	
Less: increase in accounts payable	5,650	
Payment to suppliers		86,350

(4)	Calculation of salaries payment	
	Salary expense	34,400
	Add : decrease in salary payable	2,050
	Payment of salaries	36,450
(5)	Insurance payments	
	Insurance	500
	Add : increase in prepaid insurance	700
	Payment for insurance	1,200
(6)	Interest payment	
	Interest expenses	10,650
	Add : Amortisation of bond premium	1,350
	Interest payments	12,000
(7)	Income tax payments	
	Income tax expense	8,150
	Less: Deferred tax	1,550
		6,600
	Changes in current tax payable	Nil
	Income tax payments	6,600

Illustration 13.

From the information contained in Income Statement and Balance Sheet of 'A' Ltd., prepare Cash Flow Statement:

Income Statement for the year ended March 31, 2010

		Rs.
Net Sales	(A)	2,52,00,000
Less:		
Cash Cost of Sales		1,98,00,000
Depreciation		6,00,000
Salaries and Wages		24,00,000
Operating Expenses		8,00,000
Provision for Taxation		8,80,000
	(B)	2,44,80,000
Net Operating Profit (A – B)		7,20,000
Non-recurring Income – Profits on sale of equipment		1,20,000
		8,40,000
Retained earnings and profits brought forward		15,18,000
		23,58,000
Dividends declared and paid during the year		7,20,000
Profit and Loss Account balance as on March 31, 2010		16,38,000

Balance Sheet

Assets	March 31, 2009 (Rs.)	March 31, 2010 (Rs.)
Fixed Assets:		
Land	4,80,000	9,60,000
Buildings and Equipment	36,00,000	57,60,000
Current Assets:		
Cash	6,00,000	7,20,000
Debtors	16,80,000	18,60,000
Stock	26,40,000	9,60,000
Advances	78,000	90,000
	90,78,000	1,03,50,000

Balance Sheet

Liabilities and Equity	March 31, 2009 (Rs.)	March 31, 2010 (Rs.)
Share Capital	36,00,000	44,40,000
Surplus in Profit and Loss Account	15,18,000	16,38,000
Sundry Creditors	24,00,000	23,40,000
Outstanding Expenses	2,40,000	4,80,000
Income-tax payable	1,20,000	1,32,000
Accumulated Depreciation on Buildings and Equipment	12,00,000	13,20,000
	90,78,000	1,03,50,000

The original cost of equipment sold during the year 2009-10 was Rs. 7,20,000.

Solution:

Cash Flow Statement of Company A Ltd. for the year ending March 31, 2010

Cash flows from Operating Activities

	Rs.
Net Profits before Tax and Extra-ordinary Item	16,00,000
Add: Depreciation	6,00,000
Operating Profits before Working Capital Changes	22,00,000
Increase in Debtors	(1,80,000)
Decrease in Stock	16,80,000
Increase in Advances	(12,000)
Decrease in Sundry Creditors	(60,000)
Increase in Outstanding Expenses	2,40,000
Cash Generated from Operations	38,68,000
Income tax Paid	8,68,000
Net Cash from Operations	30,00,000

Cash flows from Investment Activities

	Rs.
Purchase of Land	(4,80,000)
Purchase of Buildings and Equipment	(28,80,000)
Sale of Equipment	3,60,000
Net Cash used in Investment Activities	(30,00,000)

Cash flows from Financing Activities

		Rs.
Issue of Share Capital	8,40,000	
Dividends Paid	(7,20,000)	
Net Cash from Financing Activities		1,20,000
Net increase in Cash and Cash Equivalents		1,20,000
Cash and Cash Equivalents at the beginning		6,00,000
Cash and Cash Equivalents at the end		7,20,000

Buildings and Equipment Account

Dr. **Cr.**

	Rs.		Rs.
To Balance b/d	36,00,000	By Sale of Asset	7,20,000
To Cash/Bank (purchase)		By Balance c/d	57,60,000
(Balancing figure)	28,80,000		
	64,80,000		64,80,000

Accumulated Depreciation on Buildings and Equipment Account

Dr. **Cr.**

	Rs.		Rs.
To Sale of Asset		By Balance b/d	12,00,000
(Accumulated depreciation)	4,80,000	By Profit and Loss (Provisional)	6,00,000
To Balance c/d	13,20,000		
	18,00,000		18,00,000

Sale of Asset Account

	Rs.
Original Cost	7,20,000
Less: Accumulated Depreciation	4,80,000
Net Cost	2,40,000
Profit on Sale of Asset	1,20,000
Sale Proceeds from Asset Sales	3,60,000

Illustration 14.

X Ltd. has the following balances as on 1st April, 2009

	Rs.
Fixed Assets	11,40,000
Less; Depreciation	3,99,000
	7,41,000
Stocks and Debtors	4,75,000
Bank Balance	66,500
Creditors	1,14,000
Bills payable	76,000
Capital (Shares of Rs. 100 each)	5,70,000

The Company made the following estimates for financial year 2009-10:

(i) The company will pay a free of tax dividend of 10% the rate of tax being 25%.

(ii) The company will acquire fixed assets costing Rs.1,90,000 after selling one machine for Rs. 38,000 costing Rs. 95,000 and on which depreciation provided amounted to Rs. 66,500.

(iii) Stocks and Debtors, Creditors and Bills payables at the end of financial year are expected to be Rs. 5,60,500, Rs. 1,48,200 and Rs. 98,800 respectively.

(iv) The profit would be Rs. 1,04,500 after depreciation of Rs. 1,14,000.

Prepare the projected cash flow statement and ascertain the bank balance of X Ltd. at the end of Financial year 2009-10.

Solution:

Working:

(i)	Cash Flow from operations	**Rs.**
	Profit for the year	1,04,500
	Add: Depreciation (non cash item)	1,14,000
		2,18,500
	Less: Profit on sale of machine	9,500
		2,09,000
	Add increase in:	
	Creditors (Rs. 1,48,200 – Rs. 1,14,000) = Rs. 34,200	
	Bills payable (Rs. 98,800 – Rs. 76,000) = Rs. 22,800	57,000
		2,66,000
	Less : Increase in stocks & debtors (Rs. 5,60,500 – Rs. 4,75,000)	85,500
	Cash from operations	1,80,500

(ii) Payment of Dividend

10% on capital Rs. 5,70,000 = Rs. 57,000

Gross up Amount

Total Dividend	Rs. 76,000
Tax 25%	Rs. 19,000
Payment of Dividend	Rs. 57,000

Note: Income Tax on Company's Profit Ignored

Projected Cash Flow Statement
for the Year ending on 31st March, 2010

		Rs.	**Rs.**
Bank Balance as on 1st April, 2009			66,500
Add:	Inflow of Cash		
	Sale of Machine	38,000	
	Cash From operation	1,80,500	2,18,500
Less:	Outflow of Cash		2,85,000
	Purchase of Fixed Assets	1,90,000	
	Payment of Dividend	57,000	
	Tax Paid	19,000	2,66,000
Bank Balance on 31st March, 2010			19,000

Illustration 15. Astor Limited had the following condensed Trial Balance as at 31-03-2009:

Debit	*Amount*	*Credit*	*Amount*
Cash	7,500	Current Liabilities	15,000
Account Receivable	30,000	Long-Term Notes Payable	25,500
Investments	20,000	Bonds Payable	25,000
Plant Assets	67,500	Capital Stock	75,000
Land	40,000	Retained Earnings	24,500
	1,65,000		1,65,000

During 2009-2010, the following transactions took place :

(i) A tract of land was purchased for Rs. 7,750 cash.

(ii) Bonds payable in the amount of Rs. 6,000 were retired for cash at face value.

(iii) An additional Rs. 20,000 equity shares were issued at par for cash.

(iv) Dividends totalling Rs. 9,375 were paid.

(v) Net income for 2002-2003 was Rs. 28,450 after allowing for depreciation of Rs. 9,500.

(vi) Land was purchased through the issuance of Rs. 22,500 in bonds.

(vii) Usha Ltd. sold a part of its investments portfolio for Rs. 12,875 cash. The transaction resulted in a gain of Rs. 1,375 for the firm.

(viii) Current liabilities increased to Rs. 18,000 at 31-3-2010.

(ix) Accounts receivable at 31-3-2010 total Rs. 38,000.

Prepare a statement of cash flows for 2009-2010 with the indirect method as per AS-3 (Revised).

Solution :

Cash Flow Statement for the year ended 31-03-2010

Cash Flows from Operating Activities		
Net Profit	28,450	
Add : Depreciation	9,500	
Less : Gain on Sale of Investment	(1,375)	
Operating Profit before Working Capital changes	36,575	
Add : Increase in current liabilities	3,000	
Less : Increase in accounts receivable	(8,000)	
Net Cash from operating activities		31,575
Cash Flows from Investing activities		
Sale of Investment	12,875	
Purchase of Land (For cash only)	(7,750)	
Net Cash from investing activities		5,125
Cash Flows from Financing Activities		
Issue of shares	20,000	

Redemption of Bonds	(6,000)	
Dividend Paid	(9,375)	
Net Cash from financing activities		4,625
Net Increase in cash and cash equivalents during the period		41,325
Add : Cash and cash equivalents in the beginning of the period		7,500
Cash and cash equivalents at the end of the period		48,825

Note : Significant Non-cash Transactions : Purchase of land by issue of bonds Rs. 22,500.

Illustration 16. From the following information, prepare cash flow statement by using indirect method as per AS-3.

Balance Sheet

Liabilities	*30.6.2009*	*30.6.2010*	*Assets*	*30.6.2009*	*30.6.2010*
Capital	50,00,000	50,00,000	Plant & Machinery	27,30,000	42,70,000
Retained Earnings	26,50,000	36,90,000	*Less* : Depreciation	6,10,000	7,90,000
Debentures	—	9,00,000		21,20,000	38,40,000
Current Liabilities :			*Current Assets :*		
Creditors	8,80,000	8,20,000	Debtors	23,90,000	28,30,000
Bank Loan	1,50,000	3,00,000	*Less* : Provision	1,50,000	1,90,000
Liability for Expenses	3,30,000	2,70,000		22,40,000	26,40,000
Dividend Payable	1,50,000	3,00,000	Cash	15,20,000	18,20,000
Creditors for plant and machinery purchased	—	2,00,000	Marketable Securities	11,80,000	15,00,000
			Inventories	20,10,000	19,20,000
			Prepaid Expenses	90,000	1,20,000
	91,60,000	1,14,80,000		91,60,000	1,14,80,000

Additional Information:

(1) Net Income for the year ended 30.06.2010, after charging depreciation Rs. 1,80,000 is Rs. 22,40,000.

(2) Debtors of Rs. 2,30,000 were determined to be worthless and were written off against the provisions for doubtful debts account.

(3) The Board of Directors declared dividend of Rs. 12,00,000.

Note : Marketable securities are treated as cash equivalents.

Solution:

Cash Flow Statement for the year ended 31-03-2010

Cash Flows from Operating Activities		
Net Income	22,40,000	
Add: Depreciation	1,80,000	
	24,20,000	
Add: Decrease in Inventories	90,000	
Increase in Provision for Doubtful Debts*	40,000	
	25,50,000	

Less: Increase in Current Assets:		
Debtors*		(4,40,000)
Prepaid Expenses		(30,000)
Decrease in Current Liabilities:		
Creditors		(60,000)
Expenses Outstanding		(60,000)
Net Cash from Operating Activities		19,60,000
Cash Flows from Investing Activities		
Payment for Purchase of Plant & Machinery (15,40,000–2,00,000)	(13,40,000)	
Cash outflow from Investing Activities		(13,40,000)
Cash Flows from Financing Activities		
Bank Loan Raised	1,50,000	
Issue of Debentures	9,00,000	
Payment of Dividend	(10,50,000)	
Cash flows from Financing Activities		—
Net Increase in cash and Cash equivalents during the year		6,20,000
Add : Opeaning balance of cash and cash equivalents		27,00,000
Cash balance as on 30-6-2010		33,20,000

*Alternatively, provision for doubtful debts created (Rs. 40,000) + Rs. 2,30,000 (Bad Debts) may be added. In that case, increase in debtors (including bad debts written off) Rs. 6,70,000 (Rs. 4,40,000 + Rs. 2,30,000) is subtracted. However, net effect will remain same. It is only a matter of presentation. Adjustment for interest on bank loan is ignored as rate of interest is not given.

Illustration 17. From the following balance sheets of X Ltd. and additional information, prepare statement of changes in financial position (working capital basis) :

Liabilities	*Previous Year*	*Current Year*	*Assets*	*Previous Year*	*Current Year*
Share capital	2,50,000	3,50,000	Goodwill	60,000	50,000
Reserves	1,30,000	1,65,000	Fixed Assets	2,90,000	3,95,000
Porposed Dividend	20,000	35,000	Current Assets	1,90,000	2,85,000
Provision for tax	50,000	60,000			
Current Liability	90,000	1,20,000			
	5,40,000	7,30,000		5,40,000	7,30,000

Additional Information:

(i) Depreciation on fixed assets provided during the year Rs. 30,000; Net profit during the year Rs. 80,000; Income-tax paid Rs. 50,000; Final dividend paid Rs. 20,000; Interim dividend was also paid.

(ii) Fixed asset costing Rs. 60,000 (accumulated depreciation Rs. 35,000) sold for Rs. 30,000.

(iii) Fixed asset costing Rs. 50,000 was purchased by issue of Share Capital.

Solution :

Cash Flow Statement for the year ended ....

Cash Flows from Operating Activities		
Net profit for the year	80,000	
Adjustment for:		
Provision for taxation (closing)	60,000	
Depreciation	30,000	
Goodwill written off	10,000	
Profit on sale of fixed assets	(5,000)	
Operating profit before working capital changes	1,75,000	
Add : Increase in current liabilities	30,000	
Less : Increase in current assets (excluding cash and cash equivalent [(2,85,000–55,000)] – [1,90,000–20,000]		(60,000)
Cash provided by operations	1,45,000	
Less : Tax paid	50,000	
Net cash flow provided by operating activities		95,000
Cash Flows from Investing Activities		
Sale of Fixed Assets	30,000	
Purchase of Fixed Asset	(1,10,000)	
Net cash used in operating activities		(80,000)
Cash Flows from Investing Activities		
Issue of shares for cash	50,000	
Payment of Final Dividend	(20,000)	
Payment of Interim Dividend	(10,000)	
Net cash flow from financing activities		20,000
Net increase in cash during the year		35,000
Add opening balance of cash and cash equivalents		20,000
Closing balance of cash and cash equivalents		55,000

Note: Significant non-cash trasnsactions: Fixed assets worth Rs. 50,000 purchased by issue of shares.

Working Notes:

Dr. *Fixed Assets Account* Cr.

To Balance b/d	2,90,000	By Bank A/c (Sale)	30,000
To Share capital A/c	50,000	By Depreciation A/c	30,000
To Profit & Loss A/c (Profit on sale)	5,000	By Balance c/d	3,95,000
To Bank A/c (balance figure)	1,10,000		
- Purchase	4,55,000		4,55,000

Calculation of Funds from Operating Activities

	Rs.
Net Profit for the year	80,000
Add : Depreciation on Fixed Assets	30,000
Provision for Taxation (Closing balance)	60,000
Goodwill written off (60,000 – 50,000)	10,000
Less : Profit on sale of Fixed Assets	1,80,000
Funds from Operating Activities before Tax	5,000
	1,75,000

Dr. *Reserves Account* Cr.

To Proposed Dividend	35,000	By Balance b/d	1,30,000
To Interim Dividend (balancing fig.)	10,000	By Net Profit	80,000
To Balance c/d	1,65,000		
	2,10,000		2,10,000

Illustration 18. The balance sheet of Hari Ltd. for 2009 and 2010 are given below:

Balance Sheet

Liabilities	*2009*	*2010*	*Assets*	*2009*	*2010*
Share Capital	6,00,000	8,00,000	Fixed Assets	16,00,000	19,00,000
Capital Reserve	—	20,000	Less : Depreciation	4,60,000	5,80,000
General Reserve	3,40,000	4,00,000		11,40,000	13,20,000
Profit & Loss A/c	1,20,000	1,50,000	Investment	2,00,000	1,60,000
Debentures	4,00,000	2,80,000	Current Assets	5,60,000	6,60,000
Current Liabilities	2,40,000	2,60,000	Preliminary Expenses	40,0000	20,000
Proposed Dividend	60,000	72,000			
Provision for Tax	1,80,000	1,70,000			
Unpaid dividends	—	8,000			
	19,40,000	21,60,000		19,40,000	21,60,000

Additional Information:

During the year 2010, the Company:

1. Sold one machine for Rs. 50,000, the cost of which was Rs. 1,00,000 and the depreciation provided on it was Rs. 40,000;
2. Provided Rs. 1,80,000 as depreciation;
3. Sold some investment at a profit of Rs. 20,000, which was credited to Capital Reserve;
4. Redeemed 30% of the Debentures @ 105;
5. Decided to value stock at cost, whereas previously the practice was to value stock at cost less 10%. The stock according to books on 31-02-2009 was Rs. 1,08,000. The stock on 31-12-2010 was correctly valued at Rs. 1,50,000; and
6. Decided to write of fixed assets costing Rs. 28,000 on which depreciation amounting to Rs. 20,000 has been provided.

Prepare cash flow statement using indirect method. Assume that investments are long-term investments and current assets in the beginning of and at the end of the year do not include cash and bank balance.

Solution:

Cash Flow Statement for the year ended ....

Cash Flow from Operating Activities		
Cash flow before working capital chages	5,44,000	
Add: Increase in current Liabilities	20,000	
	5,64,000	
Less: Increase in Current Assets (6,60,000–5,72,000)	(88,000)	
Cash generated by operations	4,76,000	
Less: Tax paid	(1,80,000)	
		2,96,000
Net Cash flow provided by operating activities		
Cash flow from Investing Activities		
Purchase of Fixed Asset	(4,28,000)	
Sale of Fixed Asset	50,000	
Sale of Investment	60,000	
Net Cash flow used in investing activites		(3,18,000)
Cash Flow from Financing Activities		
Issue of share capital		2,00,000
Redemption of Debentures	(1,26,000)	
Dividend Paid	(52,000)	
Net Cash flow provided by financing activities		22,000
Net increase (decrease) in cash and Cash Equivalents during the year		—
Add : Balance in the beginning		—
Balance of Cash and Cash equivalents at the end of the year		—

Working Notes:

Calculation of Funds from Operation before tax

Increase in Profit and Loss A/c	18,000
[1,50,000 – (1,20,000 + 12,000)]	
Add: Transfer to general reserve	60,000
Preliminary Expenses written off	20,000
Depreciation	1,80,000
Loss on sale of machine	10,000
Decrease in fixed assets (28,000 – 20,000)	8,000
Premium on redemption of debentures	6,000
Proposed dividend	72,000
Provision for tax	1,70,000
Funds from operating activities before tax	5,44,000

Dr. *Fixed Assets Account* Cr.

To Balance b/d	16,00,000	By Asset Disposal A/c	1,00,000
To Bank A/c (balancing fig.)	4,28,000	By Asset Disposal A/c	28,000
		By Balance c/d	19,00,000
	20,28,000		10,28,000

Sale of Investment = Decrease in balance + Gain on sale

= (2,00,000 – 1,60,000) + 20,000 = Rs. 40,000

Loss on Sale of fixe Assets = Cost – Accumulated Depreciation – Sale Price

= 1,00,000 – 40,000 – 50,000 = Rs. 10,000

3. Unpaid dividend is taken as non-current item and dividend paid is shown on the application side. Alternatively, unpaid dividend may be taken as current liability and dividend declared (paid plus unpaid) is shown as application of funds.

4. Revaluation of stock will increase opening stock by Rs. 12,000 and also the opening balance of profit and loss account by Rs. 12,000. The opening balance of profit and loss account after revaluation of stock will be Rs. 1,32,000 (1,20,000 + 12,000).

5. Working capital at the end = 6,60,000 – 2,60,000 = 4,00,000

   Working capital in the beginning = (5,60,000 + 12,000) – 2,40,000 = 3,32,000

   68,000

Illustration 19. ABC Limited gives you its Balance Sheet as on 31st March, 2010 and its projected Profit and Loss Account for the year ended 31st March, 2011:

Balance Sheet

Liabilities	*Amount*	*Assets*		*Amount*
Share Capital :		Fixed Assets :		
Equity Shares of Rs. 100		Machinery at cost	7,00,000	
each fully paid	6,00,000	Less : Depreciation	1,40,000	5,60,000
Reserves and Surplus :		Motor car at cost	80,000	
Securities Premium	20,000	Less : Depreciation	30,000	50,000
General Reserve	1,30,000	Current Assets :		
Profit and Loss Account	65,000	Stock		5,60,000
Secured Loans :		Book Debts		2,20,000
8% Debentures	3,00,000	Bank balances		1,20,000
Current Liabilities :		Loans & Advances :		
Sundry Creditors	2,85,000	Advance Income Tax		1,00,000
Provision for Taxation	1,40,000	Miscellaneous Expenditure:		
Proposed Dividend (Equity)	90,000	Preliminary Expenses		20,000
	16,30,000			16,30,000

Projected Profit and Loss Account for the year ended 31st March, 2011

To Opening Stok	5,60,000	By Sales :	
To Purchase	14,40,000	Cash	3,70,000
To Wages	80,000	Credit	18,00,000
To Manufacturing Expenses	40,000	By Stock	4,20,000
To Office & Administration Exp.	50,000	By Profit on Sale of Machinery	10,000
To Selling & Distribution Exp.	30,000		
To Interest	24,000		
To Depreciation :			
Machinery 56,000			
Car 14,000	70,000		
To Preliminary Expences	10,000		
To Provision for Taxation	1,36,000		
To Proposed Dividend on Equity	1,00,000		
To Balance	60,000		
	26,00,000		26,00,000

The company proposes to issue one equity share for two equity shares with nominal value of Rs. 3,00,000 at a premium of 10%. Machinery will be acquired for Rs. 1,00,000. The cost of machinery to be sold in the year ended 31st March, 2011 is Rs. 80,000 with a depreciation provision of Rs. 45,000.

It is expected that:

(i) Tax liability upto 31st March, 2010 will be settled for Rs. 1,20,000 within 31st March, 2012.

(ii) Advance Income Tax amounting to Rs. 1,30,000 is proposed to be paid in 2010-2011.

(iii) Book Debts will be 10% mor than warranted by the credit period of two months.

(iv) Creditors for goods will continue to extend one and half months' credit and manufacturing expenses outstanding at the end of March, 2011 will be Rs. 5,000.

You are required to:

(i) Draft the Company's projected Balance Sheet as on 31st March, 2011.

(ii) Draft the statemet showing cash flows during the year ended 31st March, 2011 using direct method.

Solution:

Projected Cash Flow Statement for the year ended 31-03-2011

Cash Flow from Operating Activities		
Cash sales	3,70,000	
Cash Received from debtors	16,90,000	
	20,60,000	
Payment to creditors	15,45,000	
	5,15,000	
Payment of Expenses (80,000-5,000+40,000+50,000+30,000)	1,95,000	
Cash generated by operations	3,20,000	
Tax Paid (1,20,000 - 1,00,000 + 1,30,000)	1,50,000	
Net Cash flow from operating activities		1,70,000
Cash Flows from Investing Activities		
Sale of machinery	45,000	
Purchase of machinery	(1,00,000)	
Net cash used in investing activities		(55,000)
Cash Flows from Financing Activities		
Issue of shares at a premium	3,30,000	
Interest paid	(24,000)	
Dividend paid	(90,000)	
Net cash from financing activities		2,16,000
Net increase in bank balances		3,31,000
Bank balances at the beginning of period		1,20,000
Bank balances at the end of period		4,51,000

Projected Balance Sheet as on 31st March, 2011

Liabilities		*Amount*	*Assets*		*Amount*
Share Capital :			*Fixed Assets* :		
9,000 Equity Shares			Machinery (see WN 1)	7,20,000	
of Rs. 100 each fully paid		9,00,000	*Less* : Depreciation (WN 2)	1,51,000	5,69,000
Reserves & Surplus :			Motor Car	80,000	
Securities Premium		50000	*Less* : Depreciation	44,000	36,000
General Reserve		1,30,000	Current Assets, Loans & Advances:		
Profit & Loss A/c:			Current Assets:		
Balance in the beginning	65,000		Stock		4,20,000
Add : Profit for the year	60,000		Debtors (Two months Sales+10%)		3,30,000
		1,45,000	Bank		4,51,000
Excess Tax provision of last year	20,000		Miscellaneous Expenditure: Preliminary Expenses		10,000

Liabilities		*Amount*	*Assets*	*Amount*
Secured Loans:				
Debentures		3,00,000		
Current Liabilities & Provisions:				
Current Liabilities:				
Creditors (1½ month purchases)		1,80,000		
Expenses Creditors		5,000		
Provision:				
Taxation	1,36,000			
Less : Advance tax	1,30,000	6,000		
Proposed Dividend on Equity Shares		1,00,000		
		18,16,000		18,16,000

Working Notes:

Dr. *Machinery Account* Cr.

To	Balance b/d	7,00,000	By	Balance A/c (80,000-45,000+10,000)	45,000
To	Profit on Sale A/c	10,000	By	Provision for Dep. A/c	45,000
To	Bank A/c	1,00,000	By	Balance c/d	7,20,000
		8,10,000			8,10,000

Dr. *Provision for Depreciation on Machinery Account* Cr.

To	Machinery A/c	45,000	By	Balance b/d	1,40,000
To	Balance c/d	1,51,000	By	Profit and loss A/c	56,000
		1,96,000			1,96,000

Dr. *Sundry Debtors Account* Cr.

To	Balance b/d	2,20,000	By	Bank A/c (balancing fig.)	16,90,000
To	Sales A/c	18,00,000	By	Balance c/d	3,30,000
		20,20,000			20,20,000

Dr. *Sundry Creditors Account* Cr.

To	Bank A/c (balancing fig.)	15,45,000	By	Balance c/d	2,85,000
To	Balance c/d	1,80,000	By	Purchase A/c	14,40,000
		17,25,000			17,25,000

Illustration 20. Examine the following schedule prepared by K Ltd.:

Schedule of funds provided by operations for the year ended 31st July, 2010

(*Rs. '000*)

Sales		32,760	
Add: Decrease in bills receivable		1,000	
Less: Increase in accounts receivable		(626)	
Inflow from operating revenues			33,134
Cost of goods sold	18,588		
Less: Decrease in inventories	(212)		
Add: Decrease in trades payable	81	18,457	
Wages and Salaries	5,284		
Less: Increase in wages payable	(12)		
Administrative Expenses	3,066		
Add: Increase in repaid expenses	11	3,077	
Property taxes		428	
Interest expenses	532		
Add: Amortisation of premium on bonds payable	20	552	
Outflow from operating expenses			27,786
Net inflow from operations			5,384
Rent Income	207		
Add: Increase in unearned rent	3		210
			5,558
Income-tax	1,330		
Less: Increase in deferred tax	50		1,280
Funds from operations			4,278

Required:

(i) What is the definition of funds shown in the schedule?

(ii) What amount was reported as gross margin in the income statement?

(iii) How much case was collected from the customers?

(iv) How much cash was paid for the purchases made?

(v) As a result of change in inventories, did the working capital increase or decrease and by what amount?

(vi) How much rent was actually earned during the year?

(vii) What was the amount of tax expenses reportd on the income statement?

(viii) Which method of calculating funds from operation is used?

(ix) Can you reconcile the profit after tax with the funds provided by the operations?

Solution:

(i) 'Funds' shown in the schedule refer to the cash and cash equivalents as defined in AS-3 (Revised) on 'Cash Flow Statement'.

(ii)

Gross margin in the income statement Rs. ('000)

Sales	32,760
Cost of goods sold	18,588
	14,172

(iii)	Cash collected from the customers	33,134
(iv)	Cash paid for purchases made	18,457
(v)	Change in inventories would reduce the working capital by	212
(vi)	Rental income earned during the year	207
(vii)	Tax expenses reported in the income statement	1330

(viii) Direct method of calculating cash flow from operating activities is used.

(ix)

Reconciliation of Profit after Tax with Cash Funds

Profit after tax	3,719
Decrease in bills receivable	1,000
Increase in accounts receivable	(626)
Decrease in inventories	212
Decrease in trades payable	(81)
Increase in wages payable	12
Increase in prepaid expenses	(11)
Increase in unearned rent	3
Increase in deferred tax	50
Funds (i.e. cash and cash equivalents) from operations as shown in the schedule	4,278

Working Notes :

(i)

Calculation of Profit after Tax Rs. ('000)

Sales			32,760
Less:	Cost of goods sold		18,588
Gross margin			14,172
Add:	Rental income		207
			14,379
Less:	Wages and salaries	5,284	
	Administrative expenses	3,066	
	Property taxes	428	
	Interest expenses	532	
	Amortisation of premium on bonds payable	20	
			9,330
Profit before tax			5,049
Less:	Income-tax		1,330
Profit after tax			3,719

(ii) Amortisation of premium payable on bonds is not an operating transaction. It should be taken as part of financing activities. Further, it is assumed that premium amortised was paid during the year and, therefore, it is a cash item affecting flow of cash.

Illustration 21. From the following information prepare cash flow statement:

Balance Sheet as at 31-12-2009 and 31-12-2010

Liabilities	*2010*	*2009*	*Assets*	*2010*	*2009*
Sundry creditors	150	1,890	Cash on hand and balance with bank	200	25
Interest payable	230	100			
Income-tax payable	400	1,000	Short-term investments	670	135
Long-term debt	1,110	1,040	Sundry Debtors	1,700	1,200
Total liabilities	1,890	4,030	Interest receivable	100	–
Shareholders' funds-			Inventories	900	1,950
Share capital	1,500	1,250	Long-term investments	2,500	2,500
Reserves	3,410	1,380	Fixed assets at cost	2,180	1,910
Total Shareholders' fund	4,910	2,630	Accumulated depreciation	(1,450)	(1,060)
Total liabilities and Shareholders' funds	6,800	6,660	Total assets	6,800	6,660

Statement of Profit and Loss for the year ended 31-12-2010 *(Rs. in thousand)*

Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administration and selling expenses	(910)
Interest expenses	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item - Insurance proceeds from earthquake disaster settlement	180
Net profit afte extraordinary item	3,530
Income-tax	(300)
Net profit	3,230

Additional information (Rs. in thousands) :

(a) An amount of Rs. 250 was raised from the issue of share capital an a further Rs. 250 was raised from long-term borrowings.

(b) Interest expense was Rs. 400 of which Rs. 170 was paid during the period. Rs. 100 relating to interest expenses of the prior period was also paid during the period.

(c) Dividends paid were Rs. 1,200.

(d) Tax deducted at source on dividends received (included in the tax expenses of Rs. 300 for the year) amounted to Rs. 40

(e) During the period, the enterprise acquired fixed assets for Rs. 350. The payment was made in cash.

(f) Plant with original cost of Rs. 80 and accumulated depreciation of Rs. 60 was sold for Rs. 20.

(g) Foreign exchange loss of Rs. 40 represents reduction in the carrying amount of a short-term investment in foreign currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investments and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Solution :

Cash Flow Statement (Direct Method) (Rs. in thousand)

Cash Flows from Operating Activities		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item :	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash Flows from Investing Activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
Net cash from investing activities		30
Cash Flows from Financing Activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowing	250	
Repaymants of long-term borrowings	(180)	
Interest paid	(270)	
Dividend paid	(1,200)	
Net cash used in financing activites		(1,150)
Net increase in cash and cash equivalents		750
Add: Cash and cash equivalents at beginning of period		160
Cash an cash equivalents at end of period		910

Cash Flow Statement (Direct Method)

Cash flows from Operating Activities		
Net profit before taxation, and extraordinary item	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expenses	400	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(500)	
Decrease in inventories	1,050	

Decrease in sundry creditors	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item :	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash Flows from Investing Activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividend received	160	
Net cash from investing activities		30
Cash Flows from Financing Activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interet paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing acitivities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period		160
Cash and cash equivalents at end of period		910

Working Notes :

1. *Cash and Cash Equivalents*

Cash and cash equivalents consist of cash on hand and balance with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts :

Particulars	*2010*	*2009*
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	870	160
Effect of exchange rate changes	40	
Cash and cash equivalents as restated	910	160

Cash an cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions. The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

3. *Cash receipts from customers*

Sales	30,650
Add : Sundry debtors at the beginning of the year	1,200
	31,850
Less : Sundry debtors at the end of the year	1,700
	30,150

4. *Cash paid to suppliers and employees*

Cost of sales		26,000
Administrative & selling expenses		910
		26,910
Add : Sundry creditors at the beginning of the year	1,890	
Inventories at the end of the year	900	2,790
		29,700
Less : Sundry creditors at the end of the year	150	
Inventories at the beginning of the year	1,950	2,100
		27,600

5. *Income taxes paid (including tax deducted at source from dividends received)*

Income tax expenses for the year (includin tax) deducted at source from dividends received)	300
Add : Income tax liability at the beginning of the year	1,000
	1,300
Less : Income tax liability at the end of the year	400
	900

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities.

6. *Repayment of long-term borrowing*

Long-term debt at the beginning of the year	1,040
Add : Long-term borrowings made during the year	250
	1,290
Less : Long-term borrowings at the end of the year	1,110
	180

7. *Interest Paid*

Interest expenses for the year	400
Add : Interest payable at the beginning of the year	100
	500
Less : Interest payable at the end of the year	230
	270

Illustration 22. Mr. Joythi of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 30.06.2010 :

	(Rs. in lakhs)
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income-tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Amortisation of Capital grant	6
Profit on sale of Investments	100
(Rs. in lakhs)	
Carrying amount of Investment sold	27,765
Interest income on investments	2,506
Interest expenses	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank balance)	56,075
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Required :

Prepare the Cash Flow statements for the year in accordance with AS-3 on Cash Flow statements issued by the Institute of Chartered Accountants of India (Make necessary assumptions).

Solution :

Cash Flow Statement for the year ended 30-06-2010

(*Rs. in lakhs*)

Cash Flow from Operating Activities		
Net Profit before Taxation (25,000 + 5,000)	30,000	
Adjustments for :		
Depreciation	20,000	
Loss on sale of assets (Net)	40	
Amortisation of capital grant	(6)	
Profit on sale of investments	(100)	
Interest income on investments	(2,506)	
Interest expenses	10,000	
Operating profit before working capital changes	57,428	
Changes in working capital (excluding cash and bank balance)	(56,075)	
Cash generated from operations	1,353	
Income taxes paid	(4,248)	
Net cash used in operating activities		(2,895)
Cash flows from investing activities		
Sale of assets (185-40)	145	
Sale of investments (27,765 + 100)	27,865	
Investment income on investments	2,506	
Purcahse of fixed assets	(14,560)	
Investment in joint venture	(3,850)	
Expenditure on construction work-in-progress	(34,740)	
Net cash used in investing activities		(22,634)
Cash flows from financing Activities		
Proceeds from calls in arrear	2	
Receipts of grant for capital projects	12	
Proceeds from long-term borrowings	25,980	
Proceeds from short-term borrowings	20,575	
Interest paid	(10,520)	
Dividend (including dividedn tax) paid	(8,535)	
Net cash provided by financing activities		27,514
Net increase in cash and cash equivalents		1,985
Add : Cash and cash equivalents at the beginning of the period		5,003
Cash and cash equivalents at the end of the period		6,988

Note : It is assumed that interest income on investments Rs. 2,506 has been received during the year.

STUDY NOTE - 4

Segmental Reporting

This Study Note includes:

- Concept of Segmental Reporting
- Need for Segmental Reporting
- International Scenario
- Indian Scenario
- Specific Isues Relating to Management Accountant

4.1 Introduction

Segmental reporting or segment reporting or line of business reporting or product line reporting is a dimension of corporate financial reporting due to diversification of industry activities into different products, geographical networks and market segments, etc.

The major purpose of segment information is to assist financial statement users in analysing and understanding the enterprise's financial statements by permitting better assessment of the enterprise's past performance and future prospects.

A company wide income statement provides only a summary of overall operations; as such, it typically does not contain enough detail to allow the manager to detect opportunities and problems that may exist in the organization. To operate effectively, managers need more information at their disposal than is available in a single company wide income statement.

4.2 Need for Segmental Reporting

In recent times it has become evident that many companies have grown much larger and more diversified. The size and relative importance of diversified companies has in turn, presented many problems for the users of accounts. Shareholders are interested in the future cash flows they may obtain from investing in a company and the risk or uncertainty of these cash flows. They are therefore interested in the performance of a company as a whole rather than the performance of any specific part of the company. However, this does not mean that only consolidated information is of value to them. Both the size and uncertainty of future cash flows are likely to be affected by many factors. Different industries have different profit potentials, degrees and types of risk, and growth opportunities. Different rates of return on investment and different capital needs are also likely to occur across the various segments of a business. Because of this diversification of operations , there has been a demand for companies also to report key disaggregated information, especially turnover and profits. Such disaggregated or segmented data is typically provided for both geographical areas and lines of business.

Segmented information is likely to aid shareholders by allowing them to combine company specific information with external information and so allow a more accurate assessment of both the risk and potential for future growth.

In addition, an idea of the success of past operations can be gained by the company with others, i.e. whether or not a company has done better than other similar companies. However, for most diversified companies, such external yardsticks are not available. In principle, the provision of disaggregated data may allow shareholders to compare the success of individual segments with those of other companies. However, given the very large degree of latitude, that companies have in deciding upon what constitutes a reportable segment, such an advantage of comparability may be more apparent than real. This is especially the case when comparing profit measures, as not only is there discretion in the choice of segments but also discretion in the methods used for common cost allocations and transfer pricing.

Other users often have a direct relationship not with the company as a whole, but with a part of the company. Disaggregated data regarding the performance of that segment of the company would then be relevant. This would apply to employees, creditors and host governments. All of those groups are likely to be interested, therefore, not only in a company as a whole but also in that sector of a company that most affects themselves. They will often require information that is even more disaggregated than that currently provided, e.g. employees will also want information at the plant level, host governments at the individual country level and creditors at the level of the individual subsidiary or legal entity. However, segmentally disaggregated information will go at least some way towards meeting these information needs.

This is especially important for those groups who often lack the power to demand specific information that is of relevance to them in particular.

It is now strongly felt that enterprises whose securities are publicly traded and other economically significant entities should disclose, as a supplement to the traditional financial statements, certain significant information for the industry segments and geographical segments. Past data are used for projecting the future. Investors -both existing and potential, lenders, employees and many others want to know the future prospects of the reporting entity, which is traditionally projected on the basis of available, aggregated financial information. However the corporate analysts would generally agree that their efforts to predict future earnings of a diversified company is seriously handicapped owing to company's non disclosure of financial information by important segments.

It is highly absurd to project earnings of a company which come from paper, chemicals, glass, food products and steel without understanding the relative contribution of different segments. The price earnings ratio (P/E) is an important fundamental indicator which the investors mostly watch. However, price earnings multiples are affected by risk and prospect for future growth in earnings. These factors vary among different industries and markets and also changes with time. Thus in the absence of segmental information the analysts hobble around blindly. A segmental reporting system can effectively subserve the information needs of user groups adequately.

The need for disclosure of the operations of the major segments of diversified firms and firms with geographical or customer segmented markets arose because the differing rates of growth, profitability and degrees of risk of various segments cannot be evaluated and analysed effectively from aggregated data. Disaggregation of financial data is necessary to permit the prediction of future return and risk for well informed decision making for capital investments The consolidated reports of diversified companies could not meet the needs of investors, creditors or antitrust authorities. Consolidated data provided becomes inadequate. By analysing segment information one may discover that the major portion of the company's earnings are in high risk area, or that the growth of certain segments has virtually stopped. So users can come to know the performance of each material segment and its importance relative to the company as a whole. Thus, the extended disclosure of segment information is necessary for proper evaluation of management ability in a highly decentralised company, its competitive position and its internal stability.

4.3 Arguments Against Segmental Reporting

The arguments against segmental reporting can be enumerated as below

- It is generally felt that segmental revenues and expenses are not distinguishable objectively in many cases. Revenues of a weak product line may be derived only because of the existence of a strong product line. Also many joint costs are only separable arbitrarily.
- Much of segmental results depend on the inter-departmental transfer pricing which are not always logically established.

- Various segments of an enterprise may use common resources which makes it difficult to arrive at a segment wise performance ratio.
- Since the users are in no position to know the proper base for cost allocation the segment results would be less than meaningful.
- The last argument consists of the competitive implications of the firm. Some academics content that company secret will be disclosed while others referred to the competitive hardship suffered by some firms if segmented data is required. Suppose that Company X, a small company, has a segment identical to one in Company Y, a huge conglomerate. Company X would have to disclose the segment while Company Y would not because the segment is not considered material to Y's operations.

However, considering the problems of joint allocation, often it is suggested to follow a contribution margin approach for reporting segmental results. By this only identifiable costs are deducted from segment revenues and gross segment margins may only be indicated. But for all practical purposes, this becomes a useless exercise when proportion of identifiable cost is insignificant.

4.4 International Scenario

In 1967 the Accounting Principles Board issued a statement urging companies to disclose segment information voluntarily. In 1969 the Securities Exchange Commission (SEC) required line of business reporting in registration statements of new stock issues and in 1970 expanded its requirement to annual reports filed on Form 10-K. In 1974 the SEC took these requirements further to include annual reports to share holders.

The Organisation for Economic Co-operation and Development (OECD) issued a guideline for disclosure of segmental information in 1976, inter-alia requiring the following disclosures.

a) The geographical areas where operations are carried out and the principal activities carried on therein by the parent company and the main affiliates.

b) The operating results and sales by geographical area and the sales in major lines of business for there enterprise as a whole.

c) Significant new capital investments by geographical areas and as far as practicable by major lines of business for the enterprise as a whole.

d) The policies followed in respect of inter group pricing.

In 1976 The Financial Accounting Standards Board (FASB) issued SFAS 14, requiring that financial statements prepared in conformity with GAAP contain information about

a) the company's operations in different industries

b) the enterprise's foreign operations and export sales, and

c) its major customers.

The information presented in this "disaggregation" of the company's consolidated financial data must be prepared using the same accounting principles. There is one major difference between consolidated information and business segment information' intercompany transactions are eliminated, but segment information includes intercompany transactions.

SFAS 14 requires a reconciliation of segment information with the amounts in the consolidated financial statements to account for this difference and generally requires that segment information be presented for the most recent three year period.

In 1996, the Canadian Institute of Chartered Accountants and the FASB issued similar Exposure Drafts pertaining to the reporting of disaggregated information about business enterprises. The FASB's Exposure Draft would supersede SFAS14 and would change the way that public enterprises report disaggregated information in their financial statements. Rather than taking an "industry segment approach," the Exposure Draft takes the position that financial information should be reported on the basis that is used internally for evaluating segment performance and deciding how to allocate resources to segments. Thus it would require that enterprises report financial and descriptive information about their "operating segments."

Operating segments are defined as revenue producing components of the enterprise about which separate financial information is produced internally and that are subject to evaluation by the chief operating decision maker in deciding how to allocate resources. The proposed Statement would require that public business enterprise reports segment profit or loss, certain specific revenue and expense items, segment assets and segment liabilities. It would require reconciliations of total segment revenues, total segment profit or loss, total segment assets, and total segment liabilities to corresponding amounts in the enterprise's general purpose financial statements.

It would require that all public business enterprises report information about the revenues derived from the product or services (or groups of similar products and services) of each operating segment and about certain countries in which the operating segments earn revenues and hold assets, regardless of whether that information is used in making operating decisions. However, enterprises would not be required to report information that is not used internally if reporting it is impracticable.

The proposed Statement also would require that a public business enterprise report descriptive information about the way that the operating segments were determined, the products or services provided by the operating segments, differences between the measurements used in providing segment information and those used in the enterprise's financial statements, and changes in the measurement of segment information from period to period.

IFRS

International Financial Reporting Standard 8- Operating Segments (IFRS - 8) was issued in November 2006 in place of IAS 14.

IFRS 8 sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates and its major customers.

Main Features:

Entities are required to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the same basis as used internally for evaluating operating segment performance.

The following items are expected to be reported:

A measure of:

Operating segment profit/loss,

Segment assets/liabilities

Particular income/expense items, if these are provided to the chief operating decision maker.

Reporting also requires the reconciliation of these measures to corresponding measures in the entity's financial statements.

The IFRS requires an entity to report information about the revenues derived from its products or services(or groups of similar products or services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether the management uses this information for decision making or not. However, if the benefit of compiling this information does not justify the cost of doing it, the IFRS does not require the information to be reported if the management does not use it for decision making.

The IFRS requires descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between measurements used in segment reporting and the entity's financial statements, and changes in measurement of segment amounts from period to period.

Applicability:

An entity shall apply this IFRS 8 for annual periods beginning on or after January 1st, 2009. Earlier application is permitted, but shall be appropriately disclosed by the entity.

Identification of segments:

An entity uses information for decision making. An entity's decision maker is the best judge regarding its division into segments for operation, sales, products, services, etc. Entities have specific characteristics and vary widely on the number of products, services, departments, importance of each product in relation to the total business volume, etc.

The decision maker is the best judge in each entity to decide what into what detailed fragments and segments infonnation is to be presented for ideal understanding and decision making. He needs this information to steer the entity to profitability, which is precisely the use an outsider reading the statements is aiming at. Hence, the IFRS allows information to be compiled according to the needs of the internal reporting requirement for business decisions. Apart from this, for the sake of uniformity, broad guidelines are given across varying enterprises in different industries to determine what a segment should comprise of, broadly on the basis of value, volume, location, importance, etc. The amount reported for each operating segment is only the measure adapted by the chief operating decision maker together with an explanation of how these measurements are made for each reportable segment.

Disclosure:

The IFRS requires an entity to disclose the following information:

a) Factors used to identify the entity's operating segments, including the basis of organisation (for example, whether management organises the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether segments have been aggregated), and

b) Types of products and services from which each reportable segment derives its revenues.

The IFRS requires an entity to disclose specified items about each reportable segment, if the specified amounts are included in the measure of segment profit or loss and are reviewed by or otherwise regularly provided to the chief operating decision maker.

The IFRS requires an entity to report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenue are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and to make decisions on resources to be allocated to the segment.

The IFRS requires an entity, including an entity with a single reportable segment, to disclose information for the entity as a whole about its products and services, geographical areas, and major customers. This requirement applies, regardless of the entity's organisation, if the information is not included as part of the disclosures about segments.

THE IFRS 8- OPERATING SEGMENTS

Core Principle:

1. An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

Scope:

2. This IFRS shall apply to:

   a) The separate or individual financial statements of an entity;

   - Whose debt or equity instruments are traded in a public market(a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets),or
   - That files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market: and

The consolidated financial statements of a group with a parent satisfying (i) or (ii) above.

3. If an entity that is not required to apply this IFRS chooses to disclose information about segments that does not comply with this IFRS, it shall not describe the information as segment information.
4. If a financial report contains both the consolidated financial statements of a parent that is within the scope of this IFRS as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

Operating Segments

An operating segment is a component of an entity:

a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity).

b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance and,

c) For which discrete financial information is available.

An operating segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be operating segments before earning revenues.

5. Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the operating segments. For the purposes of this 1FRS, an entity's post-employment benefit plans are not operating segments.
6. The term 'chief operating decision maker' identifies a function and not necessarily a manager with a specific title. The Junction is to allocate resources and to assess the performance of the operating systems of an entity and could therefore refer to more than a single individual.
7. An entity may make use of reports in more than one way of presentation. Also, every segment need not have a manager, and every segment manager need not have a single segment under him. In such cases, information may be suitably classified and aggregated for efficient use by the chief decision maker. He will, in these cases, take one of the presentations as operating segment reports for the purpose of this IFRS.
8. Aggregation Criteria:
9. Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating systems would be expected if their economic characteristics were similar. Therefore, segments could be aggregated if they are similar in respect of:
   i) The nature of products and services
   ii) The nature of production processes
   iii) The type or class of customer for their products and services
   iv) The methods used to distribute their products or provide their services and
10. If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.
11. Quantitative thresholds:

    An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

    a) Its reported revenue, including internal transfers and external sales is 10 % or more of the combined revenue, internal and external, of all operating segments.

    b) The absolute amount of its reported profit or loss is 10 % or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating systems that reported a loss.

    c) Its assets are 10% or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

12. An entity may combine segments not individually meeting the aforesaid quantitative criteria only if they have similar economic characteristics,

13. Even if the quantitative threshold is not met, additional segments may be identified and reported if the existing number of segments does not constitute at least 75 % of the total external revenue of the entity.

14. Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an "all other segments" category separately from other reconciling items in the reconciliations required in para 28.The sources of revenue included in this category shall be described.

15. A segment identified as reportable in the immediately preceding period shall continue to be reportable if the management considers it as significant, even though it now fails to meet the criteria to qualify as a reportable segment.

16. Contrarily, if a segment is identified as reportable in the current period due to its meeting the requisite criteria, the segment data for the immediately preceding period shall be restated along the same comparable lines, except if the additional cost exceeds the benefits of this exercise in the eyes of the management.

17. Segmental information on too many segments may result in too much detail. The entity should consider whether a practical limit has been reached if the number of reportable segments exceeds ten.

18. An entity shall report separately information about each operating segment that:

    - Segments have been identified in accordance with the foregoing paragraphs and
    - Segments exceed the quantitative thresholds described above.

19. Disclosure:

    An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

    To give effect to this principle, an entity shall disclose the following for each period for which an income statement is presented:

a) General information on the factors used to form reportable segments, for example, whether geographic area, types of products or services, regulatory environment or a combination of factors and also the type of products or services from which reportable segment derives its revenues.

b) Information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets and liabilities and the basis of measurement.

c) Reconciliation of the above measures to corresponding entity amounts.

Information about profit or loss, assets and liabilities:

The following information shall be reported on each reportable segment if such information is reviewed by or regularly provided to the chief operating decision maker of the entity:

a) Revenues from external customers

b) Revenues from transactions with other operating segments of the same entity

c) Interest revenue

d) Interest expense

e) Depreciation and amortisation

f) Material items of income and expenditure disclosed in accordance with IAS -1

g) The entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method

h) Income tax expense or income

i) Material non cash items other than depreciation and amortisation

An entity shall report interest revenue separately from interest expense for each reportable segment unless amajority of the segment's revenues are frominterest and the chief operating decision maker relies primarily on net revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's revenue net of its interest expense and disclose that it has done so.

An entity shall disclose the following about each reportable segment if the specifies amounts are included in the measure of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the measure of segment assets:

a) The amount of investments in associates and joint ventures accounted for by the equity method, and

b) The amounts of addition to non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts.

The amount of each segment item reported shall be the measure provided to the chief operating decision maker for allocating resources to the segment. If the decision maker uses more than one measure, then the one which is more consistent with the measurement principles of the entity in its financial statements shall be used for the segment report.

At a minimum, an entity shall disclose the following:

a) The basis of accounting for any transactions between reportable segments

b) The nature of differences between the measurement of the reportable segments' assets and liabilities and those of the entity. Those differences could include accounting policies and policies for allocation of jointly used assets or liabilities that are necessary for an understanding of the reported segment information.

c) The nature of changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of thole changes on the measure of segment profit or loss.

d) The nature and effect of any asymmetrical allocations to reportable segments. For example, an entity may allocate depreciation expense to a segment without allocating the related depreciable asset to the segment.

Reconciliation:

An entity shall provide reconciliation of the amounts of a reportable segment to the entity's total, in respect of revenues, profit or loss, assets, liabilities and every material item of information included in the reportable segment's report and all such reconciliation items identified separately and described.

Restatement of previously reported information:

If an entity changes the internal organisational structure so as to effect a change in constitution of reportable segments, the segment information shall be restated to provide the corresponding information for the earlier periods unless the costs of restating do not justify provision of such information and this fact of not restating shall be disclosed by the entity in the year of restructuring.

Entity-wide disclosures:

The following paragraphs on information about products and services, geographical areas and major customers shall apply to all entities subject to this IFRS including those having a single reportable segment. Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products and services, or more than one of its reportable segments may provide essentially the same products and services. A similar situation may exist for assets. Information required by the following paragraphs shall be provided only if it is not provided as part of the reportable segment information required by this IFRS.

Information about products and services

An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the information necessary is not available and the cost to develop it would be excessive, in which case, that fact shall be disclosed. The amount of revenues reported shall be based on the financial information used to provide the entity's financial statements.

Information about geographical areas

a) An entity shall report the following geographical information, unless the necessary information is not available and the cost to develop it will be excessive:

b) Revenues from external customers (i) attributed to the entity's country of domicile and (ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. An entity shall disclose the basis for attributing revenues from external customers to individual countries.

c) Non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts under (i) and (ii) above.

The amounts reported shall be based on the financial information that is used to produce the entity's financial statements. Subtotals of geographical information about groups of countries may be provided at the option of the entity.

Information about major customers

An entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to ten per cent or more of an entity's total revenues, the entity shall disclose the fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues each segment reports from that customer. For the purposes of this IFRS, a group of entities known to a reporting entity to be under common control shall be considered a single customer, and a government (national, state, provincial, territorial, local or foreign) and entities known to the reporting entity to be under the control of that government shall be considered a single customer.

Transition and effective date

An entity shall apply this IFRS in its annual financial statements for periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies this IFRS earlier to this date, it shall disclose that fact.

4.5 The Indian Scenario

In India, disclosures of disaggregated information are required as per Schedule VI to the Companies Act, 1956. A manufacturing company is required to disclose value and quantities of opening and closing stock of goods produced by each class of goods. Also it has to disclose quantitative information about licensed and installed capacities and actual production by each class of goods.

Although these disclosure requirements give certain vital information to the users of accounts, they fall short of segmental reports. It is difficult to link raw materials consumption to sales by each class of goods. Moreover, information about direct production costs are missing. Hence it can be said that disclosure of segmental financial information has not become popular in India and the disaggregated quantitative and value disclosures that are presently required as per the Companies Act, 1956 are not par with the international requirements.

4.5.1 Definitions

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying

geographical segments include:

(a) similarity of economic and political conditions;

(b) relationships between operations in different geographical areas;

(c) proximity of operations;

(d) special risks associated with operations in a particular area;

(e) exchange control regulations; and

(f) the underlying currency risks.

A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement. Enterprise revenue is revenue from sales to external customers as

reported in the statement of profit and loss.

Segment revenue is the aggregate of

(i) the portion of enterprise revenue that is directly attributable to a segment,

(ii) the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

(iii) revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include income tax assets.

Segment assets are determined after deducting related allowances/ provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Segment liabilities do not include income tax liabilities.

Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting.

Reportable Segments

A business segment or geographical segment should be identified as a reportable segment if:

(a) its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or

(b) its segment result, whether profit or loss, is 10 per cent or more of -

  (i) the combined result of all segments in profit, or

  (ii) the combined result of all segments in loss,

  whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent, until at least 75 per cent of total enterprise revenue is included in reportable segments.

4.5.2 Disclosure Requirements

An enterprise should disclose the following for each reportable segment:

(a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

(b) segment result;

(c) total carrying amount of segment assets;

(d) total amount of segment liabilities;

(e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

(f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

(g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

4.5.3 Accounting and Auditing Issues

Segment information includes an entities operation in different industries, its foreign operations and export sales, and its major customers in annual financial statements that are intended to present financial position, results of operations and cash flows in conformity with generally accepted accounting principles. Disclosure of segment information requires the disaggregation of 'certain significant elements of an entities financial statements, such as revenue, operating profit or loss, identifiable assets, depreciation and capital expenditures. The preface to the statements of Accounting Standards issued by ICAI states that -

While discharging their attest function, it will be the duty of the members of the institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the standards, it will be also their duty to make adequate disclosures in their reports so that the users of such financial statements may be aware of such deviation.

Further, AAS - 2 of ICAI on Objective and Scope of Audit of financial statement indicates as follows - Objective of an Audit :

The objective of an audit of financial statements, prepared within a frame work of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. In the context of reporting segment wise information the auditor performing an audit of financial statements in accordance with the generally accepted auditing standards considers the segmental information as other informative disclosures in relation to the financial statements taken as a whole. Hence, it can be said that the auditors objective is to find out whether -

1. The information provided by the segments are in conformity with the generally accepted accounting principles, and
2. The disclosures of the segment are in conformity with the disclosure provided by the enterprise as a whole.

In the context of the above the following issues emerge -

A. Inapplicability of segment wise information and refusal of segment wise information.

Under the Indian context it is not mandatory for any company to give the breakup of the information segment wise except that what is stated under schedule VI. Hence, unless or otherwise disclosure requirements are made mandatory the above issue is not strictly relevant. However if it is made mandatory it is necessary for the auditor to make out a qualification.

If the auditor is unable to reach a conclusion based on his knowledge of the entitys business or if the entity declines to provide such information which the auditor considers necessary for reaching a conclusion the auditor should indicate the same i.e. the limitation of his audit and qualify his opinion on the financial statements taken as a whole.

B. Materiality and consistency.

The concept of materiality is applied by the auditor while determining the nature, timing and extent of auditing procedures to be applied. Materiality of segmental information is analysed by relating the value of the information to the financial statement taken as a whole. However, there may be a contradiction as regards the materiality of a segment since, it may not depend entirely on the size. Further, it may be that the segment may carry a different product line. In that context it may be necessary for the auditor to give a separate report on the segment and in such a situation the materiality should be confined to the segments only.

As per AS-1, going concern, consistency and accrual are the generally accepted fundamental accounting assumptions. Hence, consistency is an important measure for preparing the segment wise information. As regards segment information inconsistencies may occur due to -

1. Change in the basis of accounting for sales or transfers between segments.
2. Change in the method of allocating operating expenses.
3. Change in the method of determining the profitability.

In all the above circumstances it may be necessary for the auditor to qualify if the nature and effect of such a change is not properly disclosed in the financial statements.

C. Plans and procedures to be adopted by auditor in evaluating the segments.

Plans :

1. Internal control system and the degree of integration.
2. Nature, size and number of the segments.
3. The accepted accounting principles for each segment if such segments are not homogeneous. Procedures
1. Find out as to how the segmental information is determined.

2. Analyse the basis of accounting with special reference to sales and transfers.
3. Application of analytical procedures for comparing the segments.
4. Analyse the methods of allocating operating expenses.
5. Analyse the consistency of the information provided.

D. Mis-statement or omission of an information at the segment level

In forming his opinion on the financial statements the auditor follows such procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and the operating results of the enterprise. The auditor recognizes that because of the test nature and other inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered.

While in many situation the discovery of a material misstatement by the management may often arise during the conduct of the audit, such discovery is not the main object of audit nor is the auditor's programme of work specifically designed for such discovery.

If the audit reveals a misstatement in the segment information that is material in relation to the financial statements taken as a while and that misstatement is not corrected, the auditor should modify his opinion on the financial statements because of a departure from generally accepted accounting principles.

If the entity declines to include in the financial statements part or all of the segment information that the auditor believes, based on his knowledge of the entity's business, is required to be disclosed, the auditor should modify his opinion on the financial statements because of the inadequate disclosure and should describe the type of information omitted. The auditor is not required to provide the omitted information in his report. The following is an example of an auditor's report qualified because of an omission of segment information.

E. The relevance of AAS - 10 and AAS - 12

In a situation where a segment happens to be a branch or a subsidiary or a division all the procedures laid down in the above two AASs will be fully applicable.

4.6 Segmental Reporting Problems & Difficulties

Depreciation accounting

Depreciation is a controllable expense. This conclusion is based on the view that the nature and the amount of capital equipment and other fixed assets employed by a division are matters over which it has a large degree of control, if not in the immediate sense at least in the longer view. Underlying this statement is (he supposition that when a decision is taken to acquire or to scrap divisional fixed assets the decision will be appropriately reflected on the debit side of the future divisional income statements through the depreciation charge for such assets. If the depreciation charges are inappropriately calculated for reasons unconnected with the circumstances of the division itself - and corporate tax requirements are the most likely cause of such inappropriate calculations - the status of depreciation as a controllable expense has to be seriously questioned.

The appropriate charge for depreciation must depend on what the role of depreciation is presumed to be. An operating asset bought under competitive conditions will have cost the purchaser a sum roughly equal to the discounted present value of the future stream of benefits expected to accrue to the purchaser from the asset. In money terms this is equivalent to the discounted present value of the assets expected contribution to net profit.

As the asset renders services over the years the assets expectation of life diminishes, and the present 'value of remaining services therefore falls. Ideally depreciation reflects this periodic fall of present value.

If the time pattern of the depreciation charges for a particular asset is to match the time pattern of its net earnings it follows that a firm with a varied collection of fixed assets should have a depreciation policy employing many different depreciation methods, each of which is appropriate to a different type of asset.

Each division should be allowed to chose its own depreciation method, subject only to the requirement that it must satisfy the corporate financial executives. The policy chosen must be appropriate to the needs of the division in the sense that it does, as accurately as possible, reflect the facts of divisional asset life expectancies. There is no reason why all division should follow a uniform policy if there needs are not uniform.

In selecting its depreciation methods, each division should classify assets into as many group as may be necessary to make each group reasonably homogeneous. In the light of the expected pattern of net results to be generated by the assets in each group the method and rate of depreciation should be chosen for each asset group.

Division should be required to account only for fixed assets under the control. Corporate assets should be held by a corporate division, and should not be allocated to divisions for the purpose of computing Capital Employed by the division or for any other purposes.

Division should be given considerable autonomy in the matter of asset disposals. They should however be required to offer surplus assets to the other divisions at the price they propose to accept from outside purchasers prior to selling the asset outside. If corporate head quarters thinks an asset up for disposal is work more than the division is ready to accept for it the asset should be transferred to the corporate division at the price acceptable to the disposable division, pending final sale or other disposition.

Direct Costing: The Allocation of Income Tax to divisions:

Divisions as such do not pay income tax since tax is levied on the legal entity. Nevertheless a majority of divisionalised companies do allocate back to each of their divisions a part of the company's tax assessment proportional to the share of the company's taxable profit deemed to have been earned by each division. This raises certain questions :

a) Is the tax allocation a controllable expense of the division?

b) Should negative tax allocation be made to divisions making losses?

c) How, if at all, should taxes be allocated to divisions, where the company chooses not to allocate central company overheads and therefore does not report divisional net profit?

Tax allocated to a division typically have two sets of determinants. One is the controllable contribution which the division make to the company's profitability, whether the divisional profit statements ever show that figure are not.

The other is made up of all those other items which account for the difference between this" Actual controllable divisional profit " and the divisions share of the company's taxable profit. These items include any difference between the divisions true depreciation and the depreciation actually charged on its assets for tax purposes.

If divisional tax allocation is the resultant of two sets of forces, one controllable and other non-controllable, at the divisional level, the net result must be declared to be non-controllable; and if the tax allocation is non controllable, the division's after tax profit must also be non controllable.

This means that after tax profit is not an appropriate figure to use in evaluating the performance of the division's management. It does not mean however that the allocation of Income tax to divisions serves no purpose whatever following the distinction between the appraisal of the performance of a division's management and the appraisal of performance of its business, though a divisional tax allocation may not be useful for the first purpose it would seem to be essential-to the second so long as it represents at least approximately the increment in the company's tax liability which results from the division's operations.

This is likely to be particularly important where the company's various divisions are not at all uniformly placed tax wise. To use before tax profits as a basis for decisions about investment policy, say would be sure to lead to unsound decisions.

Turning now to the treatment divisions making losses the question was raised whether they should receive negative tax allocation. Many companies do give tax relief to loss making divisions on the ground that the company's tax liability is reduced by reason of a division's loss. The rule of divisional profit independence would seem to veto negative tax allocation to loss making divisions except to the extent that a separate company making losses could recover taxes it had previously paid.

4.7 Specific Issues Relating to Management Accountants

TRANSFER PRICING & INTERDIVISIONAL RELATIONSHIP

If a divisionalized company could arrange its affairs so that its divisions had no dealings of any kind with each other it would have removed one of the principal complexities of divisional profit measurement. It would also however, have lost a valuable feature of decentralisation, namely, the capacity to enjoy the fruits of division of labour and of specialisation while simultaneously benefiting from integration to a greater or lesser degree. The fact that a divisionalized company is more than the sum of its parts is evidenced through the intricate pattern of interdivisional relationships, which can establish itself within a large divisionalized company.

Whenever transactions between divisions make up 'more than a negligible proportion of the total transactions, it is obvious that the division's relative profitability can be very much affected by the formulae used for pricing interdivisional business. The more important these interdivisional transactions become, the more dependent is the whole system of profit measurement on the system of transfer pricing. Unfortunately, as the performance of one division becomes increasingly bound up with the affairs of other divisions, it also becomes more doubtful whether separate profit responsibility, the hallmark of a full-fledged division continues to be feasible.An essential condition , if a division's separate profit responsibility is to become a reality, is that the division must be substantially independent of other divisions, both in respect of its production facilities and marketing organization.

The apparent advantages of decentralisation through delegated profit responsibility has caused some companies to adopt a semblance of this system where it was not appropriate, and a set of more or less arbitrarily chosen transfer prices has been one of the investments which has made the system appear to work.

Since transfer prices are an essential part of the profit measurement system, they must, as accurately as possible, help management to evaluate the performance of the profit centres viewed as separate entities. They must also motivate them to set in, a manner which is conducive to the success of the company as a whole. There is, unfortunately, a real possibility of conflict here, for a set of transfer prices suitable for evaluating performance may lead divisions to act contrary to the corporate interest. Contrariwies, a set of transfer prices providing the right motivation may leave certain divisions, currently contributing materially to corporate success, with losses, showing on their divisional income statement.

The motivating aspect of transfer prices is of primary importance. It is cleared that a system which makes it possible for a division to add to its own profit while reducing that of the corporation as a whole, is not to be tolerated.

A badly chosen set of transfer prices may, however do just that. e.g.: A division supplying another with an intermediate product may be in the position of a monopolist supplier. By taking advantage of its own position it could hold the division it suppliers up to ransom.

The parent corporation could perhaps afford to take a detached view of the situation if the amount which the transferor division could add to its own profit merely offset the dimination in the profit of the transferee division. But it is more than possible that the transferee division will lose more than the transferor division can gain.

It is common to find one supplier division supplying intermediate product to two or more other divisions which incorporate the intermediate in final products for sale to outside customers. Each of the divisions using the intermediate can estimate the net incremental revenue to be obtained by adding to its consumption and processing of the intermediate for sale as a final product. These net incremental revenues can be aggregated for all the consuming divisions. Before the right course for the supplying division and the several consuming divisions can be determined, this aggregate net incremental revenue, the incremental cost of the supplying division, and the competitive price at which the intermediate can be bought and sold on the market must all be looked together. The theoretically correct course is to set the transfer price equal to the competitive market price.

The divisions, which consume the intermediate product, will each require that quantity of it, which equates its market price with the net incremental revenue, derived from processing the marginal unit taken. The supplier division will wish to produce at that level which equates its incremental cost with a market price of the intermediate.

If this level exceeds the aggregate demand of the consumer divisions, the supplier division must sell its surplus out put on the outside market; if, on the other hand, the aggregate demand of the consumer division exceeds the amount which the supplier division wishes to produce at the market price, then the consumer divisions should make up their supply from external sources at that price.

In highly theoretical conditions, the total profit of the company would unaffected if the supplier division did no business with the other divisions, but sold the whole of its out put on the, market, leaving the consumer divisions to buy all their requirements out side. In real life, however such behaviour would not be likely to leave the company's profit unchanged. The supplier division would incur selling expenses in making outside sales which it does not incur on inter divisional sates. It will also incur collection expenses and bad debts.

It would probably cost the consuming division no more, on the other hand to buy from another company than to buy from another division of their own company.

If the supplier division really does change the full market price therefore the other divisions will not be driven by self interest to take their supplies from it; and if they do not the corporation will be poorer to the extent of the selling expenses incurred by the supplier division in disposing of its output to outsiders. In recognition of this fact, many companies modified the "Market price" rule for pricing interdivisional transfers.

They deduct from the market price a margin estimated to cover either the whole, or a part, of the selling and collection expenses and bad debts which the transferor division saves on internal transfers as compared with outside sales.

Where the transferred product is also sold outside, a deduction from the competitive price is made for selling expenses not incurred, to encourage divisions to buy internally. As cash discounts are not given on payment of inter divisional invoices, these discounts are allowed for in the transfer prices.

In arriving at the maximum transfer price where transferred products are not also sold outside, no deduction from the competitive price is made for selling expenses not incurred by the transferor division. If this maximum price were charged, therefore there would be no incentive for the purchasing division to buy internally rather than externally. This may involve the company in loss though there is an "escape clause" in that the transferor division-may charge less than the maximum allowed use of the "escape clause" would substitute a negotiated price for the market price.

If a good competitive market for the intermediate product is lacking, or if for any other reason there is not a well-defined market for it, independent of the quantity bought or sold by the divisions of the company themselves, then another basis of transfer pricing has to be found.

The transfer price conducive to optimal decision making in that it will lead the divisions to maximize the corporation's profits, is the marginal or incremental cost of the transferor division for that output at which this marginal cost equals the transferee division's net marginal revenue from using the transferred products. Even when there is an outside competitive price which can be used, the marginal cost rule still holds. The transferor division should produce up to the point where its marginal cost equals the competitive price, so that by setting the transfer price equal to the competitive price we are also setting it equal to the transferor division's marginal cost for its marginal unit of output.

Transfer prices should be set equal to the marginal cost of supply, not just any output, but at one particular equilibrium output. What this rule means is that assuming a company's object is to maximize profit the production policy best for it if it were organized as a single profit centre is also best if it is organised divisionally.

If the firm were organised with a single manager in charge of both the production of the intermediate and of its conversion into the final product, the most profitable course would be to push production to the point where the marginal cost of output equaled the marginal revenue to be obtained from it.From the company's point of view, this policy does not cease to be right just because the responsibility for production divided between two or more profit centres.

Strong reinforcement for the marginal cost rule is to be found whenever a choice has to be made between buying an intermediate needed by a division or having it made by another division and transferred- Within a decision, “make or buy” decisions, if made rationally call for a comparison of the cost of buying outside with the incremental cost of producing the article inside. The nature of the decision, from the company’s point of view, is not changed simply because the intermediate would have to cross divisional lines if made internally. The use of incremental cost as the basis of transfer pricing will enable the make or buy decision to be made list as it would be in a non-divisionalised firm. If there is a competitive market outside for the intermediate in which the divisions are really free to buy and sell there is no problem.

In the absence of such a market some common bases of transfer pricing - full standard cost, or full standard cost plus a return on investment could cause a division to buy an intermediate outside because the price was below the transfer price, even though the incremental cost of production internally in another division would have been below the outside price. Obviously in such a situation, outside purchase would add more to the company’s outlays than production within the company would have done.

SEGMENTAL PERFORMANCE – MEASUREMENT & EVALUATION

The proper measures of performance of a segment are related to the degree of de-centralization present and are a function of the level of the organization as a whole. Segments may take various forms such as department or cost centre, plant or operating unit, branch or a division or a subsidiary and company. Measures of performance can be either quantitative or qualitative. While qualitative measures may be with reference to attributes such as quality, efficiency, safety, customer satisfaction, morale etc. quantitative measures are confined to financial measures. Such measures often lead to assessment of the profitability of the enterprise as well as the return on investment. In other words they are measurements concerning revenue and capital.

One of the most crucial factors that goes with the measurement of performance is the concept of controllability. From the view point of accounting and finance it is essential that the concept of controllability exists what ever be the nature of the segment. In this chapter the two most commonly used performance measures namely -i) Return on Investments (ROI) (ii) Residual Income (RI) are discussed.

ROI is calculated by dividing operating income by average (depreciated) or beginning investment. Accounting numbers are traditionally used to measure income and investment, so ROI is encumbered with many of the problems that plague the determination of accounting income.

Residual income (Rl) is operating income minus an implicit interest cost on the investment. The calculation of RI has the same accounting problems as that of ROI. ROI can be an appropriate device to measure the performance of division managers provided the limitations of the technique are clearly understood. However ROI probably should not be employed as the only means of evaluating performance. The separate components of ROI must be properly defined and valued for ROI to be a useful measure. The investment should include only these assets under the control of the division manager and the division manager should exercise control over all revenue and expenses of the division.

Investment base is defined as assets employed less division liabilities which implies that corporate assets are not allocated to divisions. In addition, division managers evidently exercise control over the investment base because they are responsible for the acquisition of division assets. Division managers apparently are responsible for all revenue and costs within the division because each division’s sales are separate.

A properly defined ROI may cause sub-optimum behavior if it is used as the sole criterion of divisional performance. Emphasis on divisional ROI may result in the rejection of an investment project which has forecasted returns in excess of the firms cost of capital if the projects return is less than the divisions present ROI; acceptance of such a project would reduce the divisions actual ROI even though the company profits would be benefited.

The sub optimum behavior which can result from ROI can be overcome by evaluating divisions on the basis of their residual income.

When residual income is adopted for evaluating purposes emphasis is placed on marginal profit above the cost of capital rather than on the rate itself. Several other performance measures might be used in conjunction with ROI to identify components which contribute to divisional performance. Additional measures may include profit margin, profit growth, sales growth, market penetration, product development and management personnel development. All of these would be compared with prior years' results and current budgets and projections to aid the evaluation of divisional performance. While the net result of these items may be reflected in the ROI calculations, a closer examination of these items provides additional insight and a more comprehensive picture of performance.

Performance Measure in multi national context

Segment performance evaluation in multinational firms presents special problems. Cultural differences across countries make the behavioral implication of performance evaluation systems unique to specific divisions in each country. Tariff and trade restrictions make evaluation of sales and profit performance more complicated. Changing relationships among foreign currencies and different tax laws introduce complexities into the measurement of the income and investment base. Differential and changing tax laws create tax incentives that vary across countries.

These problems have not been solved completely by many international firms that are struggling with performance evaluation criteria for their multinational operations. The problems of evaluating the performance of foreign subsidiaries are - Analysis of results - Should it be local currency or foreign currency?

1. Management explanation of variances - in local currency or foreign currency?
2. What should be the time frame for comparative data - Plan or forecast?

4.8 Segmental Disclosure – A practical example

The following is the disclosure made by Infosys Technologies pursuant to Accounting Standard 17 – Segment Reporting

The Infosys Group's operations predominantly relate to providing end-to-end business solutions, that leverage technology thereby enabling clients to enhance business performance, delivered to customers globally operating in various industry segments. Accordingly, revenues represented along industry classes comprise the primary basis of segmental information set out in these financial statements. Secondary segmental reporting is performed based on the geographical location of customers.

The accounting principles consistently used in the preparation of the financial statements are also consistently applied to record income and expenditure in individual segments. These are as set out in the note on significant accounting policies.

Industry segments at the Company are primarily financial services comprising customers providing banking, finance and insurance services; manufacturing companies; companies in the telecommunications and the retail industries; and others such as utilities, transportation and logistics companies.

Income and direct expenses in relation to segments is categorized based on items that are individually identifiable to that segment, while the remainder of the costs are categorized in relation to the associated turnover of the segment. Certain expenses such as depreciation, which form a significant component of total expenses, are not specifically allocable to specific segments as the underlying services are used interchangeably. The Company believes that it is not practical to provide segment disclosures relating to those costs and expenses, and accordingly these expenses are separately disclosed as "unallocated" and directly charged against total income.

Fixed assets used in the Company's business or liabilities contracted have not been identified to any of the reportable segments, as the fixed assets and services are used interchangeably between segments. Accordingly, no disclosure relating to total segment assets and liabilities are made.

Customer relationships are driven based on the location of the respective client. North America comprises the United States of America, Canada and Mexico; Europe includes continental Europe (both the east and the west), Ireland and the United Kingdom; and the rest of the world comprises all other places except those mentioned above and India.

Geographical revenues are segregated based on the location of the customer who is invoiced or in relation to which the revenue is otherwise recognize.

Industry Segments
Year ended March 31, 2008 and 2007:

in Rs. crore

Particual	Financial service	Manufac-turing	Telecom	Retail	Others	Total
Revenues	5,706	2,291	3,215	1,945	2,491	15,648
	4,951	1,805	2,409	1,386	2,598	13,149
Identifiable operating expenses	2,426	1,028	1,401	836	1,085	6,776
	2,139	767	1,096	588	1,111	5,621
Allocated expenses	2,426	572	804	485	624	3,909
	1,224	454	605	384	652	3,303
Segemental operating income	1,856	691	1,010	624	782	4,963
	1,568	584	788	450	835	4,225
Unallocable expenses						546
						469
Operating income						4,417
						3,756
Other income (expense), net						683
						373
Net profit before taxes and exceptional items						5100
						4,129
Income taxes						630
						352
Net profit after taxes and before exceprional items						4,470
						3,777
Income on sale of investments (net on taxes						-
						6
Net profit after taxes and exceptional itmes						4,470
						3,783

Geographical Segments
Year ended March 31, 2008 and 2007:

in Rs. crore

Particual	North America	Europe	India	Rest of the World	Total
Revenues	9,873	4,207	219	1,349	15,648
	8,395	3,393	214	1,147	13149
Identifiable operating expenses	4,308	1,668	46	754	6,776
	3,636	1,314	53	618	5,621
Allocated expenses	2,466	1,050	56	337	3,909
	2,110	853	53	276	3,303
Segemental operating income	3,099	1,489	117	258	4,963
	2,649	1,226	108	242	4,225
Unallocable expenses					546
					469
Operating income					4,417
					3,756
Other income (expense), net					683
					373
Net profit before taxes and exceptional items					5100
					4,129
Income taxes					630
					352
Net profit after taxes and before exceprional items					4,470
					3,777
Income on sale of investments (net on taxes					-
					6
Net profit after taxes and exceptional itmes					4,470
					3,783

4.9 Illustrations on Segmental Rporting

Accounting policy leading to a change in segment identification

Illustration - 1

A Manufacturer of traditional electrical and engineering goods such as switchgears, motors, etc. each constituting a separate division has entered into new areas such as telecom, software, etc. Due to significant change in its activity profile, it has changed its internal reporting structure to combine the traditional products such as switchgears, switchboard and motors into one division. According to management the earlier form of segmental reporting is no longer relevant and they plan to switch to reporting the traditional products under one segment. The following questions are relevant:

Can this be done? If no, will we have to reconstruct segment information based on the earlier position? If yes, would it constitute a change in segment accounting policy? In that case what are the disclosures required?

Solution:

Whether the three traditional divisions of the company can be combined into one segment for financial reporting, after they have been merged for internal reporting purposes? To answer this question several factors have to be considered. These are:

Are the risks and returns to switchgear, switchboard and motors significantly different from each other? Or can they be for all practical purposes combined into one basket of traditional engineering/electrical goods? Factors that should be considered in determining whether products and services are related include:

- the nature of the products or services:
- the nature of the production processes:
- the type or class of customer for the products or services: and
- the methods used to distribute the products or provide the services

A single business segment does not include products and services with significantly different risks and returns. While there may be dissimilarities with respect to one or several of the above factors, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

The predominant sources of risks affect how most enterprises are organized and managed. Therefore, the organizational structure of an enterprise and its internal financial reporting system is normally the basis for identifying its segments. If in the given situation, it can be demonstrated that the traditional products faced the same risks and return situation (i.e., they are not significantly different) and that the internal reporting has actually changed, then it should be possible to combine the three divisions for segment reporting purposes.

Based on the analysis above, the following position would emerge:

a) Telecom and software development activities cannot be combined with the traditional product-line (switch gear etc) and made into one segment.

b) Subject to fulfillment of definition criteria laid down in AS 17, traditional product lines can be combined into one segment.

c) Changes in identification of segments would not constitute a change in accounting policy because there is no change in the policy parse, the policy for the current year continues to be to determine segments based on the internal reporting structure and the guidelines set out in AS 17.

Illustration - 2

From the following information of a company having two primary segments, prepare a statement classifying the same under appropriate heads.

		(Rs. in lakh)
Segment Revenue	A	27,050
Segment Revenue	B	3,280
Inter Segment Revenue	A	50
Segment Profit	A	4,640
	B	
Segment Profit	Loss	197
Dividend Income		285
Interest Expense		35
Tax Provision		1,675
Capital Expenditure	A	1,300
Capital Expenditure	B	16
Non Cash Expenses (excluding epreciation)		
Segment	A	114
Segment	B	16
Liabilities	A	3,430
Liabilities	B	770
Other Liabilities		2,200
Assets	A	19,450
Assets	B	2,700
Other Assets		6,550
Depreciation	A	110
Depreciation	B	15

Solution:

	Particulars	Segment A	Segment B	Others	Eliminations	Total
I	Revenue:					
	a) External Revenue	27,050	3,280			30,330
	b) Inter segment Revenue	50			-50	
	Total	27,100	3,280		-50	30,330

II	Result:	4,640	-197		4,443
	a) Income from Investment				285
	b) Interest Expenses				-35
	c) Tax provision				-1,675
	d) Net profit				3,018
III	Assets:				
	a) Segment assets (directly attributable & allocated)	19,450	2,700		22,150
	b) Unallocated assets				6,550
IV	Liabilities				
	a) Segment assets (directly attributable & allocated)	3,440	770		4,200
	b) Unallocated liabilities				2,200
V	Others:				
	a) Depreciation	110	15		125
	b) Non cash expenses	114	16		130
	c) Capital Expenditure	1,300	16		1,316

STUDY NOTE - 5

Development in External Reporting

This Study Note includes:

- Brief analysis - Indian Accounting Standard and its application
- Annual Reports - Statutory Requirements and External Reporting

5.1 Indian Accounting Standards

Accounting standard put together provides a framework of norms as to recognition, measurement and disclosure on the part of all enterprises that follow them to ensure comparability and depiction of true and fair view of the Financial Statements. High quality accounting standards are a prerequisite and important for a sound Capital Market System. The surge in the cross-border capital raising and Investment transactions demands formulation of high quality international accounting standard for financial reporting worldwide.

The various factors that have led to difference in accounting practices comprise widely of the culture, traditions, economic development, economic growth mode, inflation, legal system etc.

The diversity demands unification to the extent possible to develop Generally Accepted Accounting Practices (GAAP).

Indian GAAP comprises of a set of pronouncement issued by various regulatory authorities mostly in consultation with the ICAI. The accounting Standard i.e. Indian GAAP is supplemented by Guidance notes, Interpretation, General Clarification and/or revision from time to time.

Until December 2006, the Accounting Standard Board (ASB) of the ICAI is entrusted to mandate by the Council of ICAI. While forming the AS, due care is taken to International Accounting Standard (IAS) as far as practicable in Indian context.

The Accounting Standard will apply to "General Purpose Financial statement" e.g. Balance Sheet, Profit & Loss A/c, Statement, Schedules and Notes forming Integral part, issued for use by the Shareholders, Members, Creditors, Employees, and Public at large. AS are intended or items, which are considered material. AS to apply prospectively unless otherwise intended.

The members of the ICAI while discharging attest functions should ensure adherence to the Mandatory AS in the financial statements covered in the Audit Report. Deviation if any should be suitably qualified to bring those to the knowledge of the users thereof. Various regulations also require disclosure as to the compliance with Mandatory AS.

AS because of the very nature of these cannot override Local Regulation including the order of the Honourable High Courts as far as these relate and contain preparation and presentation of financial statements.

However in such cases, the ICAI will decide the extent and manner of disclosures by way of appropriate explanatory notes classificatory in nature and need not to be treated as "Adverse Comment" in relation to the Financial Statements.

5.1.1 Companies (Accounting Standards) Rules, 2006.

The Central Government in exercise of the powers conferred by Section 642 (1) (a) of the Companies Act, 1956 read with 211(3C) and Section 210A the Companies Act, 1956 and in consultation with the National Advisory Committee on Accounting Standards notified the rules named "Companies (Accounting Standards) Rules, 2006.

Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

(f) "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non- SMCs.

General Instructions for Small and Medium Companies

SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

The SMCs that does not disclose the information in line with the exemption provided by the Rules shall disclose the same in the following manner.

> "The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard, provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

5.1.2 Applicability of Accounting Standard to Non-corporate Entities:

Criteria for classification of Non-corporate entities for applicability of Accounting Standards

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Applicability of Accounting Standards to Non-corporate Entities (As on 1.4.2008)

(I) Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 22 Accounting for Taxes on Income

AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 24 Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates with Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

As explained in the summary of the Standards.

(ii) AS 19, Leases

Certain paragraphs relating to Disclosure requirements

Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Disclosure Requirement as laid in the Standards are not applicable to Level II and Level III Enterprises.

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

5.2 Accounting Standards

This Study Note includes

- **Accounting Standards - Applicability, Interpretation, Scope and Compliance**

Introduction

Accounting standards are written , policy documents issued by expert accounting body or by Government or other regulatory authorities covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statement.

The main purpose of formulating accounting standard is to standardize the diverse accounting policies with a view to eliminate to the extent possible the incomparability of information provided in financial statements and add reliability to such financial statements. To discuss on whether such standards are necessary in present days it will be beneficial to go through the advantages and disadvantages which they are said to provide.

ADVANTAGES :

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant’s resistance against the pressure from directors to use accounting policy which may be suspect in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistent basis from period to period.
5. It helps the users compare the financial statements of two or more organisaitons engaged in same type of business operation.

DISADVANTAGES :

1. Users are likely to think that said statements prepared using accounting standard are infallible.
2. They have been derived from social pressures which may reduced freedom.
3. The working rules may be rigid or bureaucratic to some user of financial statement.
4. The more standards there are, the more costly the financial statements are to produce.

Accounting Standard No.	Title of Accounting Standard
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories (Revised)
AS- 3	Cash Flow Statements (Revised)
AS-4	Contingencies and Events (Occurring after the Balance Sheet Date)
AS-5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)
AS-6	Depreciation Accounting

AS-7	Construction Contracts (Revised)
AS- 8	Accounting for Research and Development (stands withdrawn after introduction of AS-26)
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets.
AS-11	The Effect of Changes in Foreign Exchange Rates (Revised)
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Employee Benefits (Revised)
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related Party Disclosures
AS-19	Leases
AS-20	Earnings Per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of Interests in Joint Venture
AS-28	Impairment of Assets
AS-29	Provisions, Contingent Liabilities and Contingent Assets
AS-30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

Applicability of Accounting Standards:

A three tier classification has been framed to ensure compliance of accounting standards for reporting enterprises.

Level I Enterprises:

- Enterprises whose equity or debt securities are listed whether in India or outside India.
- Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board resolution in this regard.
- Banks including co-operative banks
- Financial institutions
- Enterprises carrying insurance business
- Enterprises whose turnover exceeds Rs.50 crores
- Enterprises having borrowings in excess of Rs.10 crores at any time during the accounting period.
- Holding companies and subsidiaries of enterprises falling under any one of the categories mentioned above.

Level II Enterprises:

- Enterprises whose turnover exceeds Rs.40 lakhs but does not exceed Rs.50 crores.
- Enterprises having borrowings in excess of Rs.1 crore but not in excess of Rs.10 crores at any time during the accounting period.
- Holding companies and subsidiaries of enterprise falling under any one of the categories mentioned above.

Level III Enterprises:

- Enterprises which are not covered under Level I and Level II.

Accounting Standard	Applicability (Based on the three tier classification)
AS1,2,4-16,22,26,28	All Enterprises
AS 3,17,18,24,	Not applicable to Level II and Level III enterprises in their entirety.
AS 19,20,29	All enterprises but relaxation given to Level I and Level II enterprises for certain disclosure requirements.
AS 21,23,27	Not applicable to Level II and Level III enterprises
AS 25	Not mandatorily applicable to Level II and Level III enterprises
AS 30,31,32	W.e.f. accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years.

It will be mandatory for on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity.

AS-1: DISCLOSURE OF ACCOUNTING POLICIES

This standard deals with disclosure of significant accounting policies followed in the preparation and presentation of the financial statements and is mandatory in nature.

The accounting policies refer to the specific accounting principles adopted by the enterprise.

Proper disclosure would ensure meaningful comparison both inter/intra enterprise and also enable the users to properly appreciate the financial statements.

Financial statements are intended to present a fair reflection of the financial position financial performance and cash flows of an enterprise.

Areas involving different accounting policies by different enterprises are

- Methods of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Treatment of foreign currency conversion/translation, Valuation of inventories
- Treatment of intangible assets
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts Valuation of fixed assets
- Treatment of contingent liabilities

Factors governing the selection and application of accounting policies are:

- *Prudence:* Prudence means making of estimates, which is required under conditions of uncertainty. Profits are not anticipated till certain for realization, while provisions are made for all known liabilities ascertainable or based on estimates (e.g. warranty expenses).
- *Substance over form:* It means that transaction should be accounted for in accordance with actual happening and economic reality of the transactions, i.e. events governed by substance and not merely by the legal form
- *Materiality :*
    a) As to the disclosure of all material items, individually or in aggregate in the context of fair presentation of financial statements as a whole if its omission or misstatement could influence the economic or financial decision of the user relying upon the financial statements

    b) Depends on the size of the items or errors judged in the particular circumstances of its omissions or misstatements.

    c) Is a cutoff point rather than being a primary qualitative characteristic which information must have.

    d) This is a matter of judgment, varies from one entity to another and over one period to another.

AS-1 requires that all "significant" (i.e. only accounting policy that is useful for an understanding by the user of the financial statements) accounting policies adopted in the preparation and presentation of financial statements, should be disclosed by way of 'Note in one place as the note No I (this is the basis of the preparation of financial statements.)

Changes in Accounting Policies:

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in the later period should be disclosed.

In the case of a change in accounting policies, having material effect in the current period, the amount by which any item in the financial statements, is affected by such change should also be disclosed to the extent as ascertainable, otherwise the fact that the effect is not (wholly or partially) ascertainable, should be disclosed.

The following are not considered as changes in accounting policies:

a) Accounting policies adopted for events or transactions that differ in substance at present (introducing Group Gratuity Scheme for employees in place of adhoc ex-gratia payment earlier followed.)

b) Accounting policies pertains to events or transactions which did not occur previously or that were immaterial.

Fundamental Accounting Assumptions

Certain basic assumptions, in the preparation of financial statements are accepted and their use are assumed, no separate disclosure is required except for noncompliance in respect of-

a) *Going Concern:* continuing operation in the foreseeable future and no interim necessity of liquidation or winding' up or reducing scale of operation.

b) *Consistency:* accounting policies are consistent from one period to another

c) *Accrual:*

    i) Revenues and costs are accrued i.e. they are earned or incurred (not actually received or paid) and recorded in the financial statements

    ii) Extends to matching revenue against relevant costs.

PROBLEMS

1. The gross block of fixed assets are shown at the cost of acquisition, which includes tax, duties (net of MODVAT and set off availed) and other identified direct expenses. Interest on borrowing to finance the fixed assets is considered as revenue.

   Answer: The policy appears to be correct.

2. Compensation payable to employees under voluntary retirement scheme has been deferred to be written off over a period of four years as against the past practice of charging out the same on payment/due basis. Comment.

   Answer: The reason for change must be incorporated with notes to accounts.

3. Sales includes inter-departmental transfers, sales during trial run and are net of discounts. Comment.

   Answer: The policy is not as per AS-9, Revenue Recognition.

AS-2: VALUATION OF INVENTORIES

At the outset AS -2 excludes the following though appears to be inventory in common parlance:

a) Work-in-progress in construction contract and directly related service contract (ref: AS-2), inventories not forming part of construction work-in-progress will attract AS-2

b) Work-in-progress arising in the ordinary course of business of service providers Shares, debentures and other financial instruments held as stock-in-trade (ref: AS-13 as Current Investments)

c) Livestock, agricultural and forest product, mineral oil/gasses as measured at net realizable value as per trade practices at certain stage of production.

AS-2 covers inventories as an item of assets which are

a] held for sale in the ordinary course of business

b] in the process of production for such sale

c] in the form of material or supplies for the process of production or rendering of service

Inventories are valued at lower of cost or net realizable value (NRV)

a) Cost to include purchase price, conversion and other costs incurred in bringing the inventories to their present location and condition.

An enterprise should use the same cost formula for all inventories having similar nature and use - specific cost, FIFO, weighted average, standard cost, adjusted selling price

b) Net realizable value is the estimated selling price in the ordinary course of business reduced by the estimated cost to bring the item in saleable condition, considered on each balance sheet date, usually on item by item basis or under suitable group of similar or related item.

Disclosure under AS-2

a) the accounting policy adopted in measuring inventories

b) the cost formula used

c) carrying amount (value) of inventory commonly classified under Raw Material and Components, Work in Progress, Finished goods and Stores, Spares and Loose tools.

d) Schedule-VI and AS-2 disclosure are at par.

PROBLEMS

1. Raw materials purchased at Rs.10 per kg. price of materials is on the decline. The finished goods in which the raw material is incorporated are expected to be sold at below cost. 1,000 kgs of raw material is in stock at the year-end. Replacement cost is Rs.8 per kg. How will you value the inventory?

   Answer: As per para 24 of AS-2, on valuation of inventories, material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there is a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

   Hence, the value of stock of 1,000 kgs. of raw materials will be valued at Rs.8 per kg. The finished stock should be valued at cost or net realizable value, whichever is lower.

2. Inventories are valued at cost except for finished goods and by products, finished goods are valued at lower of cost of realizable values and by products are valued at realizable value. Comment on the accounting policy.

   Answer: The accounting policy followed by the company is at par with AS-2.

3. Cost of Production of product A is given below:

Raw material per unit	Rs.150
Wages per unit	Rs.50
Overhead per unit	Rs.50
	Rs.250

As on the balance sheet date the replacement cost of raw material is Rs.110 per unit. There are 100 units of raw material on 31.3.08.

Calculate the value of closing stock of raw materials in the following conditions:

(i) If finished product is sold at Rs.275 per unit, what will be the value of closing stock of raw material?

(ii) If finished product is sold at Rs.230 per unit, what will be the value of closing stock of raw material?

Answer: (i) The realizable value of the product is more than the total cost of the product. The cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on actual cost.

Therefore, the value of raw materials: 100 units x Rs.150 per unit= Rs.15,000

(iii) The realizable value of the product is less than the total cost of the product. Though the cost of raw material per unit is more than the replacement cost, hence, raw materials should be valued on replacement cost.

Therefore, the value of raw materials: 100 units x Rs.110 per unit= Rs.11,000

AS-3 (REVISED): CASH FLOW STATEMENT

Cash Flow Statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

- Cash comprises cash on hand and demand deposits with banks.
- Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
- Cash flows are inflows and outflows of cash and cash equivalents.
- Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Methods of preparing Cash Flow Statement:

1. Direct Method: In this method major classes of gross cash receipts and gross cash payments are disclosed.
2. Indirect Method: Under this method, the following adjustment to reported net profit or loss to be made:
    - Effects of transactions of non-cash nature.
    - Deferrals in accruals of past or future operating receipt or payments.
    - Changes in current assets and liabilities
    - Income & expenses associated with investing and financing cash flows.

PROBLEMS

1. Oriental Bank of Commerce, received a gross Rs.4,500 crores demand deposits from customers and customers withdrawn Rs.4,000 crores of demand deposits during the financial year 2007-08. How would you classify such cash flows?

    Answer: It will be treated as an Operating activity, on net basis Rs.500 crores,inflow.

2. Consider a hypothetical example on the preparation of cash from operating activities under both direct and indirect method of preparing cash flow statement.

Direct Method Cash Flow Statement [Paragraph 18(a)] (Rs. '000)

Cash flows from operating activities

Cash receipts from customers	33,150
Cash paid to suppliers and employees	(29,600)
Cash generated from operations	3,550
Income taxes paid	(1,860)
Cash flow before extraordinary item	1,690
Proceeds from earthquake disaster settlement	180
Net cash from operating activities	1,870

Indirect Method Cash Flow Statement [Paragraph 18(b)] (Rs. ’000)

Cash flows from operating activities

Net profit before taxation, and extraordinary item	3,350
Adjustments for:	
Depreciation	450
Foreign exchange loss	40
Interest income	(300)
Dividend income	(200)
Interest expense	400
Operating profit before working capital changes	3,740
Increase in sundry debtors	(500)
Decrease in inventories	1,050
Decrease in sundry creditors	(740)
Cash generated from operations	3,550
Income taxes paid	(1,860)
Cash flow before extraordinary item	1,690
Proceeds from earthquake disaster settlement	180
Net cash from operating activities	1,870

AS-4(REVISED): CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

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

For the purpose of AS-4 the meaning is restricted to condition or situation at the Balance Sheet date, the financial effect of which is to be determined by future events which may or may not occur.

AS-4 does not deal with the following subjects, though may result in contingencies in respect of:

a) Liabilities of Life and General Insurance out of policies issued by the enterprise.

b) Obligations under retirement benefit plan/scheme

c) Commitment arising from long-term lease contract

Estimates are required to be made for the amounts to be stated in the financial statement for many ongoing and recurring activities of an enterprise. Distinction should be made between an event that is certain and that is uncertain.

Contingent losses depend on the outcome of the contingencies. It should be provided by way of a charge in the statement of profit/loss

a) if it is probable that future events will confirm after taking into account the probable recovery in this respect, that an asset has been impaired or a liability has been incurred as at the B/S date, and

b) a reasonable estimate of the resulting loss can be estimated otherwise the existence of the contingent loss should be disclosed in the financial statements.

Provisions for contii1gencies are not made in respect of general or unspecified business risk since they do not relate to conditions or situations existing at the B/S date.

The disclosure requirements apply only for those contingencies or events which affect the financial position of the enterprise to a material extent stating:

a) The nature of contingency;

b) The uncertainty which may affect the future outcome;

c) The estimate of the financial effect;

d) A statement that such an estimate cannot be made;

Contingent gains are not recognized because of uncertainty of realization; however, there is no restriction to disclose as such in the 'Notes to Accounts' in a manner not likely to mislead the users of the financial statements.

Events occurring after the B/S date or those significant events, both favourable and unfavourable that occur between the B/S date and the date of approval of the financial statements by the appropriate authority (e.g. Board of Directors of a company) can be of:

a) Those which provide further evidence of condition that existed at the B/S date adjusting events (e.g. insolvency of a customer that occur after B/S date)

b) Those which are indicative of conditions that arose subsequent to the B/S date non-adjusting events (loss due to earthquake, war)

Events occurring after the B/S date but indicative of the enterprise ceases to be a going concern (destruction of major production plant by fire after B/S date) needs to be considered and evaluated to justify "going concern concept" for preparation of Financial statements.

PROBLEMS

1. The assets in a factory of a limited company was damaged due to a fire break out on 15th April. The Loss is estimated at Rs. 50 crores out of which Rs.35 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final account for the previous year.

   Answer: This has to be shown as a disclosure by way of note to account.

2. Board of Directors of a limited company approved the financial account for the year 2007-08 on 31st July,2008. The following events occurred before the approval of financial statements by Board of Directors. State how would you deal with these situations:

   (a) The Board of Directors at their meeting on June 30, 2008 has recommended a dividend of 10% to be paid to the shareholders after it is approved at the annual general meeting.

   Answer: Proposed Dividend must be shown in the Balance Sheet.

(b) A debtor, who was declared insolvent on 10th July 2008. The total outstanding amount was Rs.2 lacs as on 31st March,2008.

Answer: A provision for loss should be provided in the books.

A5-S (REVISED): NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES.

The statement requires the classification and disclosure of extraordinary and prior period items and the disclosure of certain items within the profit or loss from ordinary activities and also accounting treatment for changes in the accounting estimate, and disclosure regarding changes in Accounting Policies in the financial statement.

To ensure preparation of Profit or Loss statement on a uniform basis, in turn to enhance better comparability of the enterprise over time and with other enterprises.

All items of income and expense, which are recognized in a period, are normally included for the determination of the Net Profit/Loss for the period unless otherwise permitted (AS-22 exception for deferred tax in the income tax).

Each extraordinary items, both income and expense arises from events/transactions, which are clearly distinct from ordinary activities and not ex petted to recur frequently or regularly, should be disclosed as apart of net profit/loss for the period in a distinct manner to understand the impact on current profit/loss.

An event or transaction may be extraordinary for one enterprise but not for the other because of difference between their respective ordinary activities.

Only on rare occasion does an event/transaction give rise to extraordinary items.

Ordinary activities are those undertaken as part of business of ail enterprise and related activities for furtherance of, incidental to or arising from these activities. Frequency of occurrence is not the sole criteria to determine extraordinary or ordinary nature.

However, when items of income or expense within profit/loss from ordinary activities are of such a size, nature or incidence that their disclosure is relevant to explain the performance for the period the nature and amount of such items should be disclosed separately as exceptional items (distinct from extraordinary items) e.g.

a) write off/ write back of inventories to Net Realizable Value, provision/write back of cost of restructuring

b) disposal of fixed asset/long term investments

c) effect of legislative changes with retrospective application

d) settlement of litigation

e) other reversal of provisions

Prior period items (income/expense) arise in the current period as a result of errors/ omissions in the preparation of the financial statements, in one or more prior period are generally infrequent in nature and distinct from changes in accounting estimates.

Prior period items are normally included in the determination of net profit/loss for the current period shown after determination of current period profit/loss. The objective is to indicate the "effect of such items in the profit/loss. The separate disclosure is intended to show the impact on the current profit/loss. Disclosure is made:

a) by showing the prior period items distinctively under the relevant head of income/expenditure

b) by putting under "Prior Period Adjustment A/c either in the main statement of P/L or in a schedule containing the respective details with the net figure in the P/L A/c of current period in compliance with schedule VI part II requirement.

Notes to the Accounts should provide detail description with impact on the current period and tax implication arising thereof (e.g. stock valuation not correctly made in the previous period).

The use of reasonable estimate based on then available information circumstances are an essential part of the preparation of financial statement. There may arise a need to change the estimate on the basis of new information more experience or subsequent development. The revision in estimate does not bring the adjustment within the definition of an extraordinary item or prior period item.

The effect of change in Accounting Estimate should be included in the determination of net profit/loss

a) in the period of change (if restricted for the period only)

b) in the period of change and future period (if the change affects both) (e.g. estimate of bad debt for (a) and change in estimated life of a depreciable asset in terms of depreciation.

Classification as to ordinary or extraordinary as previously followed should be maintained to disclose the effect of changes in accounting estimate for better comparability.

The nature and change in an accounting estimates having material effect in the current period or in subsequent period should be disclosed. If quantification is not predictable such fact should also be disclosed.

If it is difficult to distinguish between a change in Accounting Policy and change in Accounting Estimate the change is recognized as change in Accounting Estimate with appropriate disclosure.

Example of various disclosures under AS-5

1. change in depreciation method: change in accounting policy
2. useful life reduced but no change: change in accounting estimate in depreciation method
3. arithmetical error in depreciation computation: prior period item
4. due to oversight depreciation incorrectly computed: prior period item
5. fixed asset destroyed in earth quake: extraordinary item
6. major disposal of fixed items: ordinary activity (exceptional item)
7. maintenance provision no longer required since major part of the assets no longer exist: the write-back. if material should be disclosed as exceptional item and not as extraordinary' or prior period item.

PROBLEMS

1. Mr.Pradip an employee of CCL Ltd.went on leave with a pay for 9 months on 1.1.2008 upto 30.9.2008. His monthly pay was Rs.25,000. While preparing the financial statement on 30.6.2002 for the year ended 31.3.08, the expense of salary of Mr.Pradip for 3 months (1.1.08 to 31.3.08) was not provided due to omission. When Mr.Pradip joined on 1.10.08, the whole salary for 9 months was duly paid to him.

   In this case, three months salary of Rs.75,000 is prior period expense and following entry should be passed:

   Salary A/c Dr. 1,50,000

   Prior period expense (Salary) A/c Dr. 75,000

   To Bank A/c 2,25,000

   If Mr. Pradip was terminated from service on 1.1.08 and was re-instated in service by the Court on 30.9.08 with full pay protection(i.e. total salary was rewarded to him). As the employee was re-instated in service as per the Court's Order as on 1.10.2008, the following entry should be made:

   Salary A/c Dr. 2,25,000

   To Bank A/c 2,25,000

In such a case, there shall arise no error or omission while preparing the financial statements for the earlier years.

AS -6 (REVISED) DEPRECIATION ACCOUNTING

Deprecation is a measure of the wearing out consumption or other loss of value of a depreciable asset due to use efflux of time or obsolescence through technology and market changes and also includes amortization of assets having predetermined life.

Different accounting policies are followed by different enterprises, hence disclosure is necessary to appreciate the view presented in the financial statements.

Depreciation has a significant effect in determining and presenting financial position and operating results.

A depreciable asset must fulfill the following criteria:

a) expected to be used for more than one accounting period

b) limited useful life

c) held for use in the production or supply of goods and services, for rental, for administrative purposes, and not for sale in the ordinary course of business.

Specific exclusions from the scope of AS-6:

1. Forest, plantation and similar regenerative resource
2. Wasting asset, expenditure or a exploration for and extraction of minerals, oils natural gas and similar non-regenerative resources.
3. R&D expenditure

4. Goodwill
5. Livestock

Depreciation charge for a period is usually recognized as an expense unless included in carrying amount (e.g. depreciation of manufacturing plant is included in the cost of conversion of inventories or depreciation of assets used for development activities may be treated as an intangible assets or capital reduced)

Useful life is either:

(a) the period over which a depreciable asset is expected to be used by the enterprise or (b) on the basis of production or similar units obtainable from the use of assets.

A change in depreciation method will arise in the following situation:

a) adoption is required by the statute, or

b) for compliance with the relevant AS, or

c) it is considered that the change would result in more appropriate presentation of the financial statements

When the change is adopted, the depreciation is reworked with reference to the date of the asset put to use by the enterprise, the deficiency/surplus is adjusted in the P/L A/c in the year *of* change given effect with appropriate disclosure since as per AS 6. This is considered as a change in the Accounting Policy.

Change in depreciation method always applies retrospectively.

Disclosure under AS-6: The following information should be disclosed in the financial statement

1) Historical cost/substituted cost *of* each class of depreciable asset

2) Total depreciation for the period with respect to (1)

3) Accumulated depreciation: Additional disclosure as part of disclosure of other accounting policies

    a) Depreciation method used

    b) Depreciation rate or the useful lives of the assets, if they differ from rates specified in the governing statute If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material should be disclosed separately (in contrast with the concept of Block under I.T Act ’61)

In case the depreciable assets are revalued, the depreciation should be provided as the revalued amount on the estimate of remaining useful life of such assets. Disclosure should be made in the year of revaluation, if the same has a material effect on the amount of depreciation.

PROBLEMS

1. Plant has useful life of 10 years. Depreciable amount of Rs.30 lakhs. The company has charged depreciation under SLM. At the end of the 6th year, the balance useful life was re-estimated at 8 years. The depreciation will be charged from the 7th year:

$$= \frac{30 - (30/10) \times 6}{8} = 1.5$$

2. B Ltd. Purchased certain plant and machinery for Rs.50 lakhs. 20% of the cost net of CENVAT credit is the subsidy component to be realized from a State Government for establishing industry in a backward district. Cost includes excise Rs. 8 lakhs against which CENVAT credit can be claimed. Compute depreciable amount.

   Answer: We shall have to determine the historical cost of the plant and machinery.

Purchase Price	Rs.50 lakhs
Less: Specific Excise duty against which CENVAT is available	Rs. 8 lakhs
Original Cost of the machinery for accounting purposes	Rs. 42 lakhs
Less: Subsidy @ 20% of Rs.42 lakhs	Rs. 8.4 lakhs
Depreciable Amount	Rs. 33.6 lakhs

Note: As CENVAT Credit on Capital Goods can be availed upto 50% in the first year of acquisition and the balance in the next year, an alternative treatment may also be considered.

The original cost of the plant and machinery can be taken at Rs. 50 lakhs and a sum of Rs.8.4 lakhs can be transferred to deferred income account by way of subsidy reserve. The portion of unavailed CENVAT Credit is also required to be reduced from cost.

AS-7(REVISED): ACCOUNTING FOR CONSTRUCTION CONTRACTS

The statement applies to accounting for construction contracts, in the financial statements of contractors,

A construction contract may be related to the construction of single asset or a number of assets closely, interrelated or interdependent in terms of the scope of the contract.

For the purpose of this statement construction contract covers:

a) Contracts for rendering of services directly related to the construction of the asset e.g. service of project-managers, architects etc.

b) Contracts for destruction/restoration of assets and restoration of environments following demolition.

c) Consultancy contracts in project management, designing, computers where such contracts are related to the construction of the asset.

d) Those long-term contracts not relating to construction of an asset.

A construction contract may be

a) a fixed-price contract with/without escalation

b) a cost-plus contract (provision for reimbursement of overhead on agreed basis in addition to fixed price/fees)

c) a mix of both (a cost-plus contract with a minimum agreed price)

The statement usually apply to each contract separately, however, sometimes it is necessary to apply the statement to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance. When a contract covers

a) *Number of assets:* each asset treated as separate contract when the proposal, negotiation and cost/revenue can be identified distinctly.

b) *Negotiated single package of interrelated identifiable with an overall profit margin performed concurrently or continuous sequence:* treated as a single contract whether a single customer or a group of customers.

c) *Construction of an additional asset as the provision of the contract:* treated as separate contract if there is significant change in design, technology or transaction from original contract in terms of the scope and/or price.

Additional asset should be treated as a separate construction contract if there is significant change in design, technology or function from the assets covered in the original contract price.

Contract revenue comprises of

a) revenue agreed in the contract

b) variations in the scope of contract, adverse/favourable

c) incentive payment (degree of certainty and reliability)

d) penalties due to delay in execution

Contract costs comprise of

a) directly related to specific contract

b) attributable cost relating to contract activity in general and precisely allocable to the contract as reduced by incidental income not included in contract revenue (sale of surplus material, disposal of contract specific plants etc).

Contract cost and revenue are recognized for accounting only when the outcome of the construction contract can be measured reliably with regard to the stage of completion of the contracts activity at its B/S date. All expected losses should recognized as an expense for the contract.

Under the percentage completion method, contract revenue is recognized in the P/L in the accounting period in which the work is performed and the related contract cost is shown as an expense. However, expected excess of total contract is recognized as an expense immediately. Revenue earlier recognized or becoming doubtful/uncollectable should be treated as an expense.

A long-term contract is subject to fluctuation for various reasons in the original estimation thus likely to affect the determination of contract results. It is necessary that an annual review of the cost already incurred and future cost required to complete the project on schedule. While estimating the future cost care should be taken for foreign exchange rate fluctuation, labour problem, changes in material price etc.

Disclosure under AS -7 (on reporting date by an enterprise)

A) An enterprise should enclose

   a) The amount of contract revenue recognized as revenue in the period

   b) The methods used to determine the contract revenue recognized in the period

   c) Method used to determine the stage of completion of contract in progress

B) An enterprise should disclose the following for contracts in progress at the reporting date

   1. The aggregate amount of costs incurred and recognized profit less recognized losses upto reporting date.

2. The amount of advance received and amount retained

C) An enterprise should present

   a) Gross amount due from customer is an asset

   b) Gross amount due to customer is a liability

   c) Contingencies as per AS-4 (warranty cost, penalties, guarantee issued by banks against counter indemnity of contractor)

PROBLEM

A Company undertook to pay contract for a building for Rs.40lakhs. As on 31.3.2008, it incurred it incurred a cost of Rs.6 lakhs and expects that there will be Rs.36 lakhs more for completing the building. It has received Rs.4 lakhs as progress payment. What is the degree of completion?

$$\text{Percentage of Completion} = \frac{\text{Cost to date}}{\text{Cumulative cost incurred + Estimated cost to complete}} \times 100$$

$$= 6/(6 + 36) \times 100 = 14.28\%$$

AS-8 ACCOUNTING FOR RESEARCH & DEVELOPMENT

(STANDS WITHDRAWN ON INTRODUCTION OF AS-26 INTANGIBLE ASSETS)

AS-9 REVENUE RECOGNITION

The statement covers the recognition of revenue arising in the course of ordinary activities. of the enterprise *from*

a) sale of goods

b) rendering of service

c) outsourcing of resources yielding interest, royalties and dividend Specific exclusion *from* the standard pertains to:

a) construction contracts

b) lease/hire purchase agreement

c) govt. grants/subsidies

d) insurance contract of insurance companies

Essential criterion for recognition for revenue *from* ordinary activities as aforesaid is that the consideration is reasonably determinable even though the payments are made by installments. In the event of uncertainty, the recognition is postponed and considered as revenue of the period in which it is properly recognized.

The standard requires, in addition to the AS- I, that an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending resolution of significant uncertainties.

NOTE:

Revenue include the gross inflow of economic benefits only accrued to an enterprise on its own e.g. sales tax, service tax, VAT etc. do not accrue to the enterprise and thus not considered as revenue under IAS-18 and US GAAP. Practices vary in India and tend to show larger gross turnover for the enterprise (incidentally section 145A of the Income Tax Act '61 require purchase, inventory and turnover inclusive of Tax, duty and cess).

ICAI recommends disclosure in the manner :

Turnover (gross)	xxx
Less Excise duty	xxx
Net Turnover	xxx

PROBLEMS

1. AB Ltd. Seeks you advise about the treatment of the following in the final statement of accounts for the year ended 31st March 2008:

   " As a result of a recent announced price revision, granted by the Government of India with effect from 1st July,2007, the company stands to receive Rs. 6 lakhs from its customers in respect of sales made in 2007-08"

   Answer: The company is preparing the financial statements for the year ended 31.3.08. Due to price revision granted by the Government of India, the company has to receive an additional sales revenue of Rs. 6 lakhs in respect of sales made during the year 2007-08.

   As per AS-9, where uncertainty exists in collection of revenue, its recognition is postponed to the extent of uncertainty involved and it should be recognized as revenue only when it is reasonably certain about its collection.

   In view of the above statement, if there is no uncertainty exists as to the collect ability of Rs. 6 lakhs, it should be recognized as revenue in the financial statements for the year ended 31.3.08.

2. Advise D Ltd.about the treatment of the following in the final statement of accounts for the year ended 31st March, 2008.

   A claim lodged with the Railways in March,2006 for loss of goods of Rs.5 lakhs had been passed for payment in March,2008 for Rs.4 lakhs. No entry was passed in the books of the company, when the claim was lodged.

   Answer: The financial statements of the company are prepared for the year ended 31.3.08.

   There was a loss of goods of Rs.5 lakhs in 2005-06 and the claim was lodged in March 2006 with the Railway authorities. No entry was passed in the books of the company when the claim was lodged and the said treatment was correct in view of AS-9, which states that if uncertainty exists as to collectability, the revenue recognition should be postponed.

   Since, the claim is passed for payment of Rs.4 lakhs in March,2008, it should be recognized as revenue in the financial statements prepared for the year ended 31.3.08.

   As per AS-5 Revised, the claim amount received will not be treated as extraordinary item. AS-5 Revised further states that when items of income and expense within profit 0r loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately.

AS-10: ACCOUNTING FOR FIXED ASSETS

Fixed assets for the purpose of the statement are those held by an enterprise with the intention of being used for the purpose of producing or providing goods or services and not held for sale in the normal course of business and applies to financial statements prepared on historical cost/substituted cost basis.

The following items need special consideration and normally not covered under this statement. unless the expenditure on individual items are separable and identified.

a) forest plantation and regenerative natural resources

b) wasting assets and non-generative resources (mineral rights. exploration of mineral, oil and natural gas)

c) expenditure on real estate development

d) livestock

Apart from direct cost, all directly attributable cost to bring the asset concerned to their working condition for intended use also forms the part of fixed asset.

Subsequent expenditure after the initial capitalization that increases the future benefits from the existing assets beyond the previously assessed standard of performance (e.g. increase in" quality of output, substantial reduction in operating cost) is capitalized to form the gross book value.

Financial statements are normally prepared on the basis of historical cost but sometimes a part or all of fixed assets, are restated (revalued) and substituted for historical cost. The commonly accepted and preferred method of restating is by appraisal by a competent valuer.

As per Schedule VI, every B/S subsequent to revaluation shall disclose the increased figure with the date of increase in place of the original cost for the first 5(five) years, but the fact of such revaluation will continue to be disclosed till such time such assets appear in the B/S.

Revaluation is made for an entire class of assets or the selection of assets on a systematic basis (fact of which should be appropriately stated).

An increase in net book value arising on revaluation of fixed assets should be credited to "Owner's Fund" under "Revaluation Reserve" unless the decrease on any previously revaluation recorded as a change in P/L A/c or "Revaluation Reserve" if increase in previous occasion was credited thereto.

All material items retired from active use and not disposed off should be stated at the lower of net book value or net realizable value as a separate item in the Schedule of Fixed Assets.

Depreciation as per AS-6 should be charged on the total value of fixed assets including revalued portion.

Disclosure in addition to AS-1 and AS-6, should be made under AS-l0 in the following lines:

a) Gross and net book value of fixed assets at the beginning and end of an accounting period with additions, disposals, acquisitions and other movements.

b) Expenditures incurred on account of fixed assets in the course of constructional acquisition

c) Revalued amounts substituted for historical cost, the basis of selection for revaluation, the method adopted, the year of appraisal, involvement of external valuer.

d) The revalued amounts of each class of fixed assets are presented in the B/S separately without netting off the result of revaluation of various classes of fixed assets.

PROBLEMS

1. A company has scrapped a semi-automatic part of a machine(not written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to more suitable place in the factory, which involved the building of new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue. As an auditor, what would you do in this situation?

   Answer: If the subsequent expenditure increases the expected future benefits from the asset beyond its pre-assessed standard of performance then as per AS-10 it should be capitalized. Otherwise, it should be treated as an expense. In this case, the replacement of semi-automatic part with a fully automatic part has doubled the output of the machine thus, it has increased future benefits beyond the machines pre-assessed standard performance, hence this expenditure should be capitalized as part of cost of the machine. However, the expenses for shifting the machine and building of a new foundation in addition to the cost of dismantling and re-erection do not contribute to any new future benefits from the existing asset. They only serve to maintain performance of the machine. Hence, this cost should be charged to revenue.

2. A publishing company undertook repair and overhauling of the machinery at a cost of Rs.5 lakhs to maintain them in good condition and capitalized the amount, as it is more than 25% of the original cost of the machinery. Advice.

   Answer: The size of the expenditure is not the criteria to decide whether subsequent expenditure should be capitalized. The important question is whether the expenditure increases the future benefits from the asset beyond its pre-assessed standard of performance as per AS-10. Only then it should capitalize. Since, in this case, only the benefits are maintained at existing level, the expenditure should not be capitalized.

3. Hero Ltd. purchased a machine of Rs.50 lakhs including excise duty of Rs. 10 lakhs. The excise duty is Cenvatable under the excise laws. The enterprise intends to avail CENVAT credit and it is reasonably certain to utilize the same with reasonable time. How should the excise duty of Rs.10 lakhs be treated?

   Answer: The following journal entries should be recorded:

In the year of acquisition:	(Rs. Lakhs)
Machinery A/c	Dr. 40
CENVAT Credit Receivable A/c	Dr. 5
CENVAT Credit Deferred A/c	Dr. 5
To Supplier's A/c	50
In the next year:	
CENVAT Credit Receivable A/c	Dr. 5
To CENVAT Credit Deferred A/c	5

4. A company purchased a machinery in the year 2005-06 for Rs.90 lakhs. A balance of Rs. 10 lakhs is still payable to the suppliers for the same. The supplier waived off the balance amount during the financial year 2007-08. The company treated it as income and credited to profit and loss account during 2007-08. whether accounting treatment of the company is correct?

Answer: As per para 9.1 of AS-10, the cost of fixed assets may undergo changes subsequent to its acquisition or construction on account of exchange fluctuation, price adjustments, changes in duties or similar factors. Considering para 9.1 the treatment done by the company is not correct. Rs.10 lakhs should be deducted from the cost of the fixed assets.

5. Z Ltd.purchased a machine costing Rs.5 lakhs for its manufacturing operations and paid transportation costs Rs.80,000. Z Ltd. spent an additional amount of Rs.50,000 for testing and preparing the machine for use. What amount should Z Ltd. record as the cost of the machine?

   Answer: As per Para 20 of AS-10, the cost of the fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use. In this case, the cost of machinery includes all expenditures incurred in acquiring the asset and preparing it for use. Cost includes the purchase price, freight and handling charges, insurance cost on the machine while in transit, cost of special foundations, and costs of assembling, installation and testing. Therefore, the cost to be recorded is Rs.6,30,000(= 5,00,000 + 80,000 + 50,000)

AS-11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

The statement applies mandatorily in respect of:

a) Accounting for transaction in foreign currencies

b) Translating the financial statements of foreign branches for inclusion in the financial statements of the reporting enterprise.

A transaction in a foreign currency is recorded in the financial records of an enterprise normally at the rate

a) On the date of transaction i.e. spot rate,

b) Approximate actual rate i.e. averaging the rates during the week/month in which transactions occur if there is no significant fluctuations.

c) Weighted average in the above line.

However, for interrelated transaction (by virtue of being set off against receivables and payables) it is translated with reference to the net amount on the date of transaction.

After initial recognition, the exchange difference on the reporting date of financial statement should be treated as under:

a) Monetary items like foreign currency balance, receivables, payables, loans at closing rate (in case of restriction or remittance other than temporary or when the closing rate is unrealistic, it is reported at the rate likely to be realized).

b) Non-monetary items like fixed assets, which are recorded at historical cost, should be made at the rate on the date of transaction.

c) Non-monetary items other than fixed assets are carried at fair value or net realizable value on the date which they are determined i.e. B/S date (inventories, investments in equity-shares).

Exchange difference on repayment of liabilities incurred for acquiring fixed assets should be adjusted in the carrying amount of fixed assets on reporting date. The same concept applies to revaluation as well but in case such adjustment on revaluation should result into showing the actual book value of the fixed assets/ or class of, exceeding the recoverable amount, the remaining amount of the increase in liability should be debited to Revaluation Reserve or P/L Statement in case of inadequacy/ absence of Revaluation Reserve.

Except as stated above (fixed assets) other exchange difference should be recognized as income or expense in the period in which they arise or spread over to pertaining accounting period.

Depreciation as per AS-6 should be provided on the unamortised carrying amount of depreciable assets (after taking into account the effect of exchange difference).

Disclosure under AS -11: An enterprise should disclose:

a) The amount of exchange difference included in the net profit or loss for the period.

b) The amount of exchange difference adjusted in the carrying amount of fixed assets during the accounting period.

c) The amount of exchange difference in respect of forward contracts to be recognized in the profit/loss for one or more subsequent accounting period.

d) Foreign currency risk management policy.

PROBLEMS

1.

	Exchange Rate
Goods purchased on 24.3.07 of US $1,00,000	Rs.46.60
Exchange rate on 31.3.2007	Rs.47.00
Date of actual payment 5.6.08	Rs.47.50

Calculate the loss/gain for the financial years 2006-07 and 2007-08.

Answer: As per AS-11, all foreign currency transactions should be recorded by applying the exchange rate at the date of transaction. Therefore, goods purchased on 24.3.07 and corr sponding creditor would be recorded at Rs.46.60

= 1,00,000 x 46.60 = 46,60,000

As per AS-11, at the balance sheet date all monetary items should be reported using the closing rate. Therefore, the creditors of US $1,00,000 outstanding on 31.3.07 will be reported as:

1,00,000 x 47.00= 47,00,000.

Exchange loss Rs. 40,000(=47,00,000 – 46,60,000) should be debited in profit and loss account for 2006-07.

As per AS-11, exchange difference on settlement on monetary items should be transferred to profit and loss account as gain or loss thereof:

1,00,000 x 47.50 = 47,50,000 -47,00,000 = Rs.50,000 should be debited to profit or loss for the year 2007-08.

2. Z Ltd. acquired a machine on 1.4.2006 costing US $ 1,00,000. The suppliers agreed to the follwing terms of payment:

1.4.2006 : down payment 50%

1.4.2007 : 25%

1.4.2008 : 25%

The company depreciates machinery @ 10% on the Straight Line Method. The rate of exchange is steady at US $ 1= Rs.40 upto 30.9.2007. On 1.10.07, due to an official revaluation of rates, the exchange rate is adjusted to US $ 1= Rs.48.

Show the extracts of the relevant entries in the Profit and Loss Account for the year ending 31st March, 2008 and the Balance Sheet as on that date, showing such workings as necessary.

Working Notes:

2006-07:

1. Original Cost of the machine = $1,00,000 x Rs.40 = Rs.40,00,000
2. Depreciation (SLM) @ 10% = Rs.4,00,000

2007-08:

1. Original Cost of the machine upto 30/9/2007 = Rs.40,00,000
2. Revised cost of the machine as on 1.10.2007

Due to official revaluation of exchange rates, the US $ 1 = Rs.48. There is a foreign exchange loss of Rs. 8 for each dollar liability. The total loss on foreign currency fluctuation was $25,000 x Rs.8 = Rs.2,00,000. This has to be added to the original cost of the machine. Therefore, revised cost of the machine as on 1.10.2007 is Rs.42,00,000 (i.e. Rs.40,00,000 + Rs.2,00,000)

The revised cost of the machine as on 1.10.2007 :		**Rs.**
Original Cost on 1.4.2006		40,00,000
Less: Depreciation:		
1.4.2006 to 31.3.2007	4,00,000	
1.4.2007 to 30.9.2007	2,00,000	6,00,000
		34,00,000
Add: Loss on foreign exchange fluctuation as on 1.10.2007		2,00,000
		36,00,000
Depreciation:		
1.4.2007 to 30.9.2007	(40,00,000 x 10/100 x 6/12)	2,00,000
1.10.2007 to 31.3.2008	$\left(\frac{36,00,000 \times 6}{8.5 \times 12}\right)$	2,11,765
Total Depreciation for the year 2007-08		4,11,765

Note: As per AS-6 Revised, 'Depreciation Accounting', in case of change in historical cost due to foreign exchange fluctuation, depreciation on the revised unamortized depreciable amount should be provided prospectively over the residual life of the asset. In this case, the residual life is 8.5 years.

Profit and Loss Account (extract)

for the year ended 31st March, 2008

Particulars	Rs.	Particulars	Rs.
To Depreciation on Machinery	4,11,765		

Balance Sheet (extract) as at 31st March,2008

Liabilities	Rs.	Assets		Rs.
Current Liabilities	12,00,000	**Fixed Assets**		
Creditors for Supply of Machinery		Machinery (at cost)	40,00,000	
		Add: Adj.for foreign Exchange fluctuation	<u>2,00,000</u>	
				42,00,000
		Less: Accumulated Depreciation	<u>8,11,765</u>	
				33,88,235

AS -12: ACCOUNTING FOR GOVERNMENT GRANTS

Government refers to Union/State, Govt. Agencies and similar bodies - Local, National or International.

Grants also include subsidies, cash incentive, and duty drawback either in cash or kind/benefits to an enterprise on recognition of compliance in the past or future compliance with condition attached to it.

The accounting for the grant should be appropriate to reveal the extent of benefit accrued to the enterprise during the reporting period.

For the purpose of the statement, following are not dealt with.

a) Effects of changing prices or in supplementary information

b) Government assistance other than grants.

c) Ownership participation by government.

In order to recognize the income there should be conclusive evidence that conditions attached to the grant have been or will be fulfilled to account for such earned benefits estimated on a prudent basis, even though the actual amount may be finally settled/received after the accounting period. Mere receipt would not suffice for income recognition.

AS-4 (contingencies etc) and AS-5 (Prior period etc) would be applicable as the case may be.

The accounting for Govt. grants should be based on the nature of the relevant grant:

a) In the nature of promoter's contribution as shareholder's fund (capital approach)

b) Otherwise as Income Approach to match with related cost recognizing AS-1 accrual concept disclosure.

Government grants in the form of non-monetary assets e.g. land or other resources is accounted for at the acquisition cost or recorded at nominal value if it is given free of cost.

Grants received specifically for fixed asset is disclosed in the financial statement either

a) by way of deduction from the gross block of the asset concerned, thus grant is recognized in P/L Account through reduced depreciation (in case of funding of specific asset Cost entirely, the asset should be stated at a nominal value in B/S); or

b) the grant treated as deferred revenue income and charged off on a systematic and rational basis over the useful life of the asset, until appropriated disclosed as "Deferred Govt. grant under Reserve and Surplus in the B/S (grants relating to depreciable assets should be credited to Capital Reserve and suitably credited to P/L Account to offset the cost charged to income).

Disclosure under AS-12

a) the accounting policy, method of presentation in the financial statements.

b) the nature and extent of Govt. grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

PROBLEMS

1. Z Ltd. has set up its business in designated backward area which entitles it to receive as per a public scheme announced by the Government of India, a subsidy of 25% of the cost of investment. Having fulfilled the conditions laid down under the scheme, the company on its investment of Rs.100 lakhs in capital assets during its accounting year ending on 31st March,2008, received a subsidy of Rs.25 lakhs in January,2008 from the Government of India. The Accountant of the company would like to record the receipt as an item of revenue and to reduce the losses on the Profit and Loss Account for the year ended 31st March,2008. Is his action justified?

Answer: As per AS-12, the Government grants related to depreciable fixed assets to be treated as deferred income which should be recognized in the Profit and Loss Account on a systematic and rational basis over the useful life of the asset. Such grants should be allocated to income over the periods and in proportions in which depreciation on those assets is charged.

The company has received Rs.25 lakhs subsidy for investment in capital assets which are depreciable in nature. In view of the provisions under AS-12, the subsidy amount Rs.25 lakhs received should not be credited to the Profit and Loss Account for the year ended 31st March,2008. the subsidy should be recognized and credited to the Profit and Loss Account in the proportion of depreciation charge over the life of the subsidized assets.

2. Hero Ltd. belongs to the engineering industry. The Chief Accountant has prepared the draft accounts,taking note of the mandatory accounting standards.

"The company purchased on 1.4.2007 a special purpose machinery for Rs.50 lakhs. It received a Central Government grant for 20% of the price. The machine has an effective life of 5 years".

Answer: AS-12 prescribes two methods in accounting treatment of Government grants for specific fixed assets.

Method I: Government grants related to depreciable fixed assets to be treated as deferred income which is to be recognized in the Profit and Loss Account in proportion in which depreciation on those assets is charged over the useful life of the asset. The deferred income pending its apportionment to Profit and Loss Account to be disclosed in the balance sheet separately with a suitable description,e.g. Deferred Government Grants, to be shown after "Reserves & Surplus" but before " Secured Loans".

AS-13: ACCOUNTING FOR INVESTMENTS

The Standard deals with accounting for investments in the financial statements of an enterprise and relevant disclosure requirement. Investments are assets held for earning income, capital appreciation or for other benefits to the investing enterprise, obviously investments held as 'stock-in-trade' are not 'Investments'.

The following are outside the purview of AS-13:

a) Recognition of income on investment as dealt with under AS-9 (Revenue Recognition)

b) Operating or Finance Lease.

c) Investment of retirement benefit plans and Life Insurance Enterprise.

d) Mutual fund, Asset Management Companies, Banks, Public Financial Institution, enacted under specific Act/Companies Act, 1956.

Reasons, type, purposes etc varies widely and for this the standard is set to harmonize the accounting.

Cost of investment, means and includes,

a) Acquisition charges e.g. brokerage, fees, duties etc.

b) If acquired by issue of shares/securities, the acquisition cost is the fair market value, may be with reference to issue price determined by statutory authorities.

Fair market value may be determined with reference to market value or net realizable value (net of expenses to be incurred) or net of recovery of cost (dividend or interest accrued and included in the price of investments).

Current investment/Short term investment:

a) Readily realizable and not intended to be held for more than a year from date of investment.

b) The carrying amount on the reporting date is taken at lower of cost or fair value to prudently account for the unrealized losses but not the unrealized gains, considering individual or category of investments (not on overall basis).

c) Any reduction to the fair value and any reversal to such reduction is included in the P/L Account.

Long-term investment:

a) Investments held otherwise even if readily marketable are long term investments

b) Intended to protect, facilitate and furtherance to existing operation, also known as Trade investments (not meant to provide additional cash resources)

c) Long-term investments are normally carried at cost unless there is a permanent diminution in the value when the same is recognized in the carrying amount by charging or reversing through P/L Account.

d) The carrying amount is determined on individual investment basis.

On disposal, the difference between the carrying amount and the net proceed of disposal is recognized in the P/L Account.

Investment in Property is in Land or Building, not intended for occupation substantially for use by or in the operation of the Investing Enterprise, should be treated as long-term investment.

Reclassification of Investments:

1) Long term to current : Take lower of cost and "carrying amount"
2) Current to Long term: Take lower of cost and " fair value"

Disclosure under AS-13:

a) Accounting policy for determination of carrying amount
b) Income separately for long-term and current investments, at gross i.e. inclusive of TDS.
c) Profit or loss on disposal and changes in carrying amount separately for long term and current investments.
d) Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
e) The aggregate amount of quoted and unquoted investments and aggregate market value of quoted investments.
f) other specific disclosure as required by Statute governing the enterprise, (e.g. Schedule VI requires classifications to be disclosed in terms of Govt. or Trust securities, shares, debentures or bonds, investment properties others)

PROBLEMS

1. In preparing the financial statements of X Ltd.for the year ended 31st March,2007, you come across the following information. State with reasons, how would you deal with them in the financial statements:

   " An unquoted long term investment is carried in the books at a cost of Rs.5 lakhs. The published accounts of the unlisted company received in June 2008 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs.1 lakh".

   Answer: As per AS-13, the long term investments should be carried in the financial statements at cost. If there is a diminution in the value of long term investments, which is not temporary in nature, provision should be made for each investment individually. Any reduction in the carrying amount should be charged to the Profit and Loss Account.

   The long term investments are carried at a cost of Rs.5 lakhs in the books of accounts. The value of investments fall down to Rs.1 lakh due to cash losses and the declining market share of the company in which the investments were made.

   In view of the provision contained in AS-13, the carrying amount of long-term investments should be brought down to Rs.1 lakh and Rs.4 lakhs should be charged to Profit and Loss Account for the year ended 31st March, 2008.

2. A company has invested a substantial amount in the shares of another company under the same management. The market price of the shares of the aforesaid company is about half of that at which these shares were acquired by the company. The management is not prepared to provide for the fall in the value of shares on the ground that the loss is only notional till the time the shares are actually sold?

   Answer: As per AS-13, for the purpose of determining carrying amount of shares the investment has to be classified into long-term and current; in the instant case, it appears that the investment is long-term, hence it should be carried at cost, unless there is a permanent diminution in value of investment. At the market price, investment is half of its cost. The reduction appears to be heavy and permanent, hence the provision for permanent diminution(decrease) in value of investment should be made. The contention of management is not as per AS-13.

3. MAGIC Bank has classified its total investment on 31.3.2008 into three categories: (a) held to maturity (b) available for sale (c) held for trading.

Held to maturity investment is carried at acquisition cost less amortised amount. Available for sale are carried at marked to market. Held for trading investments are valued at weekly intervals at market rates or as per the prices declared by FIMMDA. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. Comment on the policy of the bank in accordance with AS-13.

Answer: As per para 2(d) of AS-13, the accounting standard is not applicable to bank, insurance company, mutual funds. In this case, MAGIC Bank is a bank, therefore AS-13 does not apply here. For the banks, the RBI has issued guidelines for classification and valuation of the investment. Therefore, the MAGIC Bank should comply with RBI guidelines.

AS -14: ACCOUNTING FOR AMALGAMATIONS

Amalgamation refers to an amalgamation as per the provision of the Companies Act,1956 or any other law applicable to Companies. Sections 391 to 394 if Companies Act,1956 governs the provisions of amalgamation.

Amalgamation may be categorized broadly as:

I) Merger : - genuine pooling of assets and liabilities and shareholder's interest of the amalgamation companies.

II) Purchase: - the shareholder of the acquired company do not continue to have proportionate share in the combined company or where the business of the former is not intended to be continued.

Amalgamation in the nature of merger:

a) All the assets and liabilities of the transferor company are taken over by the transferee company.

b) Such assets and liabilities are incorporated without any adjustment (except to ensure uniformity of accounting policies) in the financial statements of the transferee.

c) At least 90 percent equity holders of transferor become equity shareholders of transferee by virtue of the amalgamation.

d) The consideration for the amalgamation is discharged by equity shareholders in the transferee, except for fractional shares by cash.

e) The business of the transferor is intended to be carried on by the transferee.

Amalgamation in the nature of Purchase:

Absence/non-fulfillment of one or more conditions as above will make the amalgamation in the nature of purchase.

Accounting methods:

1) **Merger - Pooling of interest method: -**

   (a) In preparing the balance sheet of the transferee company after amalgamation, line by line addition of the respective assets and liabilities of the transferor and transferee company should be made except for share capital;

   (b) If Purchase Consideration is **more** than Share capital(equity + preference) of the transferor company, the difference will be adjusted with Reserves. No goodwill can be created or recognized since there is no acquisition. If Purchase consideration is less than share capital, such shall be recognized as Capital Reserve, as per the Expert Advisory Committee (EAC) of the ICAI, April 2004.

2) **Purchase method:**

   a) The transferee record the assets and liabilities at their existing carrying amount or by allocating the consideration to individual identifiable assets and liabilities (even may be unrecorded in transferors' financial statements) at fair value on the date of amalgamation;

   b) If Purchase consideration is **more** than the value of net asset acquired by transferee be recognized as "Goodwill" in the financial statement. (if feasible and practicable, the goodwill is amortised over the useful life, otherwise over a period of not exceeding 5 years). In a **reverse** situation it is Capital Reserve which cannot be transferred to General Reserve.

   c) In case of amalgamation in the nature of purchase the identity of reserves other than Statutory Reserve (Development Allowance/ Investment Allowance Reserve under I.T Act), is not preserved.

Disclosure under AS-14 (in the first financial statement after the amalgamation)

a) Names and general nature of business of the amalgamating companies

b) Effective date of amalgamation for accounting purpose

c) The method of accounting used

d) Particulars of the scheme sanctioned under statute

e) Additional disclosure for merger

   1. Description and number of shares issued

   2. Percentage of each company's equity shares exchanged under amalgamation

   3. The amount of difference between the consideration and the value of net identifiable assets acquired and treatment thereof

f) Additional disclosure under 'Purchase' method

   1. Consideration for the amalgamation and a description of the consideration paid or contingently payable

2. Amount of difference as above and the treatment/amortization period for goodwill

g) Where the scheme sanctioned under a statute prescribes a different treatment other than AS-14, for better understanding:

1. A description of the accounting treatment and reasons for variation with AS-14
2. Deviation in the accounting treatment as prescribed in he scheme under statute as compared to AS-14, if followed had there been no treatment prescribed by the scheme.

PROBLEMS

1) X Ltd. having a share capital of Rs.20 lakhs and Y Ltd.having a share capital of Rs.30 lakhs. Z Ltd. was formed to take over the business of X Ltd and Y Ltd. at a purchase consideration of Rs. 25 lakhs and Rs.28 lakhs, payable in shares of Z Ltd. The assets and liabilities were taken at their carrying amounts.

Solution: Since the purchase consideration is payable in shares of the transferee company and all the assets and liabilities are taken over at their carrying amounts, the amalgamation is in the nature of merger, i.e. pooling of interests method.

For X Ltd. Purchase consideration = Rs.25 lakhs

Less: Share capital of X Ltd = Rs.20 lakhs

Excess of purchase consideration = Rs.5 lakhs. This shall have to be adjusted against the Reserves of Z Ltd.

For Y Ltd. Purchase Consideration = Rs.28 lakhs

Less: Share Capital of Y Ltd = Rs.30 lakhs

since purchase consideration is less than share capital of the transferor company, Rs.2 lakhs shall be treated as Capital Reserve.

Note: In case of amalgamation in the nature of purchase, goodwill shall have to be shown in the Balance Sheet of the Transferee company. Such goodwill shall have to be written off over a maximum period of 5 years.

2) Net Assets of the Transferor Campany : Rs. 20 lakhs. If Purchase Consideration is (i) Rs. 18 lakhs (ii) Rs.23 lakhs & amalgamation is in the nature of purchase.

Answer: (i) Net Assets Rs.20 lakhs > Purchase Consideration Rs.18 lakhs. So, Rs.2 lakhs will be treated as Capital Reserve.

(ii) Net Assets Rs20 lakhs < Purchase Consideration Rs.23 lakhs. So, Rs.3 lakhs will be treated as Goodwill.

AS-15: EMPLOYEE BENEFITS

The statement applies to benefit usually comprising of Provident Fund, Superannuation/Pension Fund, Gratuity, Leave encashment or retirement, Post retirement health and welfare schemes and other benefits provided by an employer to employees either in pursuance of legal requirement or otherwise, but does not extend to employers’ obligation which cannot be reasonably estimated (e.g. ex-gratia ad-hoc on retirement).

There may be obligation on the part of the employer either against defined contribution plan or defined benefit schemes as elaborated below:

a) Defined Contribution Plans (DCP):

   1) Retirement benefit is determined by contribution at agreed/specified rate to the Fund together with earnings thereof.

   2) Contribution (e.g. PF) whether paid or payable for the reporting period is charged to P/L statement

   3) Excess if any is treated as prepayment

b) Defined Benefit Plans (DBP):

   1) Amount paid is usually determined with reference to employee's earnings and/or years of service (if the basis of contribution are determined, it will be treated as defined contribution scheme)

   2) However, if the employer's responsibility is subject to specified benefits or a specified level of benefits, it is defined benefit scheme.

   3) The extent of employer's obligation is largely uncertain and subject to estimation of future condition and events beyond control.

Accounting treatment for Gratuity benefit and other defined benefit schemes depends on the arrangement made by the employer:

a) No separate fund i.e. out of nonspecific own fund:

   1) Provision for accruing liability in the P/L Account for the accounting period is made.

   2) The provision is based on an actuarial method or some other rational method (assumption that all employers are eligible at the end of the accounting period)

b) *Own separate/specific fund established through Trust:*

   The amount required to be contributed on actuarial basis is certified by the Actuary, and the actual contribution plus and shortfall to meet the actuarial amount is charged to P/L Account for the accounting period, any excess payment treated as prepayment.

c) *Fund established through Insurer:* in the same manner as in (b) above

   Actual valuation may be carried out annually (cost can be easily determined for the purpose of contribution as a charge to P/L) or periodically (say, once in 3 years) where Actuary's certificate specifies contribution on annual basis during inter-valuation period.

   Leave encashment is an accrued estimated liability based on employers' past experience as to such benefit actually availed off and probability of encashment in future and therefore should relate to the period in which relevant service is rendered in compliance with section 209(3) - accrual basis and AS-15.

Disclosure under AS-15:

a) In view of the varying practices, adequate disclosure of method of accounting for an understanding of the significance of such costs to an employer.

b) Disclosure separately made for statutory compliance or otherwise the retirement benefit costs are treated as an element of employee remuneration without specific disclosure.

c) Financial statements should disclose whether actuarial valuation is made at the end of the accounting period or earlier (in which case the date of actuarial valuation and the method used for accrual period if not based on actuary report).

Treatment of Voluntary Retirement scheme payments:

1) Termination benefits to be paid irrespective of the voluntary retirement scheme i.e. balance in P.F, leave encashment; gratuity etc.

2) Termination benefits which are payable on account of VRS i.e. monetary payment on the basis of years of completed service or for the balance period of service whichever is less and notice pay.

Expert Advisory Committee (EAC) opines in favour of treating the costs (except gratuity which should have been provided for in the respective accounting period) as deferred revenue expenditure since it is construed upon as saving in subsequent periods, on some rational basis over a period, preferably over 3 - 5 year. However, the terminal benefit is, to the extent these are not deferred should be treated as expense in the P/L Account with disclosure.

PROBLEMS

1. ZERO Bank has followed the policies for retirement benefits as under:

   (a) contribution to pension fund is made based on actuarial valuation at the year end. In respect of employees who have opted for pension scheme.

   (b) Contribution to the gratuity fund is made based on actuarial valuation at the year end.

   (c) Leave encashment is accounted for on "PAY-AS-YOU-GO" method.

   Comment whether the policy is in accordance with AS-15.

   Answer:

   (a) As the contribution to Pension Fund is made on actuarial basis every year, there fore the policy is as per AS-15, which is based on actuarial basis of a counting.

   (b) As the contribution is being made on annual basis to gratuity fund on actuarial basis, the policy is in accordance with AS-15.

   (c) As regard leave encashment, which is accounted for on PAY-AS-YOU-GO basis, it is not in accordance with AS-15. It should be accounted for on accrual basis.

2. In the context of relevant Accounting Standards, give your comment on the following matter for the financial year ending 31st March,2008:

   "Increase in pension liability on account of wage revision in 2007-08 is being provided for in 5 instalments commencing from that year. The remaining liability of Rs.300 lakhs as redetermined in actuarial valuation will be provided for in the next 2 years"

   Answer: As per AS-15, the costs arising from an alteration in the retirement benefits to employees should be treated as follows:

   (i) The cost may relate to the current year of service or to the past years of service.

(ii) In case of costs relating to the current year, the same may be charged to Profit and Loss Account

(iii) Where the cost relates to the past years of service these should be charged to Profit and Loss Account as 'prior period' items in accordance with AS-5.

(iv) Where retirement benefit scheme is amended in a manner which results in additional benefits being provided to retired employees, the cost of the additional benefits should be taken as " Prior Period and Extraordinary Items" as per AS-5.

In view of the above, the method adopted for accounting the increase in pension liability is not in consonance to the provisions mentioned in AS-15.

AS-16: BORROWING COST

Borrowing costs are interests and other costs incurred by an enterprise in connection with the borrowing of funds.

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

Examples of qualifying assets:

- Any tangible fixed assets, which are in construction process or acquired tangible fixed assets, which are not ready for use or resale. Such as plants and machinery.
- Any intangible assets, which are in development phase or acquired but not ready for use or resale, such as patent.
- Investment property.
- Inventories that require a substantial period(i.e. generally more than one accounting period) to bring them to a saleable condition.

The Statement is applied in accounting for borrowing costs which include:

1. Interest and commitment charges on bank borrowing and other short term borrowings
2. Amortization of discounts/premium relating to borrowings
3. Amortization of ancillary cost incurred in connection with arrangement of borrowings
4. Finance charges for assets acquired under finance lease or other similar arrangement
5. Exchange difference in foreign currency borrowing to the extent it relates to interest element

Borrowing cost incurred on assets, which takes substantial period, is treated as cost of that asset in respect of (1) above.

As per the Guidance Note on Audit of Miscellaneous Expenditure issued by ICAI, deferment for amortization cost upto the time the asset is put to use, in respect of (2) and (3), should be capitalized (see below for AS-16 provision).

Finance charges as in (4) can be capitalized upto the time the asset is put to use (AS-19 deals with elaborate provision)

Conditions for capitalization of borrowing costs:

- Directly attributable costs for acquisition, construction or production of qualifying asset, are eligible for capitalization.
- Qualifying assets will render future economic benefit to the enterprise and the cost can be measured reliably.

Amount of borrowing costs eligible for capitalization (specific borrowing):

- Amount of borrowing eligible for capitalization = Actual borrowing cost incurred during the period **less** income generated on the temporary investment of amount borrowed.

All other borrowing costs are charged to P/L Account:

AS-16 establishes a key test for capitalization which states that "borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those costs that would have been avoided if the expenditure on the qualifying asset had not been made".

Accounting treatment of borrowing cost as per AS-16:

a) Borrowing costs should either be capitalized or charged to P/L Account depending on the situation but deferment is not permitted.

b) Borrowing costs are capitalized as part of cost of qualifying asset when it is probable that they will result in future economic benefits and cost can be measured reliably - other borrowing costs are charged to P/L Account in the accounting period in which they are incurred.

c) Capitalization, on one hand reflects closely the total investment in the asset and on the other hand to charge the cost to future period against accrual of revenue.

d) Notional interest cost are not allowed to be capitalized.

e) A qualifying asset is an asset that necessarily takes a substantial period of time (usually a period of 12 months unless otherwise justified on the basis of facts and circumstances) to get ready for its intended use or sale.

f) Capitalization should be suspended during extended period in which active development is interrupted.

g) Capitalization should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

h) Capitalization also ceases 'when part is completed, which is capable of being used independent of the whole.

Disclosure under AS- 16

a) Accounting Policy adopted

b) Amount of borrowing cost capitalized during the accounting period

PROBLEMS

1. A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Whether it leads to unusual accounting?

Answer: The Accounting Standard Board(ASB) has opined that investments other than investment properties are not qualifying assets as per AS-16, Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying assets, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale, even where the investment properties meet the definition of "qualifying asset", for the capitalization of borrowing costs the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization as per paragraphs 17 and 18 of AS-16 have to be complied with.

2. X Ltd. has obtained an institutional loan of Rs. 800 lakhs for modernization and renovation of its machinery. Machinery acquired under the modernization scheme and installation completed on 31.3.08 amounts to Rs. 600 lakhs. Rs. 80 lakhs has been advanced to suppliers for additional assets and balance loan of Rs.120 lakhs has been utilized for working capital purpose. The total interest paid for the above loan amounted to Rs.80 lakhs during 2007-08.

You are required to state how the interest on the institutional loan is to be accounted in the year 2007-08.

Answer: The total interest of Rs.80 lakhs is related to two periods. Upto the date of installation of the machinery, amount disbursed is Rs.680 lakhs(Rs.600 + 80). Interest on such amounting to Rs.68 lakhs should be capitalized and the balance of the interest Rs.12 lakhs (i.e. Rs.80-68) should be treated as an expense.

3. Happy Ltd.has taken a loan of US $10 lakhs on 1st April,2007, for a specific project at an interest rate of 10% p.a., payable annually. On 1st April,2007, the exchange rate between the currencies was Rs.45 per US $. The exchange rate, as at 31stMarch,2008, is Rs.48 per US $. The corresponding amount could have been borrowed by Happy Ltd. in local currency at an interest rate of 15% p.a. as on 1st April,2007.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS-16.

(a) Interest for the period = US $10,00,000 x 10% x Rs.48 per US $ = Rs. 48,00,000

(b) Increase in the liability towards the principal amount= US $ 10,00,000 x (48-45)= Rs.30,00,000.

(c) Interest that would have resulted if the loan was taken in Indian currency = US $ 10,00,000 x 45 x 15% = Rs.67,50,000

(d) Difference between interest on local currency borrowing and foreign currency borrowing = Rs.67,50,000 – Rs. 48,00,000 = Rs,19,50,000

Therefore, out of Rs.30,00,000 increase in the liability towards principal amount, only Rs. 19,50,000 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs.67,50,000 being the aggregate of interest of Rs.48,00,000 on foreign currency borrowings (as per Para 4(a) of AS-16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs.19,50,000. Thus, Rs.67,50,000 would be considered as the borrowing cost to be accounted for as per AS-16 and the remaining Rs.10,50,000 would be considered as the exchange difference to be accounted for as per AS-11 "The Effects of Changes in Foreign Exchange Rates".

4. On 30.4.2008 MNC Ltd.obtained a loan from the bank for Rs.50 lakhs to be utilized as under:

(i)	Construction of a factory shed	Rs.2 crores.
(ii)	Purchase of Machinery	Rs. 1.5 crores.
(iii)	Working Capital	Rs. 1 crore.
(iv)	Advance for Purchase of truck	Rs. 50 lakhs.

In March 2008, construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ended 31.3.08 was Rs.90 lakhs. Show the treatment of interest as per AS-16.

Answer: As per AS-16, borrowing cost(interest) should be capitalized if borrowing cost is directly attributable to the acquisition, construction or production of qualifying asset. Rs.5 crores borrowed from Bank was utilized for four different purposes, only construction of factory shed is a qualifying asset as per AS-16, while the other three payments are not for the qualifying asset. Therefore, borrowing cost attributable to the construction of a factory shed should only be capitalized which will be equal to Rs. 90 lakhs x 2/5= Rs.36 lakhs.

The balance of Rs. 54 lakhs (Rs.90 lakhs – Rs.36 lakhs) should be treated as an expense and debited to Profit and Loss Account.

AS 17: SEGMENT REPORTING

In view of the complexities of types of businesses, the aggregated financial information is not adequate to evaluate a company's and management's operating and financial strategies with regard to specific or distinct line of activities i.e. segment. As an enterprise deals in multi-product/ multiple services and operates in different geographical areas, the **degree of risk and return** also varies considerably.

Segment information will enable the users to understand better and also to assess the underlying risks and returns of an enterprise.

Initially the segment needs to be broadly classified into either 'Business Segments' or 'Geographical Segments' before being slotted as 'Primary' or 'Secondary' for reporting in the financial statements as per AS- 7.

A **'Business Segment'** is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of products or services, and that is subject to risk and return as distinctly different from those of other business segments. For grouping related products or services, following factors are considered:

a) The nature of product/service;

b) The nature of production processes (e.g. labour or capital intensive);

c) The type or Class of customer (e.g. gender, income).

d) The method used to describe the products or provide services (e.g. wholesaler, franchisee, dealer) similarity of economic and political condition relationship between operations in different geographical areas proximity of operation special risks associated with operation in a particular area exchange control regulation underlying currency risk (geographical location means the location of production or service facilities and other assets of an enterprise and the location of markets and customers).

e) Nature of regulatory environment e.g. insurance, banking, public utilities etc the majority of the factors will be considered to form a single segment even though, there may be dissimilarities and a single business segment does not include products and services with significant differing risks and returns (risk in investment and potential earnings as reward).

A **'Geographical segment'** is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risk and returns that are different from those of components operating in other economic environments. Factors for identification of geographical segments are:

a) Significant difference in risk and rewards;

b) Internal MIS and organization structure;

c) Essential factors that defines a business segment.

Segment accounting policies: AS-17 does not require that the enterprise apply accounting policies to reportable segments on stand-alone reporting entities, hence, additional segment information may be disclosed provided that:

i) Information is reported internally to the Board or CEO for the purpose of making decisions about allocating resources to the segment and assessing its performance.

ii) The basis of measurement for additional information is closely described.

Segment Revenue is the aggregate of the portion of enterprise's total revenue that is attributable to a segment on a reasonable basis as distinct from other segments including inter-segment transfer with the exception of

a) extra ordinary item as AS-5

b) income by way of interest/dividend etc unless the operation of the segments are primarily of a financial nature

c) gains or sale of investment or on extinguishments of debts unless the operation of the segment, are primarily of a financial nature

Inter-segment transfer should be made on the basis that is actually used to price those transfers i.e. at cost, below cost or market price and the same should be disclosed and followed consistently.

Segment result is segment revenue less segment expense

Segment Assets comprise of directly attributable or reasonably allocable operating asset to the segment as reduced by related allowances or provisions pertaining to those assets including allocable common assets, however exclude:

a) income tax asset

b) general enterprise asset/H.O asset

Segment liabilities are worked out or above basis but excluding:

a) income tax liabilities

b) general enterprise liabilities/H.O lease liabilities.

For primary segment disclosure required for:

a) segment revenue with a break-up of sales to external customers and inter segment result deduction made to arrive at segment result in respect of total amount of non cash expenses (provisions, unrealized foreign exchange gain/loss as included in segment expenses);

b) total amount of depreciation and amortization in respect of segment assets (not required if cash flow of the enterprise reports operating, investing and financing activities;

c) total carrying amount of segment assets;

d) total amount of segment liabilities;

e) total cost incurred during the period to acquire segment assets that are expected to be used for more than one period (both fixed assets and intangible assets).

For secondary segment, disclosure required for:

a) If primary format for reporting segment is business segment, it should also report;

   1. segment revenue from external customers by geographical location of customers for each geographical segment consisting 10 percent or more of enterprise revenue.
   2. total carrying amount of segment assets, by geographical location of assets for each of such geographical segment accounting for 10 percent or more of the total assets of all geographical segments.
   3. total cost incurred during the accounting period to acquire segment assets, which are expected to be used for more than one accounting period with 10 percent more criteria as in the aforesaid line.

b) where primary format is geographical, disclosure also required for each business segment accounting for 10 percent or more of revenue from sales to external customers of enterprises' total revenue or whose segment assets are 10 percent or more of the total assets of all business segments:

   1. segment revenue from external customers
   2. total carrying amount of segment assets
   3. total cost incurred during the accounting period to acquire segment assets with expected use extending beyond one accounting period (both tangible and intangible) of all geographical location where geographical segment used for primary format is based on a location, of assets which is different from location of customers.

Additional disclosure required for

1) revenue from sales to external customers for each customer based geographical segment whose revenue from sales to external customers constitutes 10 percent or more of enterprise's revenue.

2) in a reverse situation, disclosure for

- i) total carrying amount of segment assets by geographical location of assets
- ii) total cost incurred during the accounting period to acquire segment assets expected to be used for more than one accounting period both tangible and intangible by location of assets.

AS -18: RELATED PARTY DISCLOSURE

The scope and objective of the standard is to establish requirements for disclosure of (a) related party relationship (b) transaction between a reporting enterprise and its related parties.

This disclosure would make the financial statements of the reporting enterprise more transparent and allow the users to compare both intra-enterprise with corresponding earlier accounting period and inter-enterprise as well.

However disclosure is not required

- (i) if there is statutory bar on the reporting enterprise on confidentiality (banks) in respect of constituents
- (ii) in case of consolidated financial statements in respect members of the group (holding & subsidiary) with exception for transaction with Associated Enterprise accounted for under equity method
- (iii) in the financial statement of State (Central or State) controlled enterprises with other state controlled enterprise even related party relationship exists. When parties are considered related?

If at any time during the reporting period one party has the ability

- (a) to control the other party
- (b) to exercise significant influence over the other party in making financial and/or operating decisions, then by virtue of AS -18 both parties would be considered as related.

Definition

a) Control:

- (i) ownership directly or indirectly, of more than 50 percent of the voting power of an enterprise
- (ii) the composition of the board of directors (company) or the Governing Body (other enterprise)
- (iii) a substantial interest in voting power and the power to direct by Statute or by agreement, the financial/operating policies of the enterprise (20 percent or more interest in voting power)

b) Significant Influence:

- (i) refers to participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.
- (ii) may be gained by ownership in share (including investment through intermediaries restricted to mean subsidiaries as defined in AS-21 Consolidated Financial Statement)

Related party disclosures are applicable only to the following related party relationships:

1. enterprises that directly or indirectly through one or more intermediaries control or are controlled by or under common control with the reporting enterprise
2. associates and joint venturers of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or joint venturer,.

3. individuals owning directly or indirectly an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise and relatives of any such individual.
4. key management personnel and relatives of such individuals.
5. enterprise over which any person in (3) and (4) is able to exercise significant influence (including enterprise owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise).

Related party transactions involve transfer of resources or obligations between related parties, regardless of whether or not .a price is charged, e.g. use of logo/brand name provision of management services, providing financial guarantee use of common infrastructure etc.

Type of disclosure under AS-18

a) in case of related party relationship by virtue of significant influence (not control) e.g. those of associates, key management personnel, relatives, there is no need. to disclose the related party relationship unless there have been actual transaction during the reporting period with such related parties.

b) in the event of transaction between related parties during the existence of a related party relationship (control or significant influence) the reporting enterprise should disclose:
    (i) the name of transacting related party
    (ii) description of the relationship between parties
    (iii) description of nature of transaction
    (iv) volume of transaction, either in amount or approximate proportions
    (v) any other element of the related party transactions necessary for understanding of financial statements (e.g. transfer of major asset taken at price different from normal commercial terms i.e. not at fair value)
    (vi) either in amount or proportion of outstanding items and provisions for doubtful debts pertaining to related parties on B/S date.
    (vii) amounts written off/back in the accounting period in respect of debts due from or to related parties.

AS -19: LEASES

Lease is an arrangement by which the "Lessor" gives the right to use an asset for given period of time to the "Lessee" on rent.

It involves two parties, a Lessor and a Lessee and an asset which is to be leased. The Lessor, who owns the asset, agrees to allow to the Lessee to use it for a specified period of time in return for periodic rent payments.

Types of lease

(a) ***Finance Lease*** – It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the Lessee by the Lessor but not the legal ownership. In following situations, the lease transactions are called Finance Lease.

- The lessee will get the ownership of leased asset at the end of the lease tern.

- The lessee has an option to buy the leased asset at the end of term at price, which is lower than its expected fair value at the date on which option will be exercised.
- The lease term covers the major part of the life of asset.
- At the beginning of lease term, present value of minimum lease rental covers substantially the initial fair value of the leased asset.
- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

(b) *Operating Lease* – It is a lease which does not transfer substantially all the risk and reward incidental to ownership.

Classification of lease is made at the inception of the lease; if at any time the Lessee and Lessor agree to change the provision of lease and it results in different category of lease, it will be treated as separate agreement.

Applicability

The Accounting Standard is not applicable to following types of lease:

- Lease agreement to explore natural resources such as oil, gas, timber, metal and other mineral rights.
- Licensing agreements for motion picture film, video recording, plays, manuscripts, patents and other rights.
- Lease agreement to use land.

Definitions

1. **Guaranteed Residual value – (G.R.V.)**
   - **In respect of Lessee:** Such part of the residual value (R.V.), which is guarantee by or on behalf of the lessee.
   - **In respect of Lessor:** Such part of the residual value, which is guaranteed by or on behalf of the lessee or by an independent third party.

For the Lessor the residual value guaranteed by the third party can arise when the asset is leased to the third party after the first lease has expired and therefore it can be called the residual value guaranteed by the third party to the Lessor.

2. ***Unguaranteed Residual Value (U.R.V)*** – The difference between residual value of asset and its guaranteed residual value is unguaranteed residual value. **[R.V- G.R.V.]**
3. ***Gross Investment (=MLP+URV)*** – Gross investment in lease is the sum of the following:
   - Minimum lease payment (from the standpoint of Lessor) and
   - Any unguaranteed residual value accruing to the Lessor.
4. ***Interest rate implicit in the lease*** – When the Lessor gives an asset on lease (particularly on finance lease), the total amount, which he receives over lease period by giving the asset on lease, includes the element of interest plus payment of principal amount of asset. The rate at which the interest amount is calculated can be simply called implicit rate of interest. It can be expressed as under:-

It is the discount rate at which

Fair Value of leased Asset =Present value of [Minimum lease payment (in respect of Lessor)]
(At the inception of lease) + Any unguaranteed residual value accruing to the Lessor.

5. ***Contingent Rent*** – Lease Rent fixed on the basis of percentage of sales, amount of usage, price indices, market rate of interest is called contingent rent. In other words, lease rent is not fixed, but it is based on a factor other than time.

6. ***Minimum lease payments [MLP]***

   - For Lessor = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (by or on behalf of lessee) – contingent Rent – cost for service and tax to be paid by the reimbursed to Lessor + residual value guaranteed by third party.

   - For Lessee = Total lease rent to be paid by lessee over the lease terms + any guaranteed residual value (for lessee) – contingent rent – cost for service and tax to be paid by and reimbursed to Lessor.

7. ***Lease includes Hire Purchase*** – The definition of a 'lease' includes agreements for the hire of an asset, which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements.

Accounting for Finance Lease – In the books of Lessee

- Leased asset as well as liability for lease should be recognized at the **lower** of –
  - o Fair value of the leased asset at he inception of lease or
  - o Present value of minimum lease payment from the lessee point of view.
- Apportionment of lease payment-Each lease payment is apportioned between finance charge and principal amount.
- The lessee in its books should charge depreciation on finance lease asset as per AS-6(in this case, straight line method will be followed)
- Initial direct cost for financial lease is included is asset under lease.

Accounting for Finance Lease – In the books of Lessor

- The Lessor should recognize asset given under finance lease as receivable at an amount equal to net investment in the lease and corresponding credit to sale of asset.

  Net Investment =Gross Investment – Unearned Finance Income.

  Gross Investment =Minimum lease payment from Lessor point of view + Unguaranteed residual value.

  Unearned Finance Income=Gross Investment – Present Value of Gross Investment.

- Recognition of Finance Income

  The Lessor should recognize the finance income based on a pattern reflecting, constant periodic return on the net investment outstanding in respect of the finance lease. In simple words interest / finance income will be recognized in proportion to outstanding balance receivable from lease over lease period.

<u>Accounting for Operating Lease- In the books of Lessor:</u>

- Record leased out asset as the fixed asset in the balance sheet.
- Charge depreciation as per AS-6
- Recognize lease income in profit & loss account using straight line method. If any other method reflects more systematic allocation of earning derived from the diminishing value of leased out asset, that approach can be adopted.
- Other costs of operating lease should be recognized as expenses in the year in which they are incurred.
- Initial direct cost of the lease may be expensed immediately or deferred.

<u>Accounting for operating lease – In the Books of Lessee</u>

Lease payments should be recognized as an expense in the profit and loss account on a straight line basis over the lease term. If any other method is more representative of the time pattern of the user's benefit, such method can be used.

"Sale and Lease back"

A sale and lease back transaction involves the sale of an asset by vendor and leasing of the same asset back to the vendor.

Accounting treatment of Sale and Lease back

1. ***If lease back is Finance Lease***

- Any profit or loss of sale proceeds over the carrying amount should **not** be immediately recognized as profit or loss in the financial statements of a seller-lessee.
- It should be deferred and amortized over lease term in proportion to the depreciation of leased asset.

Example 1 – H Ltd. Sells machinery, WDV of which was Rs. 400 lakhs for Rs. 500 lakhs to B Ltd. The same machinery was leased back to H Ltd. by BLtd. for 10 years resulting in finance lease. What should be the treatment of profit in the books of seller lessee (H Ltd.)?

The profit of Rs.10 lakhs on sale of machinery by H Ltd. (seller lessee) should not be immediately recognized in books rather it should be deferred and amortized over 10 years in proportion of the depreciation amount to be charged by the H Ltd. on the machinery.

2. ***If lease back is Operating Lease***

Any profit or loss arising out of sale transaction is recognized immediately when sale price is equal to fair value.

(A) ***If Sale price" below" fair value***

- Profit – i.e. carrying amount (=book value or value as per balance sheet) is **less** than the sale value, recognize profit immediately.

  - Loss – i.e. carrying amount is **more** than the sale value, recognize loss immediately, provided loss is **not** compensated by future lease payment.
  - Loss – i.e. carrying amount is **more** than sale price defer and amortize loss if loss is compensated by future lease payment.

(B) If Sale price "above" fair value

  - If carrying amount is **equal** to fair value which will result in profit, amortize the profit over lease period.
  - Carrying amount **less** than fair value will result in profit – amortize and defer the profit equal to "sale price less fair value" and recognize balance profit immediately.
  - Carrying amount is **more** than the fair value – which will result in loss equal to – (carrying amount less than fair value), should be recognized immediately. Profit equal to – selling price less fair value – should be amortized.

Example 2: H Ltd. sold machinery having WDV of Rs. 400 Lakhs to B Ltd. for Rs. 500 Lakhs and the same machinery was leased back by B Ltd. to H Ltd. The Lease back is operating lease.

Comment if –

a) Sale price of Rs. 500 lakhs is equal to fair value

b) Fair value is Rs. 600 lakhs

c) Fair value is Rs. 450 lakhs and sale price is Rs. 380 lakhs

d) Fair value is Rs. 400 lakhs and sale price is Rs. 500 lakhs

e) Fair value is Rs. 460 lakhs and sale price is Rs. 500 lakhs

f) Fair value is Rs. 350 lakhs and sale price is Rs. 390 lakhs

Answer:

a) H ltd. should immediately recognize the profit of Rs. 100 lakhs in its books.

b) Profit Rs. 100 lakhs should be immediately recognized by H Ltd.

c) Loss of Rs. 20 lakhs to be immediately recognized by H Ltd. in its books provided loss is not compensated by future lease payment.

d) Profit of Rs. 100 lakhs is to be amortized over the lease period.

e) Profit of Rs. 60 lakhs (460-400) to be immediately recognized in its books and balance profit of Rs. 40 lakhs (500-460) is to be amortized / deferred over lease period.

f) Loss of Rs. 50 lakhs (400-350) to be immediately recognized by H Ltd. in its books and profit of Rs. 40 lakhs (390-350) should be amortized / deferred over lease period.

AS -20: EARNING PER SHARE (EPS)

Disclosure under AS-20:

a) The applicability of the standard is mandatory with effect from accounting year commencing on or after 01-04-2001 in respect of enterprises whose equity shares or potential equity shares are listed on a recognized stock exchange in India.

b) However under Part IV of Schedule VI of the Companies' Act '56 every company is required to disclose EPS in accordance with AS-2O, whether listed on a recognized stock exchange or not.

c) Presentation of EPS is required to be made both on the basis of consolidated financial statement, as well as individual financial statements of the parent company.

d) Presentation should be made in terms of Basic and Diluted EPS on the face of 'the Profit & Loss Account for each class of equity share that has a different right to share in the net profit for the accounting period. For equity shares having different nominal value but carrying same voting rights should be covered into equivalent number of shares of the same nominal value.

e) Both Basic and Diluted EPS should be presented with equal prominence for all periods even if the amounts are negative (a loss per share).

f) In addition to above, following are also disclosed:

   1. the amount used as the numerator and a reconciliation of those amounts to the net profit/loss for the accounting period.
   2. the weighted average number of equity shares used as the denominator and a reconciliation of those denominator to each other.
   3. the nominal value of shares along with EPS figure.

g) Disclosure may also be made of terms and conditions of contracts generating potential equity which affect the basic and diluted EPS both on the weighted average number of shares outstanding and any consequent adjustments to net profit attributable to equity shareholders, following the computation of the denominator in accordance with AS-20.

Basic EPS:

a) Basic EPS is worked out by dividing the net profit /loss for the accounting period by the equity share using weighted average number of equity shares outstanding during the same period.

b) Net profit or loss should be arrived at after considering all income and expense recognized during the period including tax expense extraordinary as reduced by preference dividend in respect of non cumulative and cumulative for the period

c) Disclosure as an alternative maybe presented for basic and diluted on the basis of earning excluding extraordinary items (net of tax expenses).

Impact of bonus element in rights issue on EPS denominator:

In a right issue the exercise price in often less than fair value of shares thus it includes a bonus element and moreover, an adjustment is needed to recompute the fair value in relation to theoretical ex-right value per share.

Diluted EPS indicates the potential variability or risk attached to the basic EPS as a consequence of the issue of potential equity shares and potential dilutive securities having significant impact on lowering EPS. However, no potential equity shares be included in the computation of any diluted per share amount in case of continuing loss from operation, even though the entity reports an overall net profit.

i) Adjustments should be made both in numerator and denominator consequent upon the conversion of potential dilution to arrive at diluted EPS in keeping with the nature of conversion including tax implication thereon in the respective year.

ii) Potential equity shares are:

a) debt instruments/preference share convertible into equity shares

b) share warrants

c) employees and other stock option plans which entitles them to receive equity shares as part of their remuneration and other similar plans

d) contingently issuable shares under contractual arrangements e.g. acquisition of a business/ assets, loan converted to equity on default

e) share application pending allotment if not statutorily required to be kept separately and is being utilized for business is treated as potential (dilutive) equity share.

PROBLEMS

1. Weighted avg. number of equity shares has been illustrated in AS-20 in the following line:

Accounting year: 2007-08				
Date	Description	Shares Issued (Nos)	Buyback (Nos)	O/S
01/04/2007	Op. Balance	1800	-	1800
30/09/2007	Issued for Cash	600	-	2400
29/02/2008	Buyback	-	300	2100
31/03/2008	C1. Balance	2400	300	2100

Weighted average number

a) (1800 x 5/12) + (2400 x 5/12) + (2100 x 2/12) i.e. 2100 shares

or

b) (1800 x 12/12) + (600 x 7/12) - (300 x 2/12) i.e. 2100 shares

2. Net profit for 2006-07: Rs 18,00,000; Net profit for 2007-08: Rs 60,00,000; No. of equity shares as on 31.12.07: Rs.20,00,000.

Bonus issued on 1-1-08 : 2 equity shares for each Equity Share outstanding at 31-12-08 i.e. Rs. 40,00,000.

Answer:

EPS for 2007-08: (Rs 60,00,000)/(20,00,000+40,00.000) = Re 1.00

Adjusted EPS for 2006-07: (earliest period reported) (Rs 18,00,000) / 60,00,000 = Re 0.30

3. Compute EPS:

a) Net profit for 2006 Rs 11,00,000

Net profit for 2007 Rs 15,00,000

b) Nos. of shares outstanding prior to Right Issue: 5,00,000 shares

c) Right Issue: one new share for 5 outstanding i.e. 1,00,000 new shares

d) Right price: Rs 15/-

e) Last date of right option: 1st March 2007

f) Fair value prior to the right option on 1st march 2007: Rs 21/- per equity share

Computation:

1) Theoretical ex-right fair value per share:

[(Rs 21 x 5,00,000) + (Rs 15 x 1,00,000)] / (5,00,000+ 1,00,000)

i.e. 1,20,00,000/6,00,000 = Rs 20/-

2) Adjustment factor:- fair value prior to exercise of rights/theoretical ex-right value. i.e. 21/20=1.05

3) Computation of EPS:

Year 2006	*Year 2007*
EPS as originally reported	
Rs. 11.00,000/5,00,000 shares	Rs 2.20
EPS restated for right issue	
Rs. 11,00,000/(5,00,000xRs 1.05)	Rs 2.10
EPS-for 2007 including rights	
Rs. 15,00,000/(5,00,000x 1.05x2/12)+(6.00,000x 1 0/12)	Rs 2.25

AS -21: CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements are presented by the parent or holding enterprise to provide financial information about the economic activities of its group - information about the parent and subsidiaries as a single economic entity revealing economic resources controlled by the group, the obligation of the group and the result that the group achieved with its resources.

AS-21 lays down the principles and procedures for preparation and presentation of consolidated financial statements in the backdrop of the facts that the Company's Act '56 doesn't provide for consolidation vis-à-vis the compliance to be made by listed companies in terms of AS-21.

Thus in parent enterprise's separate financial statements, investment in subsidiaries should be accounted for as per AS-l3, i.e. Accounting for Investments.

The consolidated financial statements even if made voluntarily should comply with AS -21.

The key note is the control by the parent which means and includes:

i) the ownership, directly or indirectly through subsidiary/subsidiaries of more than 50% of the voting power of an enterprise or,

ii) control of the composition of the Board of Directors or Governing Body (e.g. in the form of restriction, holding a position and right in nomination exercisable by the parent with reference to the subsidiary) as the case may be so as to obtain economic benefits from its activities.

Further "Control" is also further screened to exclude a subsidiary if;

a) it is intended to be temporary i.e. the subsidiary is acquired and held exclusively with a view to subsequent disposal in near further, in other words not intended for long term purpose.

b) there is long term restriction on the subsidiary which significantly impair its ability to transfer funds to the parent enterprise. (e.g. embargo on fund transfer by foreign subsidiary-severe devaluating currency)

In above cases investment would be valued as per AS -13 and not AS-21. AS-2) does not deal with the specific AS as under:

i) AS-14 - Accounting for Amalgamation

ii) AS-23 - Accounting for Investment in Association

iii) AS-27 - Accounting for investment in Joint Venture

Since schedule VI is not tailored to the presentation of consolidated financial statement. ICAI has provided general guideline vide GC-5/2002 which broadly states that the following principles should be served:

a) notes which are necessary for presenting a true and fair view of the consolidated finance statements should be included as an integral part thereof.

b) Only the notes involving items, which are material, need to be disclosed and the materiality is judged in the context of consolidated financial statement. Applicability of other Accounting Standard, in the preparation and presentation of consolidated statements are stated below:

    a) irrespective of the format followed, the minimum disclosure under various mandatory standards should be made.

AS-1: disclosure of accounting policies (e.g. going concern)

AS-22: accounting for taxes and income as applicable to the individual entity only cannot be given setoff treatment in CFS.

Specific items to AS in respect of balances of individual enterprise and not as a group e.g. "Current Investment valued at lower of cost or market price" Segmental information on consolidated numbers of individual enterprise in the group only.

Disclosure relating -to operating lease (AS-19) would not be required since the same is setoff and eliminated at consolidated level.

Related party transaction, within the group would not require discloser since eliminated at consolidated level.

Accounting related treatment for in consolidated financial statements:

a) Consolidation should be made on line by line basis by adding together like items- assets, liabilities, income and expense

b) All group balances and group transactions and unrealized profits arising thereon should eliminated

c) Dividend - minority share when paid is deduced from opening "Minority Interest" A/c and the portion attributable to parent is eliminated from Consolidated Reserves.

d) Excess of cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary on date of investment is recognized as 'goodwill' or in reverse situation as 'capital reserve' and the 'minority interest' as a liability separately in the consolidated financial statement as a distinct item.

e) When carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered

f) Usually consolidated financial statements are drawn upto the same date for reporting. In case, the reporting dates are different, the subsidiary normally prepares statements as at the same date of the parent. However, impracticable, different dates may be reported but the difference should not be more than six months with adjustments made for the effects, of significant transactions during the intervening period in respect all the items in the financial statements pertaining to that transaction e.g. cost of sales, inventory, unrelated gains, inter group balances. If not material otherwise, may be adjusted in income statement.

g) AS-21 permits the use of different accounting policies and estimates between group members, as long as the proportion of these in the in the context of the CFS are properly disclosed and explained.

h) AS-21 allows the use of financial statements of the subsidiary for the immediately preceding period if the financial statements as on the date of investments are not available or impracticable to draw the financial statements as on that date. As stated earlier, effects of significant transactions or events occur between the two dates are made.

i) I several investments are Trade over time to make it 51 % control, goodwill may be determined when the last investment is made to bring the slake to 51 % or alternatively on each step-up investment basis.

j) Goodwill is determined on the basis of carrying value of assets/liabilities of the subsidiary at the balance sheet date, thus fair value accounting for acquisition is not permitted under AS-21.

k) Where a group has acquired several subsidiaries, some resulting in goodwill and others a capital reserve, set off is not made for consolidation purpose.

Disclosure in terms of AS-21

a) Disclosure should be made in accordance with the format of the parent company's financial statements. Further disclosure under all the mandatory accounting standards when material and also compliance with General Classification no. 5/2002 should be made in order to ensure comparability for one period to the next, supplementary information about the effect of acquisition and disposal of subsidiaries on the financial position at the reporting date and results for the reporting period with comparative preceding period amount, should be disclosed.

b) Reasons for exclusion from consolidation of subsidiaries should be disclosed. List of all subsidiaries- name, country of incorporation/residence, proportion of ownership interest and if different proportion of voting power.

c) Nature of relationship if the parent does not own directly or indirectly more than 50% of voting power of the subsidiary.

d) Names of subsidiary/subsidiaries of which reporting dates are different from that of the parent and the difference in reporting dates.

AS-22: ACCOUNTING FOR TAXES ON INCOME

The need for establishing a standard arises due to difference between profit computed for accounting and that for tax purpose. As per this standard, the income tax-expense should be treated just like any other expenses on accrual basis irrespective of the timing of payment of tax.

Tax expense = current tax + deferred tax

Current tax is the amount of income-tax determined to be payable(recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing difference.

The difference accounts for:

a) treatment of revenue and expenses as appearing in the profit and loss Ale and as considered for the tax purpose.

b) the amount of revenue or expenses as recognized in the P/L A/c and as allowed for tax purpose.

The difference as arising in the above context gives rise to 'deferred tax' and it needs to be ensured that the tax charges in future accounting period is not vitiated.

The difference in accounting profit and taxable profit can be broadly categorized into two:

a) *Permanent difference:* which originates in one period and do not reverse in subsequent periods, e.g. personal expenses disallowed, interest/penalty disallowed as expense or tax-free agricultural income, various deduction under section 10, benefit/reliefs under section 80 in computing taxable income.

Permanent differences do not result in deferred taxes.

b) Timing difference: which originates in one period and is capable of reversal in subsequent period(s):

- difference in net block of fixed assets as per accounts and as per tax due to difference in the rate and method of depreciation;
- provision for doubtful debts and advances, provision for warranties, provision for VRS, provision for asset write-off, disallowed payments under 43B of Income Tax Act, provision for excise liabilities, provision for diminution in value of investments, scientific research expenditure (not weighted deduction which is a permanent difference), section 350 deduction, amortization of deferred revenue expenditure, lease income.

Situations which leads to Deferred Tax:

Deferred tax is the tax effect due to timing difference. They arise due to the following reasons:

- Accounting Income **less** than Tax Income
- Accounting Income **more** than Tax Income
- **Income** as per Accounts but **loss** as per IT Act
- **Loss** as per Accounts but **income** as per IT Act

Impact of such timing differences may lead to:

- Deferred Tax Liability (DTL): postponement of tax liability, which states Save Now, Pay Later.

  Profit and Loss A/c………..Dr

  To Deferred Tax Liability A/c

- Deferred Tax Asset (DTA): pay you tax liability in advance, which states Pay Now, Save Later.

  Deferred Tax Asset A/c……….Dr

  To Profit and Loss A/c

In the year of reversing time difference, either DTL is written back to profit and loss or the DTA is reversed by debiting profit and loss account.

For the recognition of DTA, prudence should be applied. Such recognition is based on " reasonable certainty" that sufficient taxable income would be available in the future to realize the DTA.

In case of unabsorbed depreciation and carry forward losses, DTA should only be recognized to the extent that there is "virtual certainty" that in future sufficient taxable income would be available to realize the DTA.

Reasonable certainty shall be deemed to be in existence if the probability of future taxable income is greater than 50%.

Virtual certainty shall be deemed to be in existence only when the evidence suggests that there will be sufficient taxable income in the future.

Disclosure under AS-22 Mandatory :

a) Break up of the deferred tax asset/liability.

b) DTL should be shown **after** the head "Unsecured Loans" and DTA **after** the head "Investments" with a separate heading.

PROBLEMS

1. From the following information for R Ltd. for the year ended 31st March,2008, calculate the deferred tax asset/liability as per AS-22

Accounting Profit	Rs.10,00,000
Book Profit as per MAT(Minimum Alternate Tax)	Rs.9,00,000
Profit as per Income Tax Act	Rs.1,00,000
Tax Rate	30%
MAT Rate	10%

Answer:

Tax as per accounting profit : 10,00,000 x 30%= 3,00,000

Tax as per Income Tax profit : 1,00,000 x 30% = 30,000

Tax as per MAT : 9,00,000 x 10%= 90,000

Tax expense = Current tax + deferred tax

3,00,000 = 30,000 + deferred tax

Therefore, Deferred Tax Liability as on 31.3.08 = Rs.3,00,000 – Rs.30,000 = Rs.2,70,000.

Amount of tax to be debited in Profit and Loss Account for the year 31.3.08:

= Current tax + deferred tax liability + Excess of MAT over current tax

= 30,000 + 2,70,000 + (90,000 – 30,000)

= 3,60,000

2. Z Ltd,has provided depreciation as per accounting records Rs.40 lakhs but as per tax records Rs.60 lakhs. Unamortized preliminary expenses, as per tax records is Rs.20,000. there is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 30%.

   Answer: As per Para 13 of AS-22, deferred tax should be recognized for all the timing differences. In this situation, the timing difference i.e. the difference between taxable income and accounting income is :

Excess depreciation as per tax Rs. (60 – 40) lakhs	=	Rs.20.00 lakhs
Less: Expenses provided in taxable income	=	Rs. 0.20 lakhs
Timing difference		Rs.19.80 lakhs

   As tax expense is more than the current tax due to timing difference of Rs.19.80 lakhs, therefore deferred tax liability = 30% of Rs.19.80 lakhs = Rs.5.94 lakhs.

   Profit and Loss A/c…………Dr 5.94

   To Deferred Tax Liability A/c 5.94

AS-23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS (CFS)

An enterprise that presents CFS should account for investments in Associates as per this standard.

This standard is not applicable for preparing and presenting stand-alone Investors' financial statement (in such cases AS] 3 is followed).

An Associate is an enterprise in which the investor has significant influence (power to participate in the financial/operating policy decisions of the investee but not control over those policies) and which is neither a subsidiary nor a joint venture of the Investor. The 'control' for the purpose of AS-23 is similar to that of AS-21.

Significant influence may be evidenced in one or more ways in the following line:

a) Representation on the Board of Directors or Governing Body of the Investee.

b) Participation in policy making process

c) Material transaction between investor and investee.

d) Interchange of managerial personnel

e) Provision of essential technical information

But it does not extend to power to govern the financial and/or operating policies of an enterprise.

Significant influence may be gained through share ownership, statute or agreement:

a) For share ownership, 20% or more in voting power in investee (held directly or indirectly through subsidiary) indicates significant influence but that is not the ultimate, the significant influence must be clearly demonstrated.

b) A substantial or majority ownership by another investor in the investee does not necessarily preclude an investor to have significant influence.

c) Voting power is determined on the basis of current outstanding securities and not potential equity.

Non applicability of AS-23:

1) Investment in associates are accounted for using the 'equity method' in the CFS except when,

    a) the investment is made and held exclusively with a view to subsequent disposal in the near future, or

    b) the associate operates under severe long-term restrictions that significantly impairs its ability to transfer funds to investor. Investments in such a situation is accounted for in accordance with AS-3 in CFS.

2) Equity method of accounting is also not applicable if

    a) it has no investment in Association

    b) it has investment in Association but has no subsidiaries, CFS is not required

    c) it has subsidiaries and associates but these are not material, hence CFS is not prepared.

    d) It is not listed enterprise hence not mandatory to present CFS or has not chosen voluntarily to present CFS.

Equity method of accounting recognizes the investment initially recorded at cost identifying goodwill/capital reserve at the time of acquisition. The carrying amount of investment is thereafter adjusted for the post-acquisition charge in the investor's share of net assets of the investee and consolidated P/L A/c reflect the investor's shares in the result of operation of the investee. Further any permanent decline in the value of investment is reduced to arrive at the carrying amount for each such investment.

Except inconsistent with AS-23, other accounting treatment would follow AS-21 Disclosure under AS-23

a) Reasons for not applying Equity Method in accounting for investments in associates in CFS .

b) Goodwill/capital reserve as included in the carrying amount of investment in Associates disclosed separately.

c) Description of associates, proportion of ownership interest and if different proportion of voting power held disclosed in CFS.

d) Investment using equity method should be classified as long-term investment in consolidated balance sheet, similarly investor's share in profit/loss in consolidated P/L Account and also investor's share of extraordinary or prior period items should be disclosed separately.

e) The names of associates of which reporting date is different from that of the financial statements of the investor and difference in reporting date should be disclosed in CFS.

f) Difference in the accounting policies if not practicable for appropriate adjustment in Associate's financial statement for being adjusted in CFS, the fact as such with description of difference in accounting policies should be disclosed.

g) In compliance with AS-4, Contingencies and events occurring after the balance sheet date, the investor discloses in the CFS:

  (i) its share of contingencies and capital commitments of an Associate for which the investor is contingently liable, and

  (ii) those contingencies that arise because the investor is severely liable for the liabilities of the associate.

PROBLEMS

1. X holds, 25% share in Y Ltd at a cost of Rs 5 lakhs as on 31-03-2001. Out of Y's shares capital and reserve Rs 20 Lakh each.

For the year ended 31-03-08 Y made a profit of Rs 80,000 and 50% distributed as dividend. In the CFS, the value (carrying amount) as at 31-03-2008 will be as under:

	Rs in Lakhs
Cost of shares in Y Ltd.	5.00
Share of Reserve	5.00
Share of profit	0.20
	10.20
Less: dividend received	0.10
Value of investment as at 31.03.08	10.10

2. Style Ltd. acquired 30% of Ugly Ltd.'s shares on April 10,2007, the price paid was Rs. 20,00,000.

	Rs.
Equity shares(Paid up)	5,00,000
Securities Premium	5,00,000
Reserve	5,00,000
	25,00,000

Further, Ugly Ltd reported a net income of Rs.3,00,000 and paid dividends of Rs.1,00,000. Style Ltd. has subsidiary on 31.3.08. Calculate the amount at which the investment in Ugly Ltd should be shown in the consolidated Balance Sheet of Style Ltd. as on 31.3.08

Answer: As per AS-23, when the investor company prepares the consolidated Balance Sheet, the investment in associate i.e. Ugly Ltd. shall be carried by equity method and goodwill and capital reserve to be identified and disclosed separately.

Value of the investment as per equity method

= 20,00,000 + 30% (3,00,000 – 1,00,000)= Rs.20,40,000.

Goodwill identified = (20,00,000 – 30% of 25,00,000) = Rs. 12,50,000

AS-24: DISCONTINUING OPERATION

AS-24 requires disclosure to be made when the discontinuation is in process and not merely once it has been fully completed for reporting information, to enhance the ability of the user of the financial statements to study projection of cash flow, earnings generating capacity and financial information differentiating between 'continuing' and 'discontinuing' operation.

Prerequisites to determine 'discontinuing operation' –

1. The enterprise in term a single plan:
    a) disposing substantially in its entirety e.g. by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholder, or
    b) disposing in piecemeal manner e.g. selling off the assets-and settling its liabilities individually or
    c) terminating through abandonment
2. That represent, a separate major line of business or geographical area of operation, and
3. That can be distinguished operationally for financial reporting purpose.

A restructuring event or transaction that does not meet with the definition of a 'discontinuing operation' within the ambit of AS-24, should not be called or treated as discontinuing operation. Typical example of instances which by itself does not mean 'discontinuing operation' but may lead to such in combination with other circumstances:

a) gradual or evolutionary phasing out of a product line or class of service
b) abrupt discontinuing of several products within an ongoing line of business
c) shifting of some production or marketing activities for a particular line of business from one location to another
d) closing of a factory to achieve productivity improvements or other cost savings. 'discontinuing operation' are expected to occur infrequently, but resulting income or expenses arising thereof needs to be disclosed in terms of AS-5 ~o explain the performance of the enterprise for the period.

Above all any transaction or event or in combination in order to be treated as 'discontinuing operation.' must be in terms of an overall plan falling within the prerequisites of 'discontinuing operation.

AS- 17 for segment reporting would normally satisfy the definition of 'discontinuing operation', but the significance for reporting under AS-24 will depend on individual judgment e.g. an enterprise operates in a single business/geographical segment though not reportable under AS- 17 may fall within the ambit of AS-24.

The criteria of discontinuation which can be distinguished operationally and for financial repotting purpose must fulfill the following:

a) the operating assets/liabilities of the component can be directly attributed to it.
b) revenue can be directly attributed to it
c) at least a majority of operating expenses can be directly attributed to it.

Going concern concept is not disturbed if an enterprise merely disposes off few of its segments but continues to operate its other business profitably, on the other hand if a substantial part of its operation is discontinued and there is no operation to carry as a result, it will cease to be going concern.

Discontinuing process need not necessarily arise out of binding sale agreement but relates back to the announcement of a detailed, formal plan approved by the Board of Directors /Governing Body, if precedes sales agreement and therefore require initial disclosure event/transaction. However the announcement must demonstrate the commitment to discontinue resulting into a constructive obligation for the enterprise. Requirement of initial disclosure in the financial statement for the period in which the event of discontinuing operation occur, are:

I. A description of discontinuing operation

2 The date and nature of initial disclosure event

3. Probable date or period by which the discontinuance is expected to be completed

4. Carrying amount of the total of assets to be disposed off and the total of liabilities to be settled as of the Balance sheet date

5. The amount of revenue and expenses in respect of ordinary activities attributable to the discontinuing operation during the current financial reporting period.

   the pre-tax profit/loss and tax expense (AS-22) in the above line. the amount of net cash flow attributable to the operating/investing/financing activities of the discontinuing operation during the current financial reporting period. If the initial disclosure event occurs in between the balance sheet date and the date of approval of financial statements by the board of directors/corresponding approving authority, disclosure compliance should be made as per AS-4 not under AS-24. Disclosure should continue till the discontinuance is substantially completed or abandoned, irrespective of receipt of payments from its buyer.

   In case the discontinuance plan is abandoned or withdrawn as previously reported, the fact, reasons and effects thereof including reversal of any prior impairment of loss or provision that was recognized in the plan, should be disclosed.

Disclosure under AS-24

1. By way of a note in the financial statement in respect of each discontinuing operation, in addition to disclosure on the face of the statements of profit/loss in respect of:
   a) the amount of pre-tax profit/loss from ordinary activities, income tax expense as attributable to discontinuing operation, during the current financial reporting period; and
   b) the amount of pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.
2. Comparative information for prior period that is presented in financial statements prepared after the initial disclosure should be restated to segregate assets, liabilities revenue expense and cash flows of continuing and discontinuing operations.
3. AS-24 does not provide for the principles to recognize and measure profit/loss in respect of discontinuing operation and therefore, other accounting standards would be applicable e.g. AS-4, AS-10 and other AS as and when applicable.

PROBLEMS

1. A FMCG company is manufacturing two brands of soap. Cinthol and Breeze. Company has gradually planned to shift all the manufacturing operation engaged in two soaps to manufacture only 'Breeze Soap' without closing the factory/plant producing the 'Cinthol Soap', rather utilizing the production facilities of 'Cinthol Soap' for producing the 'Breeze Soap'. Can we consider the operation to have been discontinued ?

Answer: Discontinuing operation is relatively large component of an enterprise which is major line of business or geographical segment, that is distinguishable operationally or for financial reporting such component of business is being disposed on the basis of an overall plan in its entirety or in piecemeal. Discontinuance will be carried either through demerger or spin-off, piecemeal disposal of assets and settling of liabilities or by abandonment.

In the given case, it is not a discontinuing operation.

2. B Ltd. is a software company, has subsidiary C Ltd. B Ltd.hold 70% shares in C Ltd. During 2007-08, B Ltd. sold its entire investment in C Ltd. Is it a discontinuing operation?

Answer: As per the definition and scope of 'discontinuing operation', the sell of investments in subsidiary company does not attract the provisions of AS-24.

Hence, it is not a discontinuing operation.

3. C Ltd.has three major lines of business: steel, tea and power generation. It has decided to sell the tea division during the financial year 2007-08. A sale agreement has been entered into on 30th September 2007 with P Ltd. under which the tea division shall be transferred to P Ltd. on 31st March,2008. Is it a discontinuing operation?

Answer: This is a case of disposing of the tea division substantially and in its entirety. It will be considered as a discontinuing operation.

However, if a special resolution is passed for sale of various assets and to repay the various liabilities individually of the tea division, it is a case of "disposing by piecemeal" and not a "discontinuing operation".

Note: Any **planned change** in the product line **may not be** treated as a **discontinuing operation.**

AS-25: INTERIM FINANCIAL REPORTING

Interim financial reporting is the reporting for periods of less than a year, generally for a period of 3 months. As per Clause 41 of listing agreement the companies are required to publish the financial results on a quarterly basis.

AS-25 prescribe minimum content of an interim financial report and principles for recognition and measurement in a complete or condensed financial statement for an interim period or specific dates in respect of asset, liability, income and expense.

There are certain typical problems not faced while preparing annual account as the reporting period is shortened, the effect of errors in estimation and allocation are magnified e.g.

i) accrual of tax credits in different interim period, makes determination of tax expense often difficult, one period may reveal tax profit while the other interim period have tax losses;

ii) benefit of expenses spread beyond interim period e.g. advertising expenses, major repair and maintenance expenses;

iii) determination of approximate amount of provisions, e.g. warranties, pension, gratuity, maybe complex 'and time consuming;

iv) revenue may be seasonal or cyclical, hence concentration falls in certain interim periods;

v) inter-company reconciliation, full stock-taking and valuation may be cumbersome and time consuming;

vi) transaction based on Annual Targets e.g.: bonus or incentives would be difficult to estimate.

The standard itself does not categorize the enterprise or frequency of interim financial report and the time limit for presentation from the end of an interim period, but if it is required to prepare and present, it should comply with AS-25.

Instances for interim financial report:

(i) quarterly report to the board of directors or bank

(ii) incase of merger and amalgamation

(iii) for IPO purpose

(iv) for consolidation of parent and subsidiary when year ends are different

(v) for declaring interim dividend' Accounting for interim transaction:

  (a) interim period is considered as integral part of annual accounting period e.g. annual operating expc!1ses are estimated and then allocated to the interim period based on estimated sales or other parameters and results of subsequent interim periods are adjusted for estimation errors (integral approach)

  (b) each interim period is considered as discrete and separate accounting period like a full accounting period e.g. no estimation or allocation and operating expenses are recognized in the concerned interim period irrespective of benefit accruing to other interim period (discrete approach).

Form and contents of interim financial statement:

a) AS 25 doesn't prohibit an enterprise from presenting a complete set of financial statements (e.g. balance sheet, profit & loss statement, cash flow statement notes to account and accounting policies, other statements and other explanatory' materials as forming integral part of the financial statement).

b) The recognition and measurement principles as stated in AS-25 also apply to complete set of financial statements for an interim period, full disclosure under this statement and other accounting standard will be required.

c) Alternatively, the statement allows preparation and presentation 'of interim financial report in a condensed form, containing as a minimum, a set of condensed financial statements, providing update on the latest annual financial statements (does not duplicate the information already reported)

Contents of a condensed Interim Financial Statements as a minimum:

1. A statement that the same accounting policies are followed as in the most recent annual financial statements - for change, description of the nature and effect of the change.

Explanatory comment, about the seasonality of the interim operations the nature and amount of items affecting assets, liability, equity, net income or cash flows that are unusual because of their nature, size or incidence.

2. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amount reported in prior financial year - if the those changes have a material effect in the current interim period.
3. Issues, buy-back, repayment and restructuring of debt, equity and potential equity shares.
4. Dividends, aggregate per share (in absolute or percentage) separately for equity and other shares
5. If compliance required under AS-17, segment revenue, segment capital employed and segment result for Business or Geographical segments (whichever is primary for reporting).
6. Effect of changes in the composition of the enterprise during the interim period (e.g. amalgamation, acquisition. or disposal of subsidiaries and long term investments, restructuring and discontinuing operation.
7. Material change in contingent liabilities since last annual *B/S* date.

The above selected explanatory notes should normally be reported on a financial year to date basis.

Period of Interim Financial Statement: interim reports should include interim financial statements (condensed or complete) for periods as follows:

a) Balance Sheet:

(1) As at the end of current interim period

(2) As at the end of the immediately preceding financial year

b) Statement of Profit and Loss:

(1) For the current period

(2) Cumulative for the current financial year to date

(3) Comparative for the comparable interim period (current arid year to date

c) Cash flow Statement:

(1) Current financial year to date

(2) Comparative for the comparable year to date for immediately preceding financial year.

PROBLEMS

1. S Ltd. presents interim financial report quarterly on 1.4.2008. S Ltd.has carried forward loss of Rs.800 lakhs for income tax purpose for which deferred tax asset has not been recognized. S Ltd.earns Rs. 600 lakhs; Rs.700 lakhs; Rs.750 lakhs and Rs.800 lakhs respectively in the subsequent quarters, excluding the carried forward losses. Income tax rate is 30%. Calculate the amount of tax expense to be reported in each quarter.

   Answer: The estimated payment of the annual tax on Rs.2850 lakhs earnings for the current year = Rs.(2,850 – 800) lakhs = Rs.2,050 lakhs.

Therefore, tax = 30% of Rs.2,050 lakhs = Rs.615 lakhs.

Average annual effective tax rate = (615/2,850) x 100 = 21.58%

Tax expense to be shown: Rs.lakhs

1st quarter= 600 x 21.58%=129.48

2nd quarter= 700 x 21.58%=151.06

3rd quarter = 750 x 21.58%=161.85

4th quarter = 800 x 21.58%=172.64

2. M Ltd. presents interim financial report(IFR) quarterly, earns Rs.800 lakhs pre-tax profit in the first quarter ending 30.6.08 but expect to incur losses of Rs.250 lakhs in each of the remaining three quarters. Effective income tax rate is 35%. Calculate the income-tax expense to be reported for each quarter as per AS-25.

   Answer: Tax expense to be reported in each of the quarters are:

   1st quarter= 800 x 35%=Rs.280.00 lakhs

   2nd quarter= (250) x 35%=Rs. (87.5)lakhs

   3rd quarter = (250) x 35%=Rs. (87.5)lakhs

   4th quarter = (250) x 35%=Rs.(87.5) lakhs

   Annual Tax Expense = Rs.17.5 lakhs

AS – 26: INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance held for production or supply of goods and services for rental to others or for administrative purposes.

AS-26:

(i) prescribes the accounting treatment for intangible assets that are not specifically covered in other accounting standard;

(ii) recognizes an intangible asset on fulfillment of certain criteria;

(iii) deals with deferment of expenses except in a few specific instances.

However AS -26 does not apply to:

a) Intangible assets covered by other accounting standards e.g. AS-2 (valuation of inventories), AS-7 (accounting for construction contracts), AS-22(accounting for taxes on income), leases falling within scope of AS-19, goodwill on amalgamation (AS-14) and on consolidation (AS-21).

b) Mineral rights and expenditure on the exploration .for or development and extraction of minerals, oils, natural gas and similar non-generative resources and intangible assets arising in insurance enterprises from contracts with policy holders however, computer software expenses, start up cost pertaining to above activities are covered by AS-26).

c) Discount Premium on borrowings.

AS-26 applies, among other things, to expenditure on advertisement, training, startup, R&D activities, Rights under Licensing Agreement for motion picture video recording, plays, manuscript, patents and copyrights, the criteria is that expenditure should provide future economic benefits to an enterprise.

Sometimes, an asset may incorporate both tangible and intangible component and it is practically inseparable. "Judgment is required to determine the applicability of AS-10 (fixed asset) and AS-26 (intangible asset).

Example:

(1) computer software which is integral part and without that the computer-controlled machine cannot operate - treated as fixed asset.

(2) computer software, not an integral part of related' hardware - treated as. an intangible asset,

Essential criteria for recognition of an intangible asset:

a) *identifiable:-* It must be separate from goodwill and the enterprise could rem. sell: exchange or distribute the future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets in the same revenue earning activity - but goodwill cannot be meaningfully transferred to a new owner without also selling the other assets or the operation of the business. e.g. patents, copyrights, license, brand name, import quota, computer software, lease hold right, marketing rights, technical know-how etc.

b) *control:-* The enterprise has the power to obtain the future economic benefits, flowing from the underlying resources and also can restrict the access of others I to those benefits (not necessarily legal right and may be in some other way – I market and technical knowledge may give rise to future economic benefit) . I

c) *future economic benefits:-* An enterprise should asses the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset on the basis of weight age to external evidence available at the time of initial recognition..

d) Cost can be measured reliably :

    i) Initially recognized at cost - purchase price, taxes duty and other directly attributable expenses to make the asset ready for its intended use, if acquired separately - purchase consideration in the form of cash or other monetary asset.

    ii) In exchange for shares or securities at fair value of those shares or securities.

    iii) In exchange or part exchange for another asset - as per AS-l0.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis for creating, producing and making the asset ready for its intended use, but in no case once treated as an expense, cannot be reversed for capitalization even if the essential criteria for recognition are complied with a later date.

Normally the following cost are not recognized for internally generated intangible asset:

1) selling, administrative and other general overhead unless directly attributable.

2) clearly identified inefficiencies and initial operating loses incurred before an asset achieves planned performance.

3) expenditure on training the staff to operate the asset.

Subsequent expenditure on an internally generated intangible asset after its purchase or completion is normally treated as expense unless it is assessed to generate future economic benefits over and above the originally assessed standard of performance or it can be measured and reliably attributed to the concerned intangible asset.

Amortization is the systematic allocation of the depreciable amount (cost less residual value usually "NIL" unless determined in terms of committed value by a third party or determined by active market price) of an intangible asset over its useful life (period of time for use, number of production or other similar units expected to obtain or legal restriction).

Under AS-26, useful life shall not exceed 10 years from the date the asset is available for use unless there is persuasive evidence to establish useful life longer than 10 years provided the enterprise

(a) amortizes over the best estimated useful life

(b) estimates the recoverable amount at least annually to identify the impairment loss

(c) disclose the reasons and factors in determining a longer life.

The amortization period and the amortization method should be reviewed at least at each, financial year and if the expected life is revised, the amortization period is revised accordingly but in no case it would tantamount to inappropriate deferment to later years.

AS-5 will be relevant in this regard as to what constitutes a change in accounting policy and what constitutes a change in estimate e.g. a change from straight-line to diminishing method or vice-versa would be change in accounting policy whereas reduction in the amortization period is change in accounting estimate.

Disclosure under AS-26

A) General

1. for each class of intangible asset distinguishing between internally generated and others
   - (a) useful lives and amortization rates used
   - (b) amortization method used
   - (c) gross carrying amount and the accumulated amortization including impairment loss at the beginning and end of the reporting period
   - (d) a reconciliation of the carrying amount (opening balance/addition/ disposal/impairment/ loss charged/reversed/amortization for the period and other changes)
2. class of intangible asset by grouping of a similar nature and use by the enterprise information on impaired intangible asset under AS-28 change in accounting policy or accounting estimate as per AS-5 reasons for amortization beyond 10 years with list of factors considered in determining the useful life.
3. Description, the carrying amount and remaining amortization period of any individual asset what is material to the financial statement as a whole.
4. Existence and carrying amount of intangible assets whose title is restricted and the carrying amount of intangible asset pledged as security for liabilities.

5. Amount of commitments for acquisition of intangible assets.

B) R&D expenditure: R&D expense (that is directly attributable or reasonably allocated on a consistent basis) recognized as an expense during the period.

C) Other information: encouraged to disclose a description of only fully amortized intangible asset but still in use.

Specific guideline for internally generated computer software - criteria for capitalization: apart from the broad recognition principles, AS-26 provides for specific guidance on internally generated computer software.

(a) At preliminary project stage, it is not recognized as an asset since the enterprise cannot demonstrate then exists as an asset from which future economic benefit will follow (making strategic decision, determination of performance requirements alternative means to achieve specified performance requirements. determination of technology to achieve performance requirements and selection of consultant to assist in development and/or installation of the software)

(b) At development stage involving detailed program design, coding working model in operative version for all major planned function and testing to bring it to a completed version together with related documentation and training material.

At this stage the internal1y generated computer software can be recognized as an asset on satisfying

1. The technical feasibility to make it available for internal use
2. Intention to complete to perform individual functions e.g. commitment for funding the project.
3. Ability to use the software
4. Usefulness of the software to generate future economic benefit
5. Availability of technical, financial and other resources to complete the development and use
6. Reliably measure the expenditure to the software development b) cost has some connotation as described earlier in the standard.

c) Accounting for software acquired or purchased should meet with the basic principle of AS-26 as discussed elsewhere in this standard.

For computer software considering the fact technological change and obsolescence.It is 3-5 years of useful life, which needs to be reasoned in the disclosure.

Expenditure for Website:

The expenditure for purchasing, developing, maintaining and enhancing hardware (servers, internet connection) related to web site are accounted for under AS-10 (fixed asset).

The expenditure may be incurred internally when developing enhancing and maintaining its own website in the context of planning, application and infrastructure development, graphical design and content development and operating stage which are directly attributable or allocable on a reasonable basis to creating, producing and preparing the asset for intended use. The nature of each activity should be evaluated to decide web site stage of development.

Accounting treatment and recognition:

a) planning stage expenditure are akin to research cost and recognized as expense when incurred.

b) expenditure arising onward development stage complying with the development criteria (refer to computer software) should be recognized as an Intangible asset.

PROBLEMS

1. On February 2008, J Ltd.bought a trademark from I Ltd. for Rs.50 lakhs. J Ltd. retained an independent consultant, who estimated the trademark's remaining life to be 14 years. Its unamortized cost on I ltd. records was Rs.35 lakhs. J Ltd.decided to amortize the trademark over the maximum period allowed. In J Ltd.'s Balance Sheet as on 31st December 2008, what amount should be reported as accumulated amortization?

   Answer: As per para 23 of AS-26, intangible assets should be measured initially at cost therefore. J Ltd. should amortize the trademark at its cost of Rs.50 lakhs. The unamortized cost on the seller's books Rs.35 lakhs is irrelevant to the buyer. Although the trademark has a remaining useful life of 14 years, intangible assets are generally amortized over a maximum period of 10 years as per AS-26. Therefore, the maximum amortization expense and accumulated amortization is Rs.5 lakhs (Rs.50 lakhs/10).

2. During 2007-08, A Ltd.incurred organization costs/preliminary expenses of Rs.40,000. What portion of the organization costs will A Ltd. defer to years subsequent to the 2007-08?

   Answer: As per para 56(a) of AS-26, organization costs /preliminary expenses are those incurred in the formation of a corporation. Since uncertainty exists concerning the future benefit of these costs in future years, they are properly recorded as an expense in 2007-08.

3. D Ltd. is developing a new distribution system of its material, following the costs incurred at different stages on research and development of the system:

Year ended 31.3.	Phase/Expenses	Amount(Rs. In lakhs)
2004	Research	8
2005	Research	10
2006	Development	30
2007	Development	36
2008	Development	50

   On 31.3.08, D Ltd. identified the level of cost savings at Rs. 16 lakhs expected to be achieved by the new system over a period of 5 years, in addition this system developed can be marketed by way of consultancy which will earn cash flow of Rs.10 lakhs per annum. D Ltd.demonstrated that new system meet the criteria of asset recognition as on 1.4.2006.

   Determine the amount/cash which will be expensed and to be capitalized as intangible assets, presuming that no active market exist to determine the selling price of product i.e. system developed. System shall be available for use from 1.4.2008.

   Answer: As per AS-26, research cost of Rs.18 lakhs to be treated as an expense in respective year ended 31st March 2004 and 2005 respectively.

The development expenses can be capitalized from the date the internally generated assets (new distribution system in this given case) meet the recognition criteria on and from 1.4.2006. Therefore, cost of Rs.30+ 36+ 50= Rs.116 lakhs is to be capitalized as an intangible asset.

However, as per para 62 of AS-26, the intangible asset should be carried at cost less accumulated amortization and accumulated impairment losses.

At the end of 31st March,2008, D Ltd. should recognize impairment loss of Rs.22.322 lakhs (= 116 - 93.678) and carry the new distribution system at Rs. 93.678 lakhs in the Balance Sheet as per the calculation given below:

Impairment loss is excess of carrying amount of asset over recoverable amount. Recoverable amount is higher of two i.e. value in use(discounted future cash inflow) and market realizable value of asset.

The calculation of discounted future cash flow is as under assuming 12% discount rate.

(Rs. Lakhs)

Year	Cost Savings	Inflow by introducing the system	Total cash inflow	Discounted at 12%	Discounted cash flow
2009	16	10	26	0.893	23.218
2010	16	10	26	0.797	20.722
2011	16	10	26	0.711	18.486
2012	16	10	26	0.635	16.51
2013	16	10	26	0.567	14.742
					93.678

No amortization of asset shall be done in 2008 as amortization starts after use of asset which is during the year 2008-09.

AS-27: FINANCIAL REPORTING OF INTEREST IN JOINT VENTURE

AS-27 is applicable for accounting in joint venture interest and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturer and investors, regardless of the structure or forms under which the joint venture activities take place,

The statement provides for display and disclosure requirement for accounting for the investment in the stand-alone and consolidated financial statements of the venturer.

A joint venture is a contractual arrangement between two or more parties undertaking an economic activity, subject to joint control (control is the power to govern the financial and operating policies of an economic activity to obtain benefit from it).

The arrangement may be:

a) Jointly controlled operations

b) Jointly controlled asset

c) Jointly controlled entities

In the event an enterprise by a contractual arrangement establishes joint control over an entity which is a subsidiary of that enterprise within the meaning of AS-21(CFS), it will be treated as joint venture as per AS-27. Joint control requires all the venturers to jointly agree on key decisions, else decision cannot be taken, as such even a minority holder (owner) may enjoy joint control.

Contractual arrangement is normally made in writing touching upon:

(a) The activity, duration and reporting obligation

(b) The appointment of the board of director/governing body and the respective voting rights/ capital contribution/sharing by ventures of the output, income, expenses or results of the joint venture.

Contractual arrangement and joint control together makes an activity a joint venture, (investment in Associates in which the investor has significant influence is covered by AS-23)

Some joint ventures involve use of own fixed assets and other resources on its own and obligation of its own.

For its interest in jointly controlled operations, a venturer should recognize in its separate financial statements and consequently in its CFS,

(a) the assets that it controls and the liabilities it incurs

(b) the expense it incurs and the share of income earned from the joint venture.

As the above are already recognized in stand-alone financial statements of the venturer and consequently in the CFS, there us no requirement for adjustment or other consolidation procedure, when the venturer present the CFS. Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture.

Some joint ventures involve joint control; by means of joint ownership by the venturers of one or more assets contributed/acquired for the purpose of joint venture - the asset are used to obtain economic benefit for the venturers, agreeing to share the output from the assets and sharing of expenses incurred.

In respect of **jointly controlled assets**, each venturer recognize in its separate financial statement and consequently in its CFS:

a) Share of the jointly controlled assets under distinct head of each asset and not as an investment

b) Any liability incurred (e.g. financing its share of the assets)

c) Share of joint liability in respect of the venturer

d) Any income from sale or use of its share of the output in the joint venture and share of expenses.

e) Expense is incurred in respect of its in the joint ventures e.g. financing the venturer's interests in the asset and selling its share of output The treatment of jointly controlled assets, recognizes the substance and economic reality (legal from of the joint venture) separate financial statements may not be prepared for the joint venture itself.

A **jointly controlled entity** involves the establishment of a corporation, partnership or lither entity in which each venturer has an interest as per contractual arrangement.

a) in a separate/stand alone financial statement of each venturer, the interest in a jointly controlled entity should be accounted for as an investment as per AS-13 only the resources contributed, forms a part of the investment and the share' of joint venture result is treated in the income statement of the venturers.

b) proportionate consolidation for joint venture is applied in case where the preparation and presenting a CFS is required, reflecting the substance and economic reality of the arrangement in the CFS. Many of the procedure in this regard are similar to AS-21 and require to be followed for treatment and disclosure.

Joint venture interest in the financial statements, of an investor is treated appropriately in terms of AS-13, AS-21 or AS-23 in CFS but for separate financial statements is should be accounted for as per *AS-13.*

Disclosure under AS-27:

I. In separate and CFS in respect of:

  a) Aggregate amount of contingent liabilities unless the probability of loss is remote separately from other contingent liabilities in relation to:

    1. Its interest in joint venture and its share in each of the contingent liabilities incurred jointly

    2. Its share of the contingent liability of the joint ventures themselves for which it is contingently liable.

    3. Those liabilities which arise because of the venturer is contingently liable for the liability of other venturers.

  b) Aggregate of commitments in respect of joint venture separately from other commitments in respect of:

    1. Capital commitment of its own and shares in the capital commitment incurred jointly with other ventures in relation to the joint venture.

    2. Share of capital commitment of the joint ventures themselves

  c) A list of all joint ventures and description of interest in significant joint venture and for jointly controlled entities the properties of ownership interest name of the country of incorporation/ residence.

PROBLEMS

1. N Ltd has 80% shares in a joint venture with Suzuki Ltd. N Ltd. sold a plant WDV Rs.20 lakhs for Rs.30 lakhs. Calculate how much profit N Ltd. should recognize in its book in case joint venture is:

   (a) jointly controlled operation;

   (b) jointly controlled asset;

   (c) jointly controlled entity.

   Answer: As per AS-27, in case of jointly controlled operation and jointly controlled assets joint venture, the venture should recognize the profit to the extent of other venturer's interest.

   In the given case, N Ltd. should recognize profit of:

   = Rs.(30 – 20)lakhs = Rs.10 x 20%= Rs.2 lakhs only.

   However, in case of jointly controlled entities N Ltd. should recognize full profit of Rs.10 lakhs in its separate financial statement. However, while preparing consolidated financial statement it should recognize the profit only to the extent of 20% i.e. Rs. 2 lakhs only.

AS-28: IMPAIRMENT OF ASSETS

An asset is impaired if its carrying amount exceeds the amount to be recovered through use or sale of the asset and given the situation the standard requires the enterprise to recognize an impairment loss i.e. the amount by which the carrying amount of an asset exceeds its recoverable amount.

Impairment loss is a normal expense and thus will have impact on distributable profit and other provisions of the company's act and applicable enactment (Acceptance of Deposit Rules, BIFR etc)

Impairment loss may be discussed in the following areas:

1) Impairment loss on a specific asset;
2) Impairment loss for a cash generating unit;
3) Impairment loss for discontinuing operation.

Impairment Loss = Carrying amount of the Asset – Recoverable amount.

Carrying amount is the amount at which asset is shown in the Balance Sheet.

Recoverable amount of an asset is **higher** of:

- Net selling price
- Value in use

Net Selling Price= Expected realizable value of an asset – cost of disposal

Net Selling price can be obtained from:

- Active market for the asset
- Binding sale agreement
- Best estimate based on information

Value in Use= Present value of estimated future cash flow arising from the use of asset + residual value at the end of its useful life.

Present value is calculated by applying discount rate to future cash flows.

Estimated cash flows includes :

- Cash inflows from continuing use of the asset
- Projected cash outflows to generate cash inflows from continuing use of the asset.
- Net cash flows if any to be received(or paid) for the disposal of the asset at the end of its useful life.

Estimated cash flows excludes:

- Cash flows from financing activities
- Payment /refund of income tax

Discount rate: It is the cost of capital to be applied to calculate the present value of estimated cash flows and is based on the following factors:

- Pre-tax rate

- Current market assessment of time value of money after considering specific risk of the asset.
- Enterprises weighted average cost of capital or incremental financial cost.
- The current rate of inflation is also considered.

AS-28 does not apply to:

- inventories (as per AS 2);
- construction contract assets (as per AS 7);
- deferred tax assets (as per AS 22);
- investments covered by AS-13 and financial instruments, because other AS provide for recognizing and measuring these assets.

1) **Assessment for impairment of assets needs to be made at the B/S date:** as to any indication in this context based on external or internal source of information.

External sources:

- Market value changes with passage of time or normal use (typewriter on invention of computer)
- Adverse effect in the light of technological, market, economic, or legal environment in which the enterprise operates.
- Change in market rate of interest or returns on investment affect the discount rates used to assess an assets value in use (if the effect is not a short-term phenomenon).
- Carrying amount of the net asset, exceeds its market capitalization (determined by future growth, profitability, threat of new products/entrants etc).

Internal sources:

- Obsolescence /physical damage is evident.
- Indication obtained internally that economic performance of an asset has worsened or likely to worse than expected.
- Continuous cash loss may indicate that one or more of the business division is impaired.

Assessment for impairment should be made on individual asset basis, except when;

(i) The asset value in use cannot be estimated to be close to the net se1ling price i.e. future cash flow from continuing use of the asset cannot be estimated to be negligible or there is no plan to dispose of the assets in near future.

(ii) The asset does not generate cash inflows from continuing use that are largely independent of those from other assets.

In the exceptional case as above, the value in use/recoverable amount can be determined with regard assets cash generating units (generate cash inflows from outside the reporting enterprise and independent of cash inflows from other assets / group of assets.

2) **Impairment Loss to a cash generating unit :**

Cash generating unit (CGU): The smallest group of an asset for which cash flows can be determined independently.

Even if the cash flows can determined independently, aggregation of cash generating units becomes necessary in some situations.

To determine impairment loss of a CGU, we have to follow 'bottom up' or 'top down' test.

[These two tests are discussed in Paper 16: Advanced Financial Accounting and Reporting, in details.]

3) Impairment Loss for discontinuing operation :

In this type of situation, the impairment loss shall depend on the way the discontinuing operation is disposed off:

a) substantially in its entirety;

b) as piecemeal sales;

c) by abandonment.

PROBLEMS

1. X Ltd.purchased a machinery on 1.1.2002 for Rs.20 lakhs. WDV of the machine as on 31.3.08 Rs.12 lakhs. The Recoverable amount of the machine is Rs.11 lakhs. What is the impairment loss?

   Answer: Impairment Loss = Carrying amount – Recoverable Amount

   = Rs.12 lakhs – Rs.11 lakhs = Rs. 1 lakh.

2. Carrying amount Rs.200 lakhs. Net Selling Price Rs.210 lakhs. Value in use Rs. 220 lakhs. What is the impairment loss?

   Answer: Carrying amount Rs.200 lakhs

   Recoverable amount Rs. 220 lakhs (being the higher of net selling price and value in use)

   Since, recoverable amount is more than carrying amount of the asset, there will arise no impairment loss.

3. C Ltd.acquired a machine for Rs.3.2 crores on 1.1.2005. It has a life of 5 years with a salvage value of Rs.40 lakhs. Apply the test of impairment on 31.3.2008:

   (a) Present value of future cash flow Rs.1.3 crores

   (b) Net selling price Rs.1.2crores

   Answer: Carrying amount of the asset: [3.2 – (3.2 – 0.4) x 39/60] = 1.38 crores.

   Time period for use of the asset: 1.1.2005 to 31.3.2008 = 39 months

   Total life period of the asset= 5 years = 60 months.

   Recoverable amount: being the higher of present value and net selling price = Rs.1.3 crores.

   Impairment Loss= Rs(1.38 – 1.3) crores= Rs.0.08 crores.

AS 29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

The objective of this Standard is also to lay down appropriate accounting for contingent assets.

This standard is not applicable to:

- Financial instruments carried at fair value
- Insurance enterprises
- Contract under which neither party has performed any of its obligations or both parties have partially performed their obligation to an equal extent
- AS 7,AS 15,AS 19 and AS 22.

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

A **liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A **contingent liability** is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognized because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation;

  or

  (ii) a reliable estimate of the amount of the obligation cannot be made.

A **contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

Past Event- A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Best Estimate: The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

Risks and Uncertainties: The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

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

Disclosure:

For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

PROBLEMS

1. There is a income tax demand of Rs.2.5 lakhs against the company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The ground of appeal deals with the points covering Rs.1.8 lakhs of the demand. State how the matter will have to be dealt with in the financial account for the year.

   Answer: A provision of Rs.0.7 lakhs and a contingent liability of Rs. 1.8 lakhs should be provided in the financial accounts for the year.

2. A company follows a policy of refunding money to the dissatisfied customers if they claim within 15 days from the date of purchase and return the goods. It appears from the past experience that in a month only 0.10% of the customers claim refunds. The company sold goods amounting to Rs.20 lakhs during the last month of the financial year. Is there any contingency?

   Answer: There is a probable present obligation as a result of past obligating event. The obligating event is the sale of the product. Provision should be recognized as per AS-29. The best estimate for provision is Rs. 2,000 (Rs.20 lakhs x 0.1%).

AS-30: Financial Instruments: Recognition and Measurement

The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, *Financial Instruments: Presentation.* Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32, *Financial Instruments:*

Definitions:

The terms defined in AS 31, *Financial Instruments: Presentation* are used in this Standard with the meanings specified in paragraph 7 of AS 31. AS 31 defines the following terms:

- financial instrument
- financial asset
- financial liability
- equity instrument

and provides guidance on applying those definitions.

Definition of a Derivative:

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

Definitions of Four Categories of Financial Instruments :

A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

  (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or

  (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

  (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss.

Accounting Standard (AS) 32, Financial Instruments: Disclosures , requires the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that meet the definition of loans and receivables; and

(c) those that the entity designates as available for sale.

An entity should not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

(a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity upon initial recognition designates as available for sale; or

(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.

Definition of a financial guarantee contract

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions Relating to Recognition and Measurement

The **amortised cost** of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Definitions Relating to Hedge Accounting

A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A **forecast transaction** is an uncommitted but anticipated future transaction.

Functional currency is the currency of the primary economic environment in which the entity operates.

A **hedging instrument** is (a) a designated derivative or (b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

A **hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

Embedded Derivative:

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

AS 31: Financial Instruments: Presentation

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30.

Definitions

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

A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A **financial asset** is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

  (i) to receive cash or another financial asset from another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity’s own equity instruments and is:

  (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity’s own equity instruments; or

  (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

A **financial liability** is any liability that is:

(a) a contractual obligation:

  (i) to deliver cash or another financial asset to another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity’s own equity instruments and is:

  (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or

  (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity ’s own equity instruments. For this purpose the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

Financial Instruments: Recognition and Measurement and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

In this Standard, **'contract'** and **'contractual'** refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

In this Standard, **'entity'** includes individuals, partnerships, incorporated bodies, trusts and government agencies.

AS 32: Financial Instruments: Disclosures

The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard

(AS) 30, Financial Instruments: Recognition and Measurement and Accounting Standard (AS) 31, Financial Instruments: Presentation.

Significance of financial instruments for financial position and performance

An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Balance sheet

Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately
    (i) those designated as such upon initial recognition and
    (ii) those classified as held for trading in accordance with AS 30;
(b) held-to-maturity investments;
(c) loans and receivables;
(d) available-for-sale financial assets;
(e) financial liabilities at fair value through profit or loss, showing separately
    (i) those designated as such upon initial recognition and
    (ii)those classified asheld for trading in accordance with AS 30; and
(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

(a) the maximum exposure to **credit risk** of the loan or receivable (or group of loans or receivables) at the reporting date.
(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
    (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to **market risk**; or
    (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset. Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.
(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

If the entity has designated a financial liability as at **fair value through profit or loss** in accordance with AS 30, it should disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

  (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk ,or

  (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

Reclassification

If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

it should disclose the amount reclassified into and out of each category and the reason for that reclassification .

5.3 Financial Reporting across the world

There are major international differences in accounting practices in reporting across the world. By the term " Accounting system", we mean the set of financial reporting practices used by a particular company for an annual report.

The factor that impact accounting development at the national level also contribute to accounting diversity at the international level.

Environmental factors may be broadly classified as:

1) The type of capital market

2) Diversify taxation and financial reporting

   If the legal framework allows two sets of reporting, one for taxation where profits are understated to minimize taxation, and external reporting is legally allowed to be presented on glossier terms to attract investment.

3) Size of business houses

   Larger business houses, consisting of large variety of products, employing thousands of people and operating in many countries, characterize developed countries. Financial reporting in these countries will be detailed and complete since it is needed to capture the economic substance of the entities of these economies. They are therefore very different from financial reporting rules sufficient for smaller and less complex entities.

4) Legal system

The legal system in countries like Rome, Germany, France etc. may be called the code – law type where accounting is regulated mainly through an account code, which tends to be highly detailed, prescriptive, procedural and is generally set by the legislature. The emphasis is on protection of creditors of the company. This is in contrast to the common law countries like United Kingdom, U.S.A. and Australia accounting regulations are set on a procedural basis, typically by a private sector standard setting body, with emphasis on presenting a true and fair picture to shareholders. This type of reporting is more timely and transparent, and regarded as being more adaptive and innovative.

Level of enforcement: Where stringent enforcement prevails, accounting and reporting practices are largely in compliance with regulatory requirements. In some countries, political patronage and proximity to the ruling group enables business entities to circumvent existing financial reporting requirements. Investors who assumed there was compliance when there was actually not, suffered sufficient losses when the true financial position of such flouting companies was disclosed.

Sometimes, countries that adopted accounting standards of other countries do not have the resources to implement and enforce the standards. Business entities need trained personnel to apply these standards, while regulatory agencies need adequate budgets to monitor compliance. When countries lack these resources, there is a gap between the requirements and actual practice.

Inflation Levels:

Countries such as U.K. and U.S. who usually keep inflation under check, tend to use the historic cost model, where as countries like Bolivia and Mexico, have to use inflation – adjusted models of Financial reporting to provide more decision – relevant information.

Political and economic ties:

Where a country was colonized for an extended period of time, it typically adopted the accounting system of the colonial power. Singapore and Malaysia continued with the British system and Philippines, with the U.S system, even after gaining independence, where as Indonesia discarded its pre – independence Dutch system in favour of the U.S. model after independence.

Status of the accounting profession:

In common law countries like the U.S., Canada and U.K, accounting is held in high esteem as a profession. In such countries the accounting profession is largely self regulating and plays a major role in setting accounting and auditing standards, as well as establishing educational and licensing requirements for entering and staying in the profession. In code law countries like France and Germany, the accounting profession has considerably less statute and power, and the Government takes the lead role in regulating the profession. In yet other countries like Russia, accounting has historically been equated with book – keeping a clerical task.

Quality of Accounting Education:

In some countries, there is a long history of including accounting as a very important course, attracting some of the country's best talent. This in turn, produces quality in the accounting practices. Other countries which treat accounting as a clerical vocation get into a vision cycle of non-improvement in the country's accounting/regulatory bodies.

Classification of Financial Accounting and Reporting system:

Classifications should reveal fundamental structures that countries belonging to a group have in common and that distinguish them from countries in other groups. Many groups of researchers have made attempts for a meaningful classification. The best among them in Nobes' Classification of accounting system which is presented below.

Multinational companies are likely to use transnational accounting practices.

Global harmonization:

Having understood the causes for differences and suitably classifying the accounting system across the world, it is necessary to achieve harmony or uniformity in the accounting system. This is the need of the hour, considering the levels of multi-nationalisation and tele-communication, which are really shrinking the world.

Harmony will ensure easy comparability, which is essential in the context of global funding and multi-national companies regulators who monitor capital markets, and the securities industries (including stock exchanges).

Definition:

Harmonisation may be defined as the process aimed at enhancing the comparability of financial statements produced in different countries' accounting regulations.

The following are the main organizations that are involved in global accounting harmonization

i) IASC: The International Accounting Standards Committee is an independent private sector organization that was established in 1973 by professional accounting organizations from 10 countries – Australia, Canada, France, Germany, Ireland, Japan, Mexico, The Netherlands, The U.K and the U.S. Now, more than 140 countries are members of the IASC. The objectives of the IASC are:

   - To formulate and publish in the public interest accounting standards to the observed in the presentation of financial statements and to promote their world wide acceptance and observance.
   - To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

IAS 1 to 39 for the various accounting standards issued by the IASC.

IASC is supported by international organization of securities commission (IOSCO), which consists of representatives of the securities regulatory organizations in over 60 countries. Where IASC lacks the authority to enforce its standards globally, IOSCO helps by enforcing these standards in its member countries.

The International Federation of Accountants (IFAC):

This is a body of national professional accounting organization that represents accountants employed in public practice, business and industry , the public sector and education as well as some specialized groups that interface frequently with the profession. It was formed in 1997 to develop the profession and harmonise its standards world wide to enable public accountant to provide good services in the public interest. Currently, IFAC has about 150 member organizations in 103 countries, representing 2 million accountants.

IFAC issues International Standards on Auditing (ISA) that are aimed at harmonizing auditing practices globally.

Another initiative of the IFAC is the establishment of international public sector standards applicable to all levels of government. IFAC has also spearheaded the organization of a forum on the development of the accounting profession, bringing together, various development banks and agencies, to determine how best to marshal the combined resources of the accounting profession, local and national governments and development agencies to meet the basic needs for an accounting framework in developing countries.

The IFAC may also be credited with reports to maintain auditor's independence in today's complex and competitive business environment.

International Organisation of Securities Commission (IOSCO)

It was formed in 1983 and is comprised of securities regulators from more than 115 securities regulatory agencies from around the world and about 85% of world's capital markets. Its general secretariat is based in Montreal. IOSCO strives to promote high standards of regulations to maintain just efficient sound markets with integrity by establishing standards and surveillance of international securities transactions and ensuring enforcement of the standards.

IOSCO has already endorsed half the IASC standards, and is in the process of endorsing the remaining, subject to its satisfying itself with a comprehensive core set of high quality accounting standards.

United Nations:

Initially in the 1970's, the UN has its group of experts on ISA and ………….. produce a list of financial and non-financial disclosures to be provided by multi- national companies. The list was detailed and included requirements for disclosure of transfer pricing policies, segment information, R&D expenditure and employee information. Those being proprietary in nature, the recommendations were rejected by most industrialized countries. More recently, the UN has worked to harmonise the accounting standards by discussing and supporting best practices, including those stipulated by the IASC. It has focused on issues such as environmental disclosures. The UN has provided funding a technical assistance towards a sound financial reporting regime in accordance with international standards, in a number of Communist bloc countries which lacked such initiative.

Organisation For Economic Corpotation And Development (OECD):

The OECD comprises 29 member countries producing two-thirds of the world's goods and services. It has an adhoc working group on accounting standards which supports current efforts on accounting harmonization by international, regional and national bodies and the UN.

Harmonisation scenarios:

Bilateral	MDS (Multi-Jurisdictional disclosure system)
	SEC & Canadian regulatory authorities.

World class issuer:

NYSC promotes criteria eg. Revenue/market capitalisation/Weekly trading volume so that such ………. (Global Blue chip companies) enter U.S. market with less risk to U.S. investors. This is not a welcome step.

The G4+1 initiave:

This is one of the several groupings of national standard setting bodies; originally consisted of standard setters in Australia, Canada, UK, US and started as a forum to exchange ideas, information and experiences. IASC joined this and hence the name +1. New Zealand lake joined this group. The G4+1 has supported the IASC, which in turn co-operates with the G4+1.

Major achievements in harmonistaion:

IASC has proved its acceptability with statistically increasing number of standards and countries following them. They remain to be vetted and endorsed by the IOSCO and SFC.

The EU is mainly backed by the EEC (Treaty of Rome, 1957), which was signed by 6 countries – Belgium, France, Germany, Italy, Luxemburg and The Netherlands; and by later admission, Denmark, Republic of Ireland, The UK, Greece, Spain, Portugal, Sweden, Finland and Austria. The objective of the EU is to bring about a common market which allows for free mobility of capital goods, and people between member countries.

The EU company law and directives ensure uniformity in law in the member countries. The fourth directives addresses all aspects of financial statements of individual companies. The seventh directive addresses the issue of consolidated financial statements and generally followed the British American emphasis on legal control, but has not led to a significant level of harmony in consolidated financial reporting due to accounting diversity, capital market structures, code law US. Common law legal systems and macro Vs micro user roles of accounting.

The EU has indicated its support for the IASC and IOSCO initiatives and is aiming at conformity with the IASs. A number of EU member countries including France and Germany have started taking steps to require IASs domestically.

ASEAN – The Association of South-East Asian Nations adopted the global paradigm. ASEAN's principal objective was to create a robust economic alliance among members viz., Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei, Vietnam, ……… & Myanmar. ASEAN adopts unilaterally the standards issued by IASC. Member countries vary widely due to each one's colonial history and regulatory preferences.

While 60% of world wide experts for members of the EU are within the EU, while this is just 20% for ASEAN. Hence, ASEAN requires a more global approach.

In the emerging situation, a global approach would be more relevant and sustainable. The only hard work is to make it happen in practice with all the diversities overcome, and translate into uniformity.

5.4 Post Balance Sheet Events

The periodic financial statements are prepared on the basis of transactions and events that have occurred during the year. However, in order that the information is complete, information regarding any significant events or material transactions beyond the traditional accounts is essential. Accounting and reporting standards ensure that the information provided in the financial statements is as complete as possible. In this section a brief introduction of the Accounting Standard 4 Contingencies and Events occurring after the Balance Sheet Date, which ensures adequate disclosure of additional evidence of conditions existing at the balance sheet date acquired up to the date of publication of the financial statements.

The preparation of the annual financial statements can be a timely process in practice and usually takes around three or four months. Company law places a maximum time limit for publication of the financial statements Six months after the year end for companies.

During the period after the balance sheet date assets such as stock will be realised into debtors or cash or, alternatively, events may occur that significantiy affect the position of the company and it is only fair to inform external users of the financial statements of any further information relevant to them regarding the items in the balance sheet at the year end. The additional information may relate to actual amounts in the balance sheet or to events that have taken place since the year end. To ensure this information is disclosed, preparers of financial statements must follow the requirements of Accounting Standard 4.

What are Post-Balance Sheet Events

Post-balance sheet events are those events, both favourable and unfavourable, which occur between the balance sheet date and the date on which the financial statements are approved by the board of directors.

Adjusting events are post-balance sheet events which provide additional evidence of conditions existing at the balance sheet date. They include events which because of statutory or conventional requirements are reflected in financial statements.

Non-adjusting events are post-balance sheet events which concern conditions which did not exist at the balance sheet date.

The date on which the financial statements are approved by the board of directors is the date the board of directors formally approves a set of documents as the financial statements.

Accounting treatment

Accounting Standard 4 gives the following accounting treatment in each case.

Adjust the financial statements if events after the balance sheet dale provide material evidence of conditions that existed at the balance sheet dale, adjusting events.

A material post-balance sheet event should be disclosed (by note) where it is a non-adjusting event of such materiality that its non-disclosure would affect the ability of users of financial statements to reach a proper understanding of the financial position.

Disclosure is also required for the reversal or maturity after the year end of a transaction entered into before the year end, the substance of which was primarily to alter the appearance of the company’s balance sheet. (If such a transaction has an income effect, adjustment would be required, for example sales returns.)

Certain post-balance sheet events are adjusted for because of statutory requirements to include them in the accounts; for example, proposed dividends, amounts appropriated to reserve, effects of changes in tax and dividends receivable from subsidiary and associated companies.

Examples of adjusting and non-adjusting events

Adjusting	Non-adjusting
Subsequent determination of proceeds of sale of fixed assets purchased or sold before the year end.	Mergers/acquisitions after the year end.
Property valuation that provides evidence of a permanent diminution in value.	Reconstructions after the year end.

Evidence re NRV < cost of stocks.	Issue of shares/debentures after the year end.
Evidence re inaccuracy of attributable profit calculations.	Purchase/sale of fixed assets after the year end.
Insolvency of a debtor	Losses re fire/flood after the year end
Dividends receivable	Extension of activities after the year end
Receipt of information re rates of tax	Significant closure if this was not anticipated at the year end
Amounts received/receivable -re insurance claims that were in the course of negotiation.	Decline in asset values if demonstrated to be after the year end.
Discovery of error or fraud.	Changes in exchange rates after the year end.
	Effect of nationalisation or strikes after the year end.
	Augmentation of pension benefits after the year end.

For a detailed discussion on the Accounting Standard 4, please refer to the earlier section in this chapter.

5.5 External Reporting under Capital Market Regulations

In India Capital Markets are regulated by the Securities Exchange Board of India (SEBI). In view of enhancing the Corporate Governance in Corporate in India the SEBI introduced the Clause 49 of the Listing Agreement, which deals with the Corporate Governance and its applicability in Listed companies.

Applicability and Date of Compliance With Revised Clause 49

The provisions of the revised Clause 49 shall be implemented as per the schedule of implementation given below:

a) For entities seeking listing for the first time, at the time of seeking in- principle approval for such listing.

b) For existing listed entities which were required to comply with Clause 49 which is being revised i.e. those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, **by April 1, 2005.**

Companies complying with the provisions of the existing Clause 49 (issued vide circulars dated 21st February, 2000, 9th March 2000, 12th September 2000, 22nd January, 2001 16th March 2001 and 31st December 2001) shall continue to do so till the revised Clause 49 of the Listing Agreement is complied with or till **March 31, 2005,** whichever is earlier.

The companies which are required to comply with the requirements of the revised Clause 49 shall submit a quarterly compliance report to the stock exchanges as per sub Clause VI (ii), of the revised Clause 49, within 15 days from the end of every quarter. The first such report would be submitted for the quarter ending **June 30, 2005.** The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

The revised Clause 49 shall apply to all the listed companies, in accordance with the schedule of implementation given above. However, for other listed entities which are not companies, but body corporate (e.g. private and public sector banks, financial institutions, insurance companies etc.) incorporated under other statutes, the revised Clause 49 will apply to the extent that it does not violate their respective statutes and guidelines or directives issued by the relevant regulatory authorities. The revised Clause 49 is not applicable to Mutual Funds.

THE REVISED CLAUSE 49

The following is the Revised Clause 49 requirement as issued by the SEBI

Clause 49 - Corporate Governance

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

(i) The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors.

(ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he is an executive director, at least half of the Board should comprise of independent directors.

(iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

  a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

  b. is not related to promoters or persons occupying management positions at the board level or at one level below the board;

  c. has not been an executive of the company in the immediately preceding three financial years;

  d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:

    i) the statutory audit firm or the internal audit firm that is associated with the company, and

    ii) the legal firm(s) and consulting firm(s) that have a material association with the company.

  e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and

  f. is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

Explanation

For the purposes of the sub-clause (iii):

a. Associate shall mean a company which is an "associate" as defined in Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements", issued by the Institute of Chartered Accountants of India.

b. "Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

c. "Relative" shall mean "relative" as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956..

d. Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Explanation:

"Institution' for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts]."

(B) Non executive directors' compensation and disclosures

All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

(C) Other provisions as to Board and Committees

(i) The board shall meet at least four times a year, with a maximum time gap of three months between any two meetings. The minimum information to be made available to the board is given in **Annexure – I A**.

(ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.

2. For the purpose of reckoning the limit under this sub-clause, Chairmanship/membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.

(iii) The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

(D) Code of Conduct

(i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

(ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

II Audit Committee

(A) Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1: The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2: A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the Audit Committee shall be an independent director;

(iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

(B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of Audit Committee

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
    a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of Section 217 of the Companies Act, 1956
    b. Changes, if any, in accounting policies and practices and reasons for the same
    c. Major accounting entries involving estimates based on the exercise of judgment by management
    d. Significant adjustments made in the financial statements arising out of audit findings
    e. Compliance with listing and other legal requirements relating to financial statements
    f. Disclosure of any related party transactions
    g. Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval
6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow up there on.

9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Explanation (i): The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India.

Explanation (ii): If the company has set up an audit committee pursuant to provision of the Companies Act, the said audit committee shall have such additional functions/features as is contained in this clause.

(E) Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

III. Subsidiary Companies

i. At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.

ii. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

iii. The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Explanation1 : The term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

Explanation 2 : The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year. Explanation 3: Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

IV. Disclosures

(A) Basis of related party transactions

(i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.

(ii) Details of m aterial individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.

(iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same..

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues etc.

When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

(E) Remuneration of Directors

(i) All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.

(ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:

    (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.

(b) Details of fixed component and performance linked incentives, along with the performance criteria.

(c) Service contracts, notice period, severance fees.

(d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

(iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

(iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.

(v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director

(F) Management

(i) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

i. Industry structure and developments.

ii. Opportunities and Threats.

iii. Segment– wise or product-wise performance.

iv. Outlook

v. Risks and concerns.

vi. Internal control systems and their adequacy.

vii. Discussion on financial performance with respect to operational performance.

viii. Material developments in Human Resources / Industrial Relations front, including number of people employed.

(ii) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its. core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

(G) Shareholders

(i) In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

  (a) A brief resume of the director;

  (b) Nature of his expertise in specific functional areas;

  (c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and

  (d) Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above

(ii) Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

(iii) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/Investors Grievance Committee'.

(iv) To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

H. CEO/CFO certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief :

  (i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

  (ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(d) They have indicated to the auditors and the Audit committee

  (i) significant changes in internal control during the year;

  (ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

(iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system

(I) Report on Corporate Governance

(i) There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in **Annexure - I C** and list of non-mandatory requirements is given in **Annexure – I D.**

(ii) The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in

Annexure I B. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company

(I) Compliance

(1) The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual report filed by the company.

(2) The non-mandatory requirements given in **Annexure – I D** may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance) / non- adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annexure I A

Information to be placed before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important.
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.

9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Annexure I B

Format of Quarterly Compliance Report on Corporate Governance

Name of the Company: Particulars Quarter ending on: Particulars	**Clause of Listing**	**Compliance Status Yes/No**	**Remarks**
I. Board of Directors	49 I		
(A) Composition of Board	49(IA)		
(B) Non-executive Directors' ompensation & disclosures	49 (IB)		
(C) Other provisions as to Board and Committees	49 (IC)		
(D) Code of Conduct	49 (ID)		
II. Audit Committee	49 (II)		
(A) Qualified & Independent Audit Committee	49 (IIA)		
(B) Meeting of Audit Committee	49 **(IIB)**		
(C) Powers of Audit Committee	49 (IIC)		
(D) Role of Audit Committee	49 II(D)		
(E) Review of Information by Audit Committee	49 (IIE)		
III. Subsidiary Companies	49 (III)		
IV. Disclosures	49 (IV)		
(A) Basis of related party transactions	49 (IV A)		
(B) Board Disclosures	49 (IV B)		

(C) Proceeds from public issues, rights issues, preferential issues etc.	49 (IV C)		
(D) Remuneration of Directors	49 (IV D)		
(E) Management	49 (IV E)		
(F) Shareholders	49 (IV F)		
V. CEO/CFO Certification	49 (V)		
VI. Report on Corporate Governance	49 (VI)		
VII. Compliance	49 (VII)		

Note:

1) The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement.

2) In the column No.3, compliance or non-compliance may be indicated by Yes/No/N.A.. For example, if the Board has been composed in accordance with the Clause 49 I of the Listing Agreement, "Yes" may be indicated. Similarly, in case the company has no related party transactions, the words "N.A." may be indicated against 49 (IV A).

3) In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the "Remarks" column as – "will be complied with at the AGM". Similarly, in respect of matters which can be complied with only where the situation arises, for example, "Report on Corporate Governance" is to be a part of Annual Report only, the words "will be complied in the next Annual Report" may be indicated.

Annexure I C

Suggested List of Items to Be Included In the Report on Corporate Governance in the Annual Report of Companies

1. A brief statement on company's philosophy on code of governance.
2. Board of Directors:
   - i. Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
   - ii. Attendance of each director at the Board meetings and the last AGM.
   - iii. Number of other Boards or Board Committees in which he/she is a member or Chairperson
   - iv. Number of Board meetings held, dates on which held.
3. Audit Committee:
   - i. Brief description of terms of reference
   - ii. Composition, name of members and Chairperson
   - iii. Meetings and attendance during the year

4. Remuneration Committee:
    i. Brief description of terms of reference
    ii. Composition, name of members and Chairperson
    iii. Attendance during the year
    iv. Remuneration policy
    v. Details of remuneration to all the directors, as per format in main report.
5. Shareholders Committee:
    i. Name of non-executive director heading the committee
    ii. Name and designation of compliance officer
    iii. Number of shareholders' complaints received so far
    iv. Number not solved to the satisfaction of shareholders
    v. Number of pending complaints
6. General Body meetings:
    i. Location and time, where last three AGMs held.
    ii. Whether any special resolutions passed in the previous 3 AGMs
    iii. Whether any special resolution passed last year through postal ballot – details of voting pattern
    iv. Person who conducted the postal ballot exercise
    v. Whether any special resolution is proposed to be conducted through postal ballot
    vi. Procedure for postal ballot
7. Disclosures:
    i. Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.
    ii. Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.
    iii. Whistle Blower policy and affirmation that no personnel has been denied access to the audit committee.
    iv. Details of compliance with mandatory requirements and adoption of the nonmandatory requirements of this clause
8. Means of communication.
    i. Quarterly results
    ii. Newspapers wherein results normally published
    iii. Any website, where displayed
    iv. Whether it also displays official news releases; and
    v. The presentations made to institutional investors or to the analysts.

9. General Shareholder information:
    1. AGM : Date, time and venue
    2. Financial year
    3. Date of Book closure
    4. Dividend Payment Date
    5. Listing on Stock Exchanges
    6. Stock Code
    7. Market Price Data : High., Low during each month in last financial year
    8. Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
    9. Registrar and Transfer Agents
    10. Share Transfer System
    11. Distribution of shareholding
    12. Dematerialization of shares and liquidity
    13. Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity
    14. Plant Locations
    15. Address for correspondence

Annexure I D

Non-Mandatory Requirements

(1) The Board

A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the Board of a company.

(2) Remuneration Committee

i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.

iii. All the members of the remuneration committee could be present at the meeting.

iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

(3) Shareholder Rights

A half-yearly declaration of financial performance including summary of the significant events in last six-months, may be sent to each household of shareholders.

(4) Audit qualifications

Company may move towards a regime of unqualified financial statements.

(5) Training of Board Members

A company may train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

(6) Mechanism for evaluating non-executive Board Members

The performance evaluation of non-executive directors could be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

(7) Whistle Blower Policy

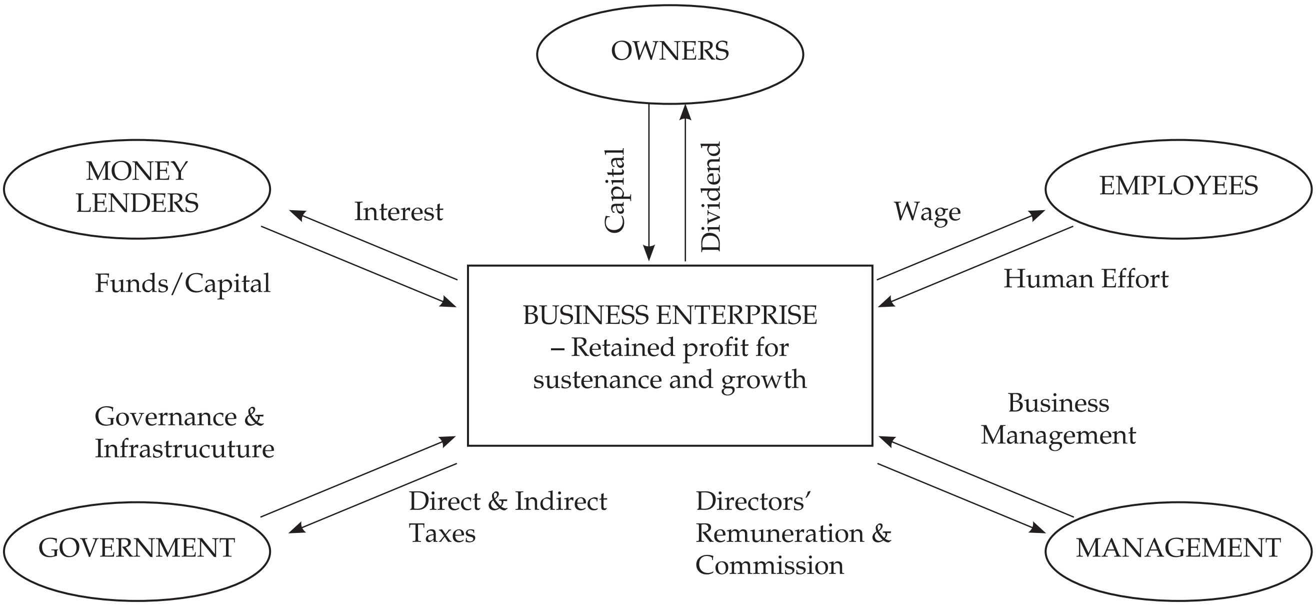
The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organization.

5.6 Value Added Statement

1. Value Added

Value Added is the wealth created by a Firm, through the combined effort of (1) Capital (2) Management and (3) Employees. This wealth concept arises due to the input- output exchange between a Firm and components of its external environment.

Value Added = Sale Value of Outputs **Less:** Cost of Bought in goods and services.



2. Gross Value Added (GVA)

Retained Profits	Sales Revenue - Materials Cost - Wages Cost - Expenses Cost - Managerial Remuneration - Depreciation Expenses - Interest paid - Taxes paid - Dividends paid.

Transposing the same, we have the following equation –

Sales Revenue - Materials Cost - Expenses Cost =	Retained Profits + Wages paid + Managerial Remuneration + Interest, paid + Taxes paid + Dividends paid + Depreciation Expense.

After adjusting for other Direct Incomes, Non-operating incomes and expenditure, we have —

Sales Revenue		Wages paid to Employees
+ Direct Incomes		+ Interest paid to Providers of Loan Funds
- Materials Cost	=	+ Taxes paid to Government
- Expenses Cost		+ Dividends paid to owners and investors
± Non-Operating Income/Expenditure		+ Retained Profits
± Extra-Ordinary Income/Expenditure		+ Depreciation (for maintenance & expansion)

This equation represents to the concept of Gross Value Added, i.e. the wealth or surplus created by the firm on the LHS (Sources) and the beneficiaries of this wealth on the RHS (Applications).

3. Net Value Added (NAV)

Net Value Added = Gross Value Added — Depreciation

Rewriting the equation for Gross Value Added as indicated above, we have —

Sales Revenue		Wages paid to Employees
+ Direct Incomes		+ Interest paid to Providers of Loan Funds
- Materials Cost	=	+ Taxes paid to Government
- Expenses Cost		+ Dividends paid to owners and investors
± Non-Operating Income/Expenditure		+ Retained Profits
± Extra-Ordinary Income/Expenditure		
- Depreciation (for maintenance & expansion)		

4. Value Added Statement for a Manufacturing Firm.

The Value Added Statement shows the Value Added of a business for a particular period. It also reveals how it is arrived at and apportioned to the stakeholders like employees, management, loan providers, Government and also to the business itself.

The Value Added Statements has two parts — the first part showing how the GVA is arrived at and the second part showing the application / distribution of Value Added to various beneficiaries.

GROSS VALUE ADDED OF A MANUFACTURING COMPANY

for the year ended 31st March, 200X

Particulars	Rs.	Percentage
Sales	XXX	
Less: Materials and Services Used	XX	
Add: Royalties and Other Direct Income	XX	
Value Added by Trading Activities	**XXX**	
Add: Investment Income	XX	
Add/Less: Extra-Ordinary Items	XX	
Gross Value Added	**XXXX**	**100%**
Applied as follows -		
1. To Employees Salaries, Wages, etc.	XXX	x%
2. To Government as Taxes, Duties, etc.	XXX	x%
3. To Financiers as Interest on borrowings	XXX	x%
4. To Shareholders as Dividends	XXX	x%
5. To Retained Earnings, including Depreciation	XXX	x%
Total	**XXXX**	**100%**

5. Utility of GVA reporting than NVA reporting.

1. **Realistic meaning of Retained profits:** There is no cash outflow from a firm to the extent of depreciation charged. Hence, GVA reporting, which includes depreciation as part of retained profits, properly reflects the amount retained for business purposes.
2. **Objectivity:** Depreciation charged in the accounts depends on the firm's policy and also on the estimates of the asset's useful life, scrap value, etc. Since the cost of bought in materials and services are deducted to compute GVA, it is derived in an objective manner than NVA.
3. **Macro level analysis:** At the macro level, Gross Domestic Product (GDP) is commonly used as an indicator of economic trends. GVA reporting will make aggregation of data easier for macro level analysis.

6. Advantages of NVA over GVA.

1. **Matching:** NVA reporting properly deducts depreciation, which represents a write off of the capital cost of the asset due to wear and tear. This results in proper matching of the period's revenues with costs.
2. **Asset Life Disparity:** Under GVA, cost of tools, jigs, etc. having a life of one year would be deducted whereas depreciation on assets having a longer useful life will not be deducted. NVA recognises both types of assets and properly records depreciation on the assets utilised.
3. **Calculation of Wealth:** Wealth or Surplus created by an entity will be overstated if no allowance is made towards wear and tear or loss of value of fixed assets used by the entity.
4. **Impact on Productivity Bonus:** When a Productivity Bonus is paid to employees based on Value Added, NVA is more appropriate since it recognises the effect of mechanization, etc. by charging depreciation.

7. (a) Proprietary Theory; (b) Entity Theory; and (c) Enterprise Theory.

1. **Proprietary Theory:** This theory is based on the principle that the proprietor is the centre of interest. This theory propounds that all assets belong to the Proprietor and all liabilities are the Proprietor's obligations. This theory holds good only for a Sole Proprietorship or a Partnership.
2. **Entity Theory:** This theory is suitable for corporate form of business enterprises. The theory suggests that the **Net Income** of the Reporting Entity is generally expressed in terms of the **Net Change** in the Stockholders' Equity. It represents the residual change in equity position after deducting all outsiders' claims. The Reporting Entity is considered as a separate economic unit operating only for the benefit of its Equity Shareholders.
3. **Enterprise Theory:** In this theory, the Reporting Entity is a Social Institution, operating for the benefit of many interested groups like Shareholders, Bondholders, Management, Employees, etc. The Value Added is an important concept in this theory. When the income is defined as the reward of a larger group of people than just shareholders, the concept and its understanding is better.

8. The relevance of Value Added Statements in Corporate Financial Reporting.

1. **Company Ranking:** The Value Added is a very good index to measure the size and importance of a Company. It also overcomes the distortion in ranking caused by the use of inflated sales.
2. **Systems Concept:** The Value Added Statement reflects the Company's objectives and responsibilities in a better fashion. It establishes the fact that the business entity is part of a larger system interacting with other components in the environment.
3. **Employee Incentives:** The Value Added Statement paves way for introduction of productivity linked bonus schemes for the employees. Calculation also becomes easier.
4. **Macro level analysis:** The Value Added Statement links the Company's financial accounts to the national income by indicating the Company's Contribution to National Income.

5. **Ratio Analysis:** The Value Added Statement helps in ratio analysis. The Value Added to Payroll, Taxes to Value Added and Value Added to Sales ratios are used as predictive tools for analysis of different firms. It also provides for adjustments in respect of inflation, to facilitate comparison between periods.

6. **Concepts:** The Value Added Statement is based on fundamental concepts that are accepted in financial statements like the going concern concept, matching concept, consistency and substance over form, etc.

7. **Performance Measure:** Value Added is a better measure of performance of business entity than the profit. It explains the input-output relationship. Once the value added is ascertained, it is possible to establish a linkage with value to be used —

   - For the work force – for Wages, Salaries and related expenses
   - For the Business – for retention
   - For the Government – for Corporation Tax
   - For the Financiers – for Interest on loans and for Dividends on Share Capital

8. **Budgeting:** Value Application is a pre-condition for value generation. So insufficiency of value added can be understood beforehand. This may be good test for Business Budgeting than Financial Reporting.

9. What information can we gather from Value Added Statements?

1. **Wealth Creation:** The Value Added Statement specifies the wealth accumulated by the Company. It states in monetary terms the wealth accumulated by the Company.

2. **Beneficiaries/participants of wealth:** The Value Added Statement states the application of Value Added to shareholders, bondholders, employees, etc. This identifies the participants/beneficiaries of the wealth generated by the Company and their interest in the Company in terms of value and percentage.

3. **Value Added based ratios:** The following ratios can be computed – Value Added to Sales, Value Added to payroll, Taxes to Value Added, etc. This facilitates comparison of ratios between periods as well as comparison between Companies.

4. **Value Added Interpretation:** Value Added facilitates interpretation of operating results or contribution of various Companies. The real wealth of Companies can be understood only from the Value Added Statement, as the comparison of Sales Turnover may not give a real picture. Many Companies can have the same turnover also.

10. Disadvantages of Value Added Reporting.

1. **Risk:** Employees, Government and Fund Providers are interested only in getting their share of Value Added. The entire business risk is borne only by the Shareholders. The residual profits after meeting the obligations of the outside groups should be shown as the Value Added accruing to the shareholders.

2. **Non-uniformity:** Value Added Statements are non-standardised in areas like inclusion or exclusion of Depreciation, Taxation on Profits, etc. This can however be overcome by defining an Accounting Standard on Value Added.

ILLUSTRATIONS

Illustration 1: Gross Value Added Statement – Treatment of Deferred Taxes

From the following details, calculate the Gross Value Added and Net Value Added of Amareshwar Ltd.

Profit and Loss Account for the year ended 31st March 200X

Particulars	Rs. 000s	Notes	Rs. 000s
Sales			8,540
Trading Profit		A	766
Less: Depreciation	121		
Interest	56	B	(177)
Add: Rent from let out properties			33
Profit Before Tax			622
Less: Provision for tax		C	(275)
Profit After Tax			347
Less: Extra-Ordinary Items		D	(7)
			340
Less: Dividend Paid and Payable			(136)
Retained Profit			204

Notes:

A. Trading Profit is arrived at after charging - (Rs. 000s) • Salaries, Wages, etc. to employees 1,475 • Directors'Remuneration 145 • Audit Fees 90 • Hire of Equipment 115	B. Interest figure is ascertained as under: (Rs. 000s) Interest paid on Bank Loans and Overdrafts 65 Interest received (9) Net Interest 56
C. Provision of Taxes includes a transfer of Rs.57(000s) to the credit of Deferred Tax Account.	D. Extra-ordinary items - (Rs. 000s) Surplus on Sale and Lease back of properties 8 Loss of Cash by theft (15)

Solution:

Expenditure debited in deriving Trading Profit (as per Note A) = 1,475 + 145 + 90 + 115 = 1,825.

Cost of Bought Out Materials = Sales - Exps as per Note A - Trading Profit = 8,540 - 1,825 - 766 = 5,949.

Value Added Statement of Amareshwar Ltd. for the year ended 31.03.200X.

Particulars	Rs. 000s	Rs. 000s
Sales/Turnover		8,540
Less: Bought in Materials	5,949	
Manufacturing and Other Expenses (90 +115)	205	6,154
Value Added by Trading Activities		2,386
Add: Other Income (Rent = + 33; Interest Received = + 9)	42	
Extra-Ordinary Items (as per Note D)	(7)	35
TOTAL VALUE ADDED		**2,421**
Applied as follows -		%
1. To Employees Salaries, Wages, etc.	1,475	61%
2. To Management as Directors' Remuneration	145	6%
3. To Government as Taxes, Duties, etc. (Tax Provn 275 — Deferred Tax 57)	218	9%
4. To Financiers as Interest on borrowings	65	3%
5. To Shareholders as Dividends	136	6%
6. To Retained Earnings as — (a) Depreciation	121	5%
(b) General Reserves	204	8%
(c) Deferred Taxation	57	2%
TOTAL APPLICATION	**2,421**	**100%**

Illustration 2: Value Added Statement – Treatment of Value Deficit

From the following data, prepare a Value Added Statemen of Bhadreshwar Ltd., for the year-ended 31.03.200X.

Particulars	Rs.	Particulars	Rs.
Decrease in Stock	24,000	Sales	40,19,000
Purchases	20,20,000	Other income	55,000
Wages & Salaries	10,00,000		
Manufacturing & Other Expenses	2,30,000		
Finance Charges	4,69,000		
Depreciation	2,44,000		
Profit Before Taxation	87,000		
Total	**40,74,000**	**Total**	**40,74,000**

Particulars	Rs.
Profit Before Taxation	87,000
Less: Tax Provisions	(40,000)
Income Tax Payments (for earlier years)	(3,000)
Add: Earlier Year Profit brought forward	38,000
Profit After Taxation	82,000
Appropriations of PAT	
Debenture Redemption Reserve	10,000
General Reserve	10,000
Proposed Dividend	35,000
Balance carried to Balance Sheet	27,000
Total	**82,000**

Solution:

Value Added Statement of Bhadreshwar Ltd. for the year ended 31.03.200X

Particulars	Rs.	Rs.
Sales/Turnover		40,19,000
Less: Bought in Materials		
• Decrease in Stock	24,000	
• Purchases	20,20,000	20,44,000
Value Added by Trading Activities		19,75,000
Add: Other Income		55,000
GROSS VALUE ADDED		**20,30,000**
Applied as follows -		
1. To Employees Salaries, Wages, etc.	10,00,000	
2. To Other Service Providers as Manufacturing & Other expenses	2,30,000	
3. To Government as Taxes, Duties, etc. (40,000 + 3,000)	43,000	
4. To Financiers as Interest on borrowings	4,69,000	
5. To "Shareholders as Dividends	35,000	
6. To Retained Earnings as –		
• Depreciation	2,44,000	
• Debenture Redemption Reserve	10,000	
• General Reserve	10,000	
TOTAL APPLICATION		**20,41,000**
VALUE DEFICIT (Reduction in P & L A/c balance = 38,000 - 27,000)		(11,000)

Note: *Alternatively, the reduction in Retained Profits (38,000 - 27,000) may be considered as an adjustment / reduction against the entry "To Retained Earnings" and the Value Deficit need not be shown.*

Illustration 3: Value Added Statement – Percentage Analysis of VA

Following is an extract of Profit & Loss A/c of Chakreshwar Ltd. for the year ended 31st March.

Particulars	Rs. 000s
Sales (including Excise Duty Recoveries) Other Income	727 13
Total	740
Materials	530
Excise Duty	62
Salaries, Wages & Employee Benefits	19
Other Expenses	47
Interest & Finance Charges	_
Depreciation	5
Provision for Taxation	31
Preliminary Expenses written off	
Transfer to Debenture Redemption Reserve	5
Proposed Dividend	5
Transfer to General Reserve	24
Total	**740**

- Other Expenses include Fees & Commissions to Whole-Time Directors amounting to Rs.9,000 and Loss on Sale of Fixed Assets of Rs.3,000.
- Interest and Finance Charges include interest on Long Term Loans of Rs.4,000; and the balance being on Short-Term Borrowings.

Prepare a Value Added Statement for the year ended 31st March.

Solution: **Value Added Statement of Chakreshwar Ltd for the year ended 31st March**

Particulars		**Rs. 000s**	**% of Sales**
A:	**VALUE ADDED**		
	Sales	727	100.0
Less:	Materials	(530)	72.9
	Other Expenses (47 - 9 - 3)	(35)	4.8
	Short-Term Interest	(3)	0.4
	Value Added from own operations	159	21.9
Add:	Other Income	13	
	TOTAL VALUE ADDED	172	

B:	**VALUE APPLIED**		**Rs. 000s**	**%**
B.1	To Employees: Salaries, Wages and Benefits		**28**	**16.3**
B.2	To Government:	Excise Duty	62	36.0
		Income-Tax	31	18.1
			93	**54.1**
B.3	To Finance Providers:	Interest on Long Term Loans	4	2.0
		Dividend on Equity	5	3.0
			9	**5.2**
B.4	To Entity's needs -			
	Meeting Loss on Sale of Fixed Assets		3	1.7
	Preliminary Expenses w/off		5	3.0
	Depreciation		5	3.0
	Transfer to Reserves (Deb. Redemption & General Reserve)		29	16.9
			42	**24.4**
	TOTAL APPLICATION		**172**	**100.0**

Illustration 4: VA Statement and Reconciliation of GVA with PAT

Prepare a Gross Value Statement from the following Profit and Loss Account of Dakshineshwar Ltd. Show also the Reconciliation between Gross Value Added and Profit before Taxation.

Profit & Loss Account for the year ended 31.03.200X

Particulars		(Rs. Lakhs)	(Rs. Lakhs)
Income:	Sales Other Income		610 25
Total Income			635
Expenditure:	Production & Operational Expenses	465	
	Administration Expenses	19	
	Interest and Other Charges	27	
	Depreciation	14	525
Less:	Profit Before Taxes		110
	Provision for Taxes		16
Add:	Profit After Taxes		94
	Balance as per last Balance Sheet		7
			101
Transferred to:	General Reserve	60	
	Proposed Dividend	11	71
	Surplus carried to Balance Sheet		30
	Total		**101**

Notes:

1. Production & Operational Expenses

	(Rs. Lakhs)
Increase in Stock	**112**
Consumption of Raw Materials	**185**
Consumption of Stores	**22**
Salaries, Wages, Bonus & other benefits	**41**
Cess and Local Taxes	**11**
Other Manufacturing Expenses	94
	465

2. Administration Expenses include inter-alia Audit Fees of Rs.4.80 Lakhs, Salaries & Commission to Directors Rs.5 Lakhs and Provision for Doubtful Debts Rs.5.20 Lakhs.

3. **Interest and Other Charges:**

	(Rs. Lakhs)
On Working Capital Loans from Bank	**8**
On Fixed Loans from IDBI	12
On Debentures	**7**
	27

Solution:

Value Added Statement of DakshinjShwar Ltd for the year-ended 31.03.200X

		Rs. Lakhs	Rs. Lakhs	%
	Sales		610	
Less:	Cost of Bought In Material and Services:			
	Production & Operational Expenses (112 + 185 + 22 + 94)	413		
	Administration Expenses (19 - 5)	14		
	Interest on Working Capital Loans	8	435	
	Value Added by Manufacturing and Trading activities		175	
Add:	Oilier Incomes	-	25	
	TOTAL VALUE ADDED		**200**	

Application of Value Added:	Rs. Lakhs	Rs. Lakhs	%
1. To pay Employees: Salaries, Wages, Bonus and other benefits		41	20.50
2. To pay Directors: Salaries and Commission		5	2.50
3. To pay Government: Cess and Local Taxes	11		
Income Tax	16	27	13.50
4. To pay providers of Capital: Interest on Debentures	7		
Interest on Fixed Loans	12		
Dividend	11	30	15.00
5. To provide for maintenance and expansion of the Company:			
Depreciation	14		
General Reserve	60		
Retained Profit (30 - 7)	23	97	48.50
TOTAL APPLICATION		**200**	**100.00**

Reconciliation between Total Value Added and Profit before Taxation

Particulars		Rs. Lakhs	Rs. Lakhs
	Profit before Tax		110
Add back:	Depreciation	14	
	Salaries, Wages, Bonus and other benefits	41	
	Directors Remuneration	5	
	Cess and Local Taxes	11	
	Interest on Debentures	7	
	Interest on Fixed Loans	12	90
	Total Value Added		**200**

Illustration 5: GrossValue Added Statement and Reconciliation ofJ&VA with PAT

The following is the Profit and Loss Account of F Ltd., from which you are required to prepare a Gross Value Added Statement and reconcile the same with Profit before Taxation.

Particulars		Rs. 000s	Rs. 000s
Income:	Sales	28,500	
	Other Income	750	29,250
Expenditure:	Operating Cost	25,600	
	Excise Duty	1,700	
	Interest on Bank Overdraft	100	
	Interest on 12% Debentures	1.150	28.550
Less:	Profit before Depreciation		700
	Depreciation		250
	Profit Before Tax		450
Less:	Tax Provision		270
	Net Profit After Tax		180
Less:	Transfer to Replacement Reserve		30
	Balance Profit		150
Less:	Dividend		50
	Retained Profit		**100**

Note:

(a) Sales are net after deducting Discounts, Returns, and Sales Tax.
(b) Operating Cost includes Rs.(000s) 10,200 as Wages, Salaries and other benefits to Employees.
(c) Bank Overdraft is a temporary source of finance.
(d) Provision for Tax includes Rs. (000s) 70 for Deferred Tax.

Solution: **Value Added Statement of F Ltd.**

Particulars	Rs. 000s	Rs. 000s	%
Sales		28,500	
Less: Cost of Materials and Services			
Operating Cost (25,600 - 10,200)	15,400		
Excise Duty	1,700		
Interest on Overdraft **(See Note 1)**	100	17.200	
Value Added by manufacturing and trading activities		**11,300**	
Add: Other Income		750	
TOTAL VALUE ADDED		**12,050**	
Application of Total Value Added:			
1. To pay Employees: Wages, Salaries and other benefits		10,200	84.65
2. To pay Government: Corporation Tax		200	1.65
3. To pay Providers of Capital: Interest on 12% Debentures	1,150		
Dividend	50	1,200	9.95
4. To Provide for maintenance and expansion of Company:			
Depreciation	250		
Replacement Reserve	30		
Deferred Tax (See Note 2)	70		
Retained Profit	100	450	3.75
TOTAL APPLICATION		**12,050**	**100.00**

Note:

1. Bank Overdraft is a temporary source of finance. It has been considered as provision of a banking service rather than provision of Capital. Hence, Interest on Bank OD has been shown as deduction from Sales and as part of "Cost of Bought In Materials & Services".
2. Deferred Taxation can also be shown as "To Pay Government".

Illustration 6: Gross Value Added Statement and Reconciliation of GVA with PAT

On the basis of the following Income Statement of G Ltd., prepare - (a) Gross Value Added Statement; and (b) Statement showing reconciliation of Gross Value Added with Profit Before Taxation. (Rs. 000')

Particulars	Rs. 000s	Rs. 000s
Income:		
Sales Less Returns		15,27,956
Dividends and Interest		130
Miscellaneous Income		474
Total Income (A)		**15,28,560**

Expenditure:		
1. Production & Operational Expenses:		
Decrease in Inventory of Finished Goods	26,054	
Consumption of Raw Materials	7,40,821	
Power & Lighting	1,20,030	
Wages, Salaries and Bonus	3,81,760	
Staff Welfare Expenses	26,240	
Excise Duty	14,540	
Other Manufacturing Expenses	32,565	13,42,010
2. Administration Expenses:		
Directors’ Remuneration	7,810	
Other Administration Expenses	32,640	40,450
3. Interest on:		
9% Mortgage debentures	14,400	
Long-Term loan from Financial Institutions	10,000	
Bank Overdraft	100	24,500
4. Depreciation on Fixed Assets:		50,600
Total Expenditure (B)		**14,57,560**

	Profit before Taxation (A) - (B)		71,000
Less:	Provision for Income Tax		25,470
	Profit after Taxation		45,530
	Balance of P & L A/c as per last Balance Sheet		6.300
	Total available for appropriation		51,830
Transferred to:			
	General Reserve 40% of Rs.45,530	18,212	
	Proposed Dividend at 22%	22,000	
	Tax on Distributed Profits at 12.81%	2,818	43,030
	Surplus carried to Balance Sheet		8,800

Solution:

Value Added Statement of G Ltd.

Particulars	Rs. 000s	Rs. 000s	%
Sales less Returns		15,27,956	
Less: Bought In Materials & Services (13,42,010 - 3,81,760 - 26,240)	9,34,010		
Administration Expenses	32,640		
Interest on Bank Overdraft	100	9,66.750	
Value Added by Manufacturing and Trading Activities		5,61,206	
Add: Dividend & Interest Received		130	
Miscellaneous Income		474	
TOTAL VALUE ADDED (See Note below)		**5,61,810**	

APPLICATION OF VALUE ADDED		Rs. 000s	Rs. 000s	%
1. To Pay Employees:	Wages, Salaries & Bonus	3,81,760		
	Staff Welfare Expenses	26,240	4,08,000	72.62
2. To Pay Directors:	Directors Remuneration		7,810	1.39
3. To Pay Government:	Income Tax	25,470		
Tax on Distributed Profits		2.818	28,288	5.04
4. To Pay to providers of Capital:	Interest on 9% Debentures	14,400		
	Interest on long-term loan from financial institution	10,000		
	Dividend to Shareholders	22.000	46,400	8.26
5. To provide for maintenance and expansion of the Company:				
	Depreciation on Fixed Assets	50,600		
	Transfer to General Reserve	18,212		
	Retained Profits (8,800 - 6,300)	2,500	71,312	12.69
TOTAL APPLICATION			**5,61,810**	**100.00**

Reconciliation of Total Value Added with Profit before Taxation

	Particulars	Rs. 000s	Rs. 000s
	Profit Before Taxation		71,000
Add back:	Wages, Salaries & Bonus	3,81,760	
	Staff Welfare Expenses	26,240	
	Directors Remuneration	7,810	
	Interest on 9% Mortgage Debentures	14,400	
	Interest on Long-Term loan from Financial Institution	10,000	
	Depreciation on Fixed Assets	50,600	4,90,810
	Total Value Added		**5,61,810**

Note: *Excise Duty may alternatively be shown as an application of Value Added under "To pay Government".*

Illustration 7: GVA Statement – Calculation of Excise Duty – Nov2004

The following is the Profit and Loss Account of Haalaasi Ltd. for the year ended 31st March. Prepare a GVA Statement of K Ltd., and show also the reconciliation between Gross Value Added and Profit before Taxation.

Profit and Loss Account for the year ended 31st March

Particulars		Rs. Lakhs	Rs. Lakhs
Income:	Sales	890	945
	Other Income	55	
Expenditure:	Production and operational expenses	641	
	Administration expenses (Factory)	33	
	Interest	29	
	Depreciation	17	720
	Profit Before Taxes		225
Less:	Provision for Taxes		30
	Profit After Tax		195
Add:	Balance as per Balance Sheet		10
Less:	Transferred to General Reserve	45	205
	Dividend Paid	95	140
	Surplus carried to Balance Sheet		**65**

1. Production and Operational Expenses consists of Consumption of Raw materials 293 Consumption of stores 59 Salaries, Wages, Gratuities etc. (Admn.) 82 Cess and Local taxes 98 Other manufacturing expenses 109	2. Interest Charges Consists of Int. on loan from ICICI Bank for working capital 9 Interest on loan from ICICI Bank for fixed loan 10 Interest on loan from IFCI for fixed loan 8 Interest on Debentures 2
3. Administration Expenses include Salaries to Directors Rs. 9 lakhs. Provision for doubtful debts Rs. 6.30 lakhs.	4. The charges for taxation Include a transfer of Rs. 3 lakhs to the credit of Deferred Tax Account.
5. Cess and Local Taxes include Excise Duty, which is equal to 10% of cost of bought-in material.	

Solution:

Value Added Statement of K Ltd. for year ending 31st March

	Particulars			**Rs. Lakhs**
	Sales			890.00
Less:	Cost of Bought in Materials & Services	(Note 1)		461.00
	Administrative Expenses	(Note 2)		17.70
	Interest	(Note 3)		9.00
	Excise Duty	(Rs.461 x	10%)	46.10
	Value Added from Manufacturing and Trading Activities			356.20
Add:	Other Income			55.00
	TOTAL VALUE ADDED			**411.20**
Application of Value Added			%	**Rs. Lakhs**
	To Pay Employees	(Note 4)	20%	82.00
	To Pay Directors	(Note 5)	2%	9.00
	To Pay Government	(Note 6)	20%	81.90
	To Pay Providers of Capital	(Note 7)	28%	115.00
	To Provide for Maintenance & Expansion of the Company	(Note 8)	30%	123.30
	TOTAL APPLICATION		**100%**	**411.20**

Working Notes:

1. **Cost of bought in materials and services** includes Raw materials, stores and other manufacturing expenses, i.e., 293 + 59 + 109 = Rs.461 Lakhs.
2. **Administrative Expenses** excludes Commission to Directors and Provision for debts i.e., [Rs.33 - (Rs.9 + Rs.6.3)] which is Rs. 17.70 Lakhs.
3. **Interest** on Working Capital - ICIC1 Bank is Rs. 9 Lakhs.
4. **Employees:** Salaries, Wages, Gratuities etc. is Rs. 82 Lakhs.
5. **Directors** - Salaries and Commission to Directors is Rs. 9 Lakhs.
6. Payment to **Government** includes Cess and Local Taxes (Rs.98 Lakhs **Less** Rs.461 Lakhs x 10%), Deferred Taxes and Provision for taxation i.e., (Rs.51.9 + Rs.3 + Rs.27 = Rs. 81.9 Lakhs.
7. Payment to **Providers of Capital** includes interest on Fixed Loan (Rs. 10 Lakhs + Rs. 8 Lakhs), Interest on Debentures and pividend i.e., Rs. 18 + Rs. 2 + Rs. 95 = Rs. 115 Lakhs.
8. **Retained earnings and Depreciation** includes depreciation, Transfer to General Reserve, Retained Profit and Provision for doubtful debts i.e., Rs.17 + Rs.45 + Rs.55 + Rs.6.3 = Rs. 123.30 Lakhs.

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5.7 Economic Value Added Statement

1. What is Economic Value Added (EVA)? How is it calculated?

1. **Meaning:** Economic Value Added (EVA) is ths surplus generated by an entity after meeting an equitable charge towards the providers of Capital.

EVA = Operating Profit-Taxes paid - (Capital Employed x WACC)

2. **Significance:** Economic Value Added is an index to measure the financial performance. It takes into account the Profit, Loss, Balance Sheet efficiency and Opportunity Cost of Capital.
3. **Uses:** EVA helps to –
   - (a) measure business performance,
   - (b) take important managerial decisions,
   - (c) equate managerial incentives with Shareholders' interest, and
   - (d) improve financial and business literacy throughout the Firm.

2. Differentiate between VA (Value Added) and Economic Value Added (EVA) concepts.

Particulars	Value Added	Economic Value Added
Meaning	VA is the **wealth** that a Firm has been able to create through the collective effort of Capital, Management and Employees.	EVA is the **surplus** generated by an entity after meeting an equitable charge towards the providers of Capital.
Computation	**VA** = Market Price of a Firm's Output — Cost of Bought in Materials and Services	**EVA** = Operating Profit - Taxes paid - (Capital Employed x WACC)
Purpose	VA provides a useful measure in **analysing the performance** and activity of the reporting entity.	EVA is a management tool to help managers take **decisions** which increase the shareholders' wealth.
Focus	VA focusses on the Firm's performance and contribution towards **various groups**.	EVA focusses on Firm's ability to create surplus above **shareholders' expectations.**
Information	VA reporting is based on the P & L Account information, which is primarily **internal** data.	EVA reporting uses **market information** and estimates like Cost of Capital, Beta, Risk Free Rate of Return etc.
Time Value of Money	VA reporting does not recognise time value of money, since it deals with the wealth created by the Firm during a specified period of time e.g. a financial year.	Time Value of Money is recognised in EVA reporting through the use of WACC. The Weighted Average Cost of Capital is based on the PV of future interest/dividend outflows.

3. List the concepts in Economic Value Added (EVA).

1. **Cost of Debt** (K_d): It is the Discount Rate that equates the Present Value of After Tax Interest Payment Cash Outflows to the current Market Value of Debt Capital. *[**Note:** Debt = Long Term Borrowings only]*

   - K_d (for Irredeemable Debt) = [Interest (100% - Tax Rate)] ÷ Long Term Debt
   - K_d (for Redeemable Debt) = $\frac{\{[\text{Interest (100\% - Tax Rate)l} + [\text{RV - NP1} \div n)}{[\text{RV + NP}] \div 2}$

   Where RV = Redemption Value of Debt; NR = Net Proceeds of Debt Issue; n = Number of years after which Debt becomes redeemable.

2. **Cost of Preference Capital** (K_p): It is the Discount Rate that equates the Present Value of Preference Dividend Cash Outflows to the current Market Value of Preference Share Capital.

   - K_p (for Irredeemable PSC) = Preference Dividend * Preference Share Capital
   - K_d (for Redeemable PSC) = $\frac{(\text{Preference Dividend + TRV - NP] \^{} n})}{[\text{RV + NP}] - 2}$

   Where RV = Redemption Value of PSC; NP = Net Proceeds of PSC Issue; n = Number of years after which PSC becomes redeemable.

3. **Cost of Equity** (K_e) is the expected Market Rate Return on Equity Capital. This is,generally derived from the Capital Asset Pricing.Model (CAPM), in the following manner –

   Cost of Equity Capital = Risk Free Rate + (Beta x **Equity Risk Premium)**

   Where Equity Risk Premium = Market Rate of Return ***Less*** Risk Free Rate of Return

4. **Cost of Retained Earnings** (K_r): Reserves and Surplus are created out of appropriation of profit, i.e. by retention of profit attributable to Equity Shareholders. So, the expectation of the shareholders to have value appreciation on this money will be same as in case of Equity Share Capital. Accumulated Reserves and Surplus which are free to Equity Shareholders carry the same cost as Equity Share Capital.

5. **Beta:**

   (a) Beta is a relative measure of volatility that is determined by comparing the return on a share to the return on the stock market. Thus, Beta is a measure of non-diversifiable risk.

   (b) The greater the volatility, the more risky the Share and hence, the higher the **Beta.** A Company having a Beta of 1.2 implies that, if the Stock Market increases by 10%, the Company's Share Price will increase by 12% (i.e. 10% x 1.2). Also, if the Stock Market decreases by 10% the Company's Share Price will decrease by 12%.

   (c) It is the basis of explaining the relationship between the Return of a particular security (e.g. Shares of a particular Company) and the return of the Stock Market as a whole (i.e. Market Risk Premium). Beta is the responsiveness of Stock Return or Portfolio Return (of a Company) to Market Return (as a whole).

   (d) Beta is a statistical measure of volatility. For Listed Companies, Beta is calculated as the co-variance of daily return on stock market indices and the return on daily share prices of a particular Company divided by the Variance of the return on daily Stock Market indices. Generally, maximum of yearly Beta of the Company should be taken for calculations.

   (e) For Unlisted Companies, Beta of similar firms in the industry may be considered after transforming it to un-geared beta and then re-gearing it according to the Debt Equity Ratio of the unlisted Company.

6. **Equity Risk Premium:** Equity Risk Premium is the excess return above tbe RisltFree Rate that investors demand for holding risky securities (i.e. Shares of the given Company). Equity Risk Premium = Market rate of Return (MRR) **Less** Risk Free Rate.

7. **Market Rate of Return:** It may be calculated from the movement of share market indices over a period of an economic cycle based on moving average, to smooth out abnormalities, if any. Market Rate of Return may be calculated as under —

$$\frac{\text{Stock Exchange Index at the end of the year} - \text{Stock Exchange Index at the beginning of the year}}{\text{Stock Exchange Index at the beginning of the year}}$$

8. Overall Cost of Capital (K_r): The Overall Cost of Capital of a Firm is the weighted average cost of the individual components of Capital i.e. Debt, Preference and Equity. Thus WACC or (K_r) is equal to -

$$K_d \text{ x } \frac{\text{Debt}}{\text{Total Funds}} + K_p \text{ x } \frac{\text{PSC}}{\text{Total Funds}} + K_e * \frac{\text{Equity}}{\text{Total Funds}}$$

Where Total Funds = Debt + Preference Capital + Equity Funds.

ILLUSTRATIONS

Illustration 1: EVA Computation

Compute EVA'of Sarin Ltd. for 3 years from the information given – (in Rs. Lakhs)

Year	1	2	3
Average Capital Employed	3,000.00	3,500.00	4,000.00
Operating Profit before Interest (adjusted for tax Effect)	850.00	1250.00	1600.00
Corporate Income Taxes	80.00	70.00	120.00
Average Debt+Total Capital Employed (In %)	40.00	35.00	13.00
Beta Variant	1.10	1.20	1.30
Risk Free Rate (%)	12.50	12.50	12.50
Equity Risk Premium (%)	10.00	10.00	10.00
Cost of Debt (Post Tax) (%)	19.00	19.00	20.00

Solution: **EVA Statement of Sarin Ltd.**

Particulars	Year 1	Year 2	Year 3
1. Cost of Equity (K^e) = Risk Free Rate+ (Beta x Equity Risk Premium)	12.5+(1.1 x 10) = 23.50%	12.5 + (1.2 x 10) = 24.50%	12.5 +(1.3 x 10) = 25.50%
2. Cost of Debt (K^d) (given)	19.00%	19.00%	20.00%
3. Debt – Equity Ratio (Debt = given; Equity is bal. fig)	40% & 60%	35% & 65%	13% & 87%
4. WACC = [(K^d) x Debt % + (K^e) x Equity%]	**21.70%** (23.50x60% + 19x40%)	**22.58%** (24.50 x 65% + 19 x 35%)	**24.79%** (25.50 x 87% + 20 x 13%)
5. Average Capital Employed (given)	3,000.00	3,500.00	4,000.00
6. Capital Charge (Fair Return to Providers of Capital i.e. Average Capital Employed x WACC) (4 x 5)	3,000x21.70% = 651.00	3,500 x 22.58% = 790.30	4,000 x 24.79% = 991.60
7. Operating Profit before Taxes & Interest	**850.00**	**1,250.00**	**1,600.00**
8. **Less:** Taxes Paid	80.00	70.00	120.00

9. Operating Profit after Taxes (This is the return to the Providers of Capital i.e. Debt and Equity)	770.00	1,180.00	1,480.00
10. Capital Charge (computed in 6 above)	651.00	790.30	991.60
11. Economic Value Added (9 - 10)	**119.00**	**389.70**	**488.40**
12. EVA as a % of Average Capital Employed	**3.96%**	**11.13%**	**12.21%**

Illustration 2: EVA Computation using WACC, Equity Risk Premium etc.

The Capital Structure of Himesh Ltd. is as under:

- 80,00,000 Equity Shares of Rs.10 each = Rs.800 Lakhs
- 1,00,000 12% Preference Shares of Rs.250 each = Rs.250 Lakhs
- 1,00,00010% Debentures of Rs.500 each = Rs.500 Lakhs
- Term Loan from Bank (at 10%) = Rs.450 Lakhs.

The Company's Profit and Loss Account for the year showed a balance PAT of Rs.100 lakhs, after appropriating Equity Dividend at 20%. The Company is in the 40% tax bracket. Treasury Bonds carry 6.5% interest afid beta factor for the Company may be taken at 1.5. The long run market rate of return may be taken at 16.5%. Calculate EVA.

Solution:

1. Profit and Loss Statement

Particulars	Commutation	Rs. Lakhs
Profit before Interest and Taxes	Balancing figure	**578.33**
Less: Interest on Debentures	10% x Rs.500 Lakhs	50.00
Interest on Bank Term Loan	10% x Rs.450 Lakhs (Rs.290.00 - 60%)	45.00
Profit before Tax		483.33
Less: Tax at 40%	(Rs.290.00 ÷ 60%) x 40%	193.33
Profit after Tax	Reverse working	290.00
Less: Preference Dividend	12% x Rs.250 Lakhs	30.00
Residual Earnings for Equity Shareholders	Reverse working	260.00
Less: Equity Dividend	20% x Rs.800 Lakhs	160.00
Net Balance in P & L Account	Given	100.00

2. **Computation of Cost of Equity:** K^e = Risk Free Rate + Beta x (Market Rate - Risk Free Rate)

= 6.5% + 1.5 (16.5% - 6.5%) = **21.5%.**

3. Computation of WACC:

Component	Amount	Ratio	Individual Cost	WACC
Equity	Rs. 800 Lakhs	800 ÷ 2000 - 40.0%	K^e=21.5%	8.60%
Preference	Rs. 250 Lakhs	250 ÷ 2000= 12.5%	K^p= 12%	1.50%
Debt	Rs. 950 Lakhs	950 ÷ 2000 = 47.5%	K^d = Interest x (100 - Tax Rate) = 10% x (100% - 40%) = 6%	2.85%
Total	**Rs.2,000 Lakhs**		**K_o =**	**12.95%**

4. Computation of EVA:

Particulars	Rs. Lakhs
Profit before Interest and Taxes (from WN 1)	578.33
Less: Taxes	193.33
Net Operating Profit After Taxes i.e. Return to Providers of Capital	385.00
Less: Capital Charge (Fair Return to providers of Capital) = WACC x Cap Emp	2,000 x 12.95% = 259.00
Economic Value Added	**126.00**

Illustration 3: EVA using Financial Leverage, PE Ratio

From the following information, compute EVA of Auto Ltd. (Assume 35% tax rate)

• Equity Share Capital = Rs.1,000 Lakhs	• PE Ratio = 5 times
• 12% Debentures = Rs.500 Lakhs	• Financial Leverage = 1.5 times

Solution:

1. Profit and Loss Statement

Particulars		%	Rs. Lakhs
	Profit before Interest and Taxes	150%	**18.00**
Less:	Interest on Debentures Rs.500 x 12%	50%	60.00
	Profit before Tax	100%	120.00
Less:	Tax at 35%	35%	42.00
	Profit after Tax	**65%**	**78.00**

Note: *Financial Leverage = PBIT + PBT = 1.5. Let PBT = 100%), then PBIT = 150%), hence, Interest = 50%.*

2. Computation of WACC

Component	Amount	Ratio	Individual Cost	WACC
Equity	Rs. 1,000 Lakhs	2/3	K^e = 1 ÷ PE Ratio = 20%	13.33%
Debt	Rs. 500 Lakhs	1/3	K^d = Interest x (100 - Tax Rate) = 12% x (100% - 35%) = 7.8%	2.60%
Total	**Rs. 1,500 Lakhs**		**K_o =**	**15.93%**

3. Computation of EVA

Particulars		Rs. Lakhs
	Profit before Interest and Taxes (from WN 1)	180.00
Less:	Taxes	42.00
	Net Operating Profit After Taxes i.e. Return to Providers of Capital	138.00
Less:	Capital Charge (Fair Return to providers of Capital) = WACC x Cap. Emp	1,500 x 15.93% = 238.95
	Economic Value Added	**Nil**

Note: *The Company does not generate sufficient profits to meet the requirements of providers of Capital.*

Illustration 4: Present Value of EVA

B & Co. has existing assets in which it has capital invested of Rs.100 Crores. The After Tax Operating Income on assets-in-place is Rs.15 Crores. The Return on Capital Employed of 15% is expected to be sustained in perpetuity, and Company has a Cost of Capital of 10%. Estimate the Present Value of Economic Value Added (EVA) to the Firm from its assets-in-place.

Solution:

Operating Profit after Tax = Rs. 15 Crores

Return on Capital Employed = 15%, but Cost of Capital = 10%

Present Value of Economic Value Added (EVA) = Operating Profit after Taxes ÷ Cost of Capital

= Rs. 15 Crores ÷ 10% = **Rs.150 Crores.**

5.8 Human Resource Accounting

1. Briefly describe the progress made by India so far in the field of HR Accounting. May 2004

1. Human Resource Accounting is a **recent phenomenon** in India. Leading Public Sector Units like OIL, BHEL, NTPC, MMTC and SAIL etc. have started reporting Human Resources in their annual reports as additional information.
2. Companies in India have basically adopted the model of Human Resource Valuation as advocated by **Lev and Schwartz.** Indian Companies focused their attention on the present value of employee earning as a measure of their human capital. However the Lev and Schwartz model has been suitably modified to suit the Company's individual circumstances.

5.9 Environmental Accounting

Introduction:

Environmental Accounting is a faithful attempt to identify and bring to light the resources consumed and the costs rendered reciprocally to the environment by a business enterprise.

It is a method of recording environmental elements and includes -

(a) valuation of natural resources,

(b) measuring the income therefrom,

(c) keeping records of the related costs,

(d) estimating their quantities and providing depreciation on them.

1. Need and significance of Environmental Accounting.

1. **Resource Utilisation:** Natural Resources (water, air, minerals, forests etc.) are required to carry on the business activities of every firm. Also, the functioning of an enterprise has some favourable and some adverse effects on the environment. Hence, there is a need for maintaining accounts of the effects of the activities of a business entity on the environment and on natural resources.
2. **Resource Availability:** Environmental Accounting is useful for disclosing how much natural resources are available in the country, their incomes and the costs incurred to use them and their depreciation, values etc.
3. **Social Responsibility:** Environmental Accounting is helpful for measuring industrial development and social welfare and the fulfilment of social responsibilities by Companies. Companies are urged to be accountable to both Shareholders and wider society. Profit Making is not considered as the sole corporate objective.
4. **Qualitative Study:** Traditional Accounting System is restricted to quantitative and monetary aspects only. Hence, Environmental Accounting is necessary to analyse the effect of environmental resources in the entire business functions of a firm.
5. **Environmental Protection:** Environmental Accounting will help in evaluating the problem of environment protection. The business activities of the enterprise should be recognised as society (environment) centred and not only profit-centred.

6. **Going Concern:** Environmental pollution and the substantial costs associated with clean-up activities, fines, compensation, and bad publicity etc. can even significantly affect the share prices and even the stability of a Company. Hence, environmental accounting awareness is required.
7. **Social Accounting:** Social Accounting has been the precursor of Environmental Accounting. Social Costs also include the use of natural resources and pollution of environments. Also preservation of the environment is a critical factor for sustainable development. So, Environmental Accounting deserves special attention of manager, investors, society, different branches of Government and other stakeholders.

2. Areas of Environmental Accounting

Areas of Environmental Accounting

National Level Environmental Accounting

- This denotes modification of National Income accounts to include environmental aspects.
- This provides only a macro viewpoint of the environmental aspects of development.

Corporate Environmental Reporting

- This denotes Voluntary and Involuntary disclosures by Corporate Entities on the impact of its activities on environment.
- This provides Corporate Environmental Accounting and may also include Social Cost Benefit Analysis of projects affecting environment.

3. National Level Environmental Accounting.

1. Rational Level Environmental Accounting, denotes a set of aggregate national data linking the environment to the economy which will have a long-term impact on the economic and environmental policy making.
2. This requires necessary amendments to the System of National Accounts (SNA) to incorporate the use or depletion of national resources. SNA is a set of accounts which every national Government compiles routinely to track the activities of the economy.
3. SNA data are used to calculate major economic indicators including GDP, GNP, Savings Rate and Balance Of Trade figures. The accounts are prepared by all countries in a standardised form, using a framework developed by the United Nations Statistical Division. It helps international comparison and thus allows to place individual countries in the context of world trends.

4. Drawbacks of National Level Environmental Accounting?

In its present format, the SNA does not include full economic value of environmental resources. SNA has to be amended in view of the following problems with the present system of national accounts.

1. **Non-recognition of Environmental Expenditure:** Expenditure to protect the environment from damage or to mitigate the environmental degradation cannot be identified and segregated from the SNA data.
2. **Non-marketed Goods and Services:** The environment provides certain goods which are not sold but which are of high value e.g. fuel-wood and building materials generated in forests, medicinal plants etc. However, some countries do not include these in their annual income accounts, estimating total consumption and then using market prices of comparable products as an alternative method to calculate the value of non-marketed goods and services.
3. **Consumption of Natural Capital:** The SNA treats gradual depletion of Physical Capital (plant and machinery etc.) as depreciation rather than income. However, the depletion of Natural Capital, forests in particular is accounted as income. Most experts of environmental accounting agree that depletion of natural capital should be accounted for in the same manner as in case of other physical assets.

5. Aspects covered in Corporate Environmental Accounting system.

Environmental Accounting System should include aspects such as –

1. Concept of National Income arising out of the use of Natural Resources;
2. Concept of Costs incurred to make use of such Resources;
3. Depreciation of Natural Resources;
4. Valuation of Natural Resources;
5. Disclosing the value of Natural Resources in the Balance Sheet;
6. Contribution of Natural Resources to Industrial Development;
7. Contribution of Industries to the Environment; and
8. Extent to which changes in the environment due to business activities has affected social well-being.

Environmental Reporting can be classified into two parts, namely –

1. **Management Note / Discussion in Director's Report:** Broad Environment Protection Policy adopted and pursued by the Company and material proceedings under environmental laws should be disclosed here.
2. **Accounting Treatment and Reporting:** Financial effect of environmental protection measures on capital expenditures and earnings should be covered in the Notes forming part of Financial Statements.

6. Reporting Requirements of Environmental Accounting.

Under a comprehensive Corporate Accounting Framework on environmental issues the Board of Directors in their Report or Management Discussions should disclose the following –

1. Type of **environmental issues** that are pertinent to the enterprise and its industry;
2. **Policy and programmes** that have been adopted by the Company with respect to Environmental Protection Measures; or where there is no policy or programmes, such fact should be disclosed;
3. **Improvements made** by the Company in key areas, since the introduction of the policy, or over the past five years, whichever is shorter;
4. **Environmental Emission Targets** that the Company has set for itself, and how the Company is performing relative to those targets;
5. Extent to which Environmental Protection Measures have been undertaken as per **Government Legislation,** and the extent to which Government Requirements (e.g. time table for reduction of emissions) are achieved;
6. Where any **material proceedings** under environmental laws have been taken, a disclosure of the known and potentially significant environmental problem shall be disclosed, unless it can be objectively concluded that the problem is not likely to occur, or if it does, the effect is not likely to be material;
7. **Financial or Operational Effect** of Environmental Protection Measures on the Capital Expenditure and Earnings of the Enterprise for the current period and any specific impact on future periods;
8. **Actual Amount charged to operations** in the current period, together with a description of the relative environmental measures.
9. **Sub-classification** of the above actual amounts into the following – (a) Liquid Effluent Treatment; (b) Waste Gas and Air Treatment; (c) Solid Waste Treatment; (d) Analysis Control and Compliance; (e) Remediation; (f) Recycling; and (g) Others (e.g. accidents, safety, etc.). Where it is not possible to segregate the amount that relates to Environmental Protection Measures, disclosure of such fact is essential.
10. When material, the **actual amount capitalised** during the current period, the accumulated amount

capitalised to date, and the period for amortising, or writing off, such amounts, together with a description of the environmental measures to whieh they relate. This amount might be sub-divided into categories stated above. Where it is not possible to segregate the amount that relates to environmental measures, this fact could be stated.

7. Disclosure of environment-related Accounting Policies.

The following environment-related Accounting Policies may be disclosed in the Notes to Accounts –

1. Recording Liabilities and Provisions;
2. Setting up of Catastrophe Reserves (though appropriations of retained earnings);
3. Disclosure of Contingent Liabilities.

   The following environment-related items could be included in Contingent Liabilities, if material –

   (a) Liabilities, Provisions and Reserves that have been set / made for the current period, and amounts accumulated to date,

   (b) Contingent Liabilities, with an estimate of the amount involved, unless the event is not likely to occur. Also, the possible loss could be quantified to the extent reasonably practicable. If the possible loss cannot be reasonably calculated, a description of the Contingent Liability could be given along with the reason why an estimate of the amount of the loss cannot be made. Completion of a feasibility study of remediation costs may be normally considered as the earliest date at which a reasonable estimate of the liability is possible.

8. Major issues in Environment Accounting.

Major Accounting Issues in Environmental Accounting are –

1. **Environmental Expenditure vs. Normal Business Expenditure:** Many machines may have state-of-the-art environmental technology. Hence, a portion of such capital costs and also the running and maintenance expenditure may be treated as environment related expenditure. There should be proper guidelines for allocating the capital and revenue expenditures between Environmental Expenditure and Normal Business Expenditure.
2. **Capitalisation vs. Charging Off of Environmental Expenditure:** Environmental protection costs relating to prior periods and current period are generally very high. If these are expensed off in one year, EPS may be adversely affected. Some Companies may capitalise such expenditure and amortise the same over say 10 years. Uniformity is required for comparative analysis of Financial Statements.
3. **Recognition of Environment related Contingent Liabilities:** Environmental Contingent Liabilities are a matter of increasing concern. Recognizing a liability for hazardous waste remediation frequently depends on the ability to estimate remediation costs reasonably. Developing a reliable estimate requires evaluation of technological, regulatory and legal factors, each of which calls for exercise of management judgement to reach a supportable accounting conclusions.

9. Reporting requirements as to Environmental Statement in the Directors' Report of Companies.

1. **Disclosure Requirements under Companies Act, 1956:** Section 217(1)(e) requires the Board of Directors to include in their Annual Report, inter-alia, the prescribed particulars in respect of – (i) conservation of energy and (ii) technology absorption. Under the Companies (Disclosure of Particulars in the Report of Board of Directors) Rules, 1988, every Company is required to disclose particulars relating to –

   (a) Energy conservation measures taken;

   (b) Additional investments and proposals, if any, being implemented for conservation of energy;

(c) Impact of the measures at (a) and (b) above, for reduction of energy consumption and consequent impact on the cost of production of goods;

(d) Total energy consumption and energy consumption per unit of production as per Form A (in respect of 21 specified industry groups e.g. Textiles, Fertilisers, Aluminium, Steel, Sugar, Tea, Paper etc.)

(e) Efforts made in technology absorption, adaptation and innovation as per Form B.

2. **Notification by Ministry of Environment and Forests:**

(a) **A Gazette Notification** on Environmental Audit had been issued by the Ministry of Environment and Forests on 3.3.1992, since amended vide Notification GSR 386(E), dated 22.4.1993.

(b) **Applicability:** The Notification is applicable to any person carrying on an industry, operations or process which requires -

- Consent to operate by or under Section 25 of the Water (Prevention and Control of Pollution) Act, 1974 or under Section 211 of the Air (Prevention and Control of Pollution) Act, 1981 or both; or
- Authorisation under the Hazardous Wastes (Management and Handling) Rules, 1989 issued under the Environment (Protection) Act, 1986.

(c) **Reporting Requirements:** As per the Notification, an Environmental Statement shall be submitted to the Pollution Control Board.

(d) **Contents:** The Environment Statement of the concerned industry should provide information on –

- Water and Raw Material Consumption,
- Pollution Generated,
- Nature of Hazardous Wastes, Solid Wastes and Disposal Practices, and
- Impact of Pollution Control Measures on conservation of natural resources.

3. **Conclusion:** The disclosures required under the Companies Act have a minimum scope but constitute a starting point for voluntary disclosure by Companies. However, considering the inadequate level of environment related disclosures in the Corporate Annual Reports, the possibility and constraints of inclusion of the Environmental Statement in the Directors Report should be judged by the user.

5.10 Guidance Notes on Accounting for Tax Matters

1. Minimum Alternate Tax (MAT)

The accounting treatment of MAT is based on the Guidance Note on Accounting for Taxes on Income, which has been withdrawn (AS - 22 is now applicable). Accordingly, Tax Charge for the period should be determined on the basis of "Tax Effect Accounting Method". The principles laid down in AS - 22 will apply.

2. Corporate Dividend Tax (CDT)

1. **Features of CDT:**

(a) CDT is in addition to Income-Tax chargeable in respect of the Total Income of a Domestic Company. CDT shall be payable even if no Income-Tax is payable by the Domestic Company on its Total Income.

(b) CDT is chargeable on any amount declared, distributed or paid by such Company by way of dividends (whether interim or otherwise) on or after 1st June, 1997. The dividends chargeable to CDT may be out of the Current Profits or Accumulated Profits.

(c) The rate of CDT is as given by the Finance Act for the relevant previous year.

(d) CDT is payable to the credit of the Central Government within 14 days of – (i) declaration of any dividend; (ii) distribution of any dividend, or (iii) payment of any dividend, whichever is the earliest.

(e) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the Company or by any person in respect of the tax so paid.

2. Recognition of CDT: Provision for Dividend is recognised in the Financial Statements of the year to which the dividend relates. Hence, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be recognized/reflected in the accounts of the same financial year (in which the dividend is recognized) even though the actual tax liability in respect thereof may arise in a different year.

3. Presentation and Disclosure:

(a) P&L Account: CDT liability should be disclosed separately in the P & L A/c, 'below the line', as under-

Dividends	XXX	
Add: Corporate Dividend Tax thereon	XXX	XXX

(b) Balance Sheet: Provision for CDT should be disclosed separately under the head 'Provisions' in the Balance Sheet.

3. Fringe Benefits Tax (FBT)

1. Features of FBT:

(a) Fringe Benefits Tax (FBT) is tax payable by an employer in respect of fringe benefits provided or deemed to have been provided by the employer to his employees during the previous year.

(b) FBT is payable at the specified rate on the value of fringe benefits and is in addition to the Income-Tax charged under the Income-Tax Act.

(c) FBT is not an allowable expenditure for the purpose of computation of taxable income.

2. Recognition of FBT: Even though the actual payment of the tax and/or assessment of the tax takes place on a later date, the employer should recognise, in the Financial Statements for the period, expense for the FBT paid/payable in respect of all expenses giving rise to such tax incurred during that period. The amount of FBT should be calculated in accordance with Sec. 115WC of the Act.

3. Presentation and Disclosure:

(a) P&L Account: FBT should be disclosed as a separate item after determining Profit Before Tax on the face of the Profit and Loss Account for the period in which the related fringe benefits are recognised. An illustration of the disclosure of FBT may be as below -

	Profit before Tax				XXX
Less:	Income Tax Expense:	Current Tax	XXX		
		Deferred Tax	XXX	XXX	
		Fringe Benefits Tax		XXX	XXX
	Profit After Tax				**XXX**

(b) Balance Sheet: The amount of FBT (net of Advance Tax thereon), outstanding if any, at the year-end, should be disclosed as a Provision in the Balance Sheet.

4. Excise Duty

1. **Features of Excise Duty:**

   (a) Excise Duty is an indirect tax, arising as a consequence of manufacture of excisable goods, irrespective of the manner of use/disposal of goods thereafter i.e. sale, destruction or captive consumption.

   (b) No sale or further utilization of excisable goods can take place, unless the duty is paid. Hence, Excise Duty is a necessary expense to be incurred if the goods are to be put in the location and condition in which they can be sold or further used in the manufacturing process.

2. **Accounting Treatment:** The accounting treatment of Excise Duty is as under –

   (a) Excise Duty should be considered as a manufacturing expense and be considered as an element of cost for Inventory Valuation.

   (b) Where Excise Duty is paid on excisable goods (inputs) and such goods are subsequently utilized in the manufacturing process, the duty paid on such goods (inputs), if the same is **not recoverable from taxing authorities,** becomes a manufacturing cost, and must be **included in the valuation of WIP** or **Finished Goods** arising from the subsequent processing of such goods.

   (c) Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made.

   (d) Excise Duty **cannot** be treated as a Period Cost.

Illustration: Excise Duty Treatment

Ram Ltd. is manufacturing goods for local sale and exports. As on 31st March, it has the following finished stocks in the factory warehouse –

(a)	Goods meant for local sale	Rs.100 Lakhs (Cost Rs.75 Lakhs).
(b)	Goods meant for exports	Rs. 50 Lakhs (Cost Rs.20 Lakhs).

Excise duty is payable at the rate of 16%. The Company's Managing Director says that Excise Duty is payable only on clearance of goods and hence is not a cost. Advise the Company on the proper treatment of Excise Duty.

Solution:

1 Excise Duty is an indirect tax, arising as a consequence of manufacture of excisable goods irrespective of the manner of use / disposal of goods thereafter i.e. sale, destruction or captive consumption.

2 Levy of excise duty is and remains upon the manufacture or production alone. Only collection part of it is shifted to the stage of removal.' Hence, the Managing Director's contention that "Excise Duty is payable only on clearance of goods and hence is not a cost" is **incorrect.**

3. As per the Guidance Note on Accounting Treatment for Excise Duty, Excise Duty should be considered as a **manufacturing expense** and like other manufacturing expenses be considered as an element of cost for inventory valuation.

4. The Guidance Note also requires that where the liability for excise duty has been incurred but its collection is deferred, **provision** for the unpaid liability should be made. Therefore, in the above case, excise duty on the goods meant for **local sales** should be provided for at the rate of 16% on the Selling Price, of Rs.100 Lakhs for valuation of stock.

5. Assuming that all the conditions specified in the Central Excise Rules, regarding export of excisable goods without paymentrfif duty are fulfilled by the Company, Excise Duty may not be provided for the goods meant for exports, even though the manufacture thereofis completed.

5. Modvat/Cenvat

1. CENVAT Scheme:

(a) Central Valued Added Tax (CENVAT) scheme is applicable w.e.f. 01.04.2000, (replacing the erstwhile MODVAT Scheme).

(b) The Scheme allows instant credit of duties paid on inputs (Raw Materials) and specified Capital Goods, used in relation to manufacture of specified final excisable goods, to be utilized for payment of excise duties in respect of such goods. Hence, duty credit taken (on inputs) is in the nature of set-off against the payment of duty on the final products.

(c) In respect of Capital Goods received in a factory at any point of time in a given financial year, credit can be taken only for an amount not exceeding 50% of the duty paid on such capital goods in such financial year. The balance credit can be taken in any subsequent financial year, provided the Capital Goods are still in the possession and use of the manufacture of final products, in such subsequent year(s).

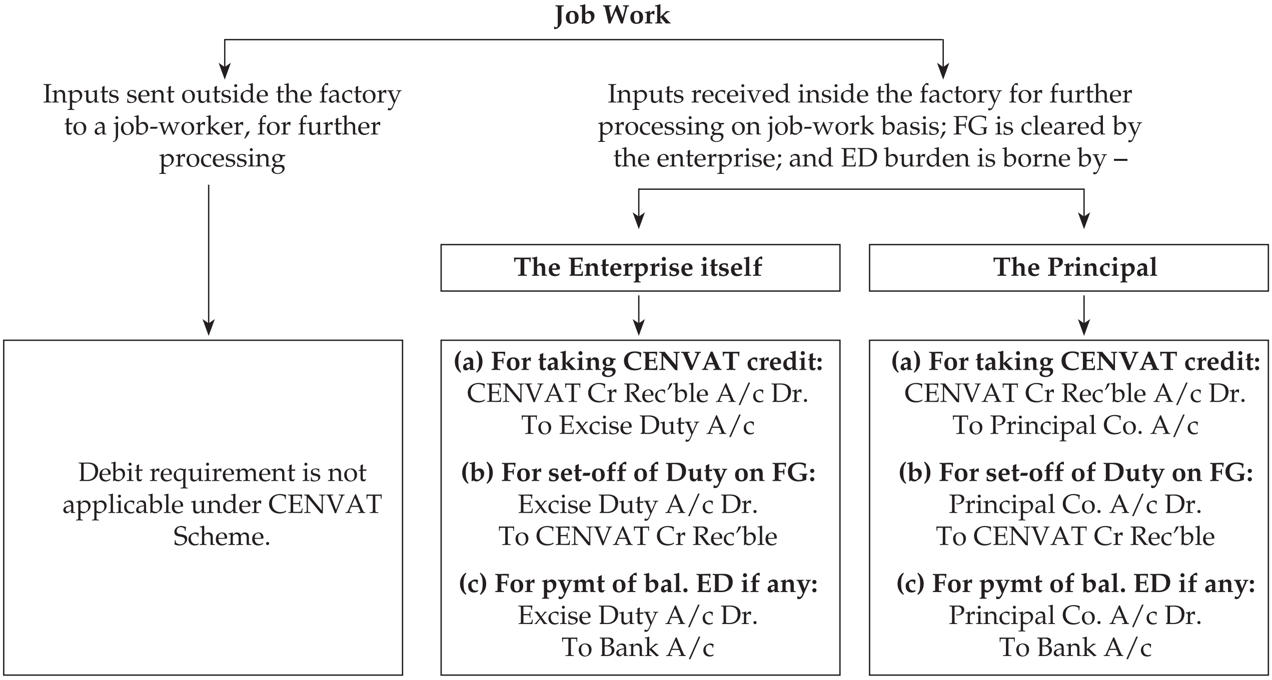
2. CENVAT Credit on Inputs used in manufacture of final products: The journal entries are given below-

S.No.	Transaction and Entry	Debit	Credit
1	**Purchase of Inputs (with Duty thereon)** Purchases A/c Dr. CENVAT Credit Receivable (Inputs) A/c Dr. To Suppliers / Sundry Creditors / Bank A/c	Pure Price net of ED ED on Purchases	Pure Price incl. ED
2	**Sale of dutiable goods** Bank/Sundry Debtors A/c Dr. To Sales A/c	FG Price incl. ED on Sales	FG Price incl. ED on Sales
3	**Set-off of CENVAT Credit** Excise Duty A/c Dr. To CENVAT Credit Receivable (Inputs)	Credit available or EO payable, whichever is less	
4	**Payment of balance ED (if credit recble is less)** Excise Duty A/c Dr. To Bank	To the extent of ED actually paid in cash i.e. when Credit Rec'ble < ED Payable on Sales	

Note:

- **Disclosure in Balance Sheet:** Debit balance in CENVAT Credit Receivable (Inputs) i.e. balance Credit Available for use in subsequent periods, will be shown on the Assets Side of the Balance Sheet under the head **"Loans and Advances".**
- **Changeover from Inclusive Method:** An enterprise which had been following the **Inclusive Method** (under the previous Guidance Note on Accounting for MODVAT) should changeover to the above method. Appropriate disclosures are required under AS - 5 are to be made.

3. Accounting Treatment in case of Job Work:



Job Work

Inputs sent outside the factory to a job-worker, for further processing

Debit requirement is not applicable under CENVAT Scheme.

Inputs received inside the factory for further processing on job-work basis; FG is cleared by the enterprise; and ED burden is borne by –

The Enterprise itself

(a) For taking CENVAT credit:
CENVAT Cr Rec'ble A/c Dr.
To Excise Duty A/c

(b) For set-off of Duty on FG:
Excise Duty A/c Dr.
To CENVAT Cr Rec'ble

(c) For pymt of bal. ED if any:
Excise Duty A/c Dr.
To Bank A/c

The Principal

(a) For taking CENVAT credit:
CENVAT Cr Rec'ble A/c Dr.
To Principal Co. A/c

(b) For set-off of Duty on FG:
Principal Co. A/c Dr.
To CENVAT Cr Rec'ble

(c) For pymt of bal. ED if any:
Principal Co. A/c Dr.
To Bank A/c

4. CENVAT Credit on Capital Goods used in manufacture of specified goods:

(a) CENVAT credit in respect of Capital Goods should be recognized in the books of account only if – (1) the enterprise is entitled to CENVAT Credit as per Rules; and (ii) there is a reasonable certainty that the CENVAT Credit would be utilized.

(b) The Journal Entries are given below —

S.No.	Transaction and Entry	Debit	Credit
1	**Purchase of Capital Goods (with Duty thereon)** Fixed Assets A/c Dr. CENVAT Credit Rec'ble (Capital Goods) A/c Dr. CENVAT Credit Deferred (Capital Goods) A/c Dr. To Asset Vendor / Bank A/c	Pure Price net of ED Credit taken during the year (i.e. maximum 50%) Balance credit to be availed in subsequent yrs	Pure Price incl. ED
2	**Set-off of CENVAT Credit during the year** Excise Duty A/c Dr. To CENVAT Credit Recble(Capital Goods)	Credit available during the year or ED payable, whichever is less	
3	**Tfr of balance Credit available in subsequent yrs** CENVAT Credit Rec'ble (Capital Goods) A/c Dr. To CENVAT Credit Deferred (Cap. Goods)	Balance Credit Available for set-off in subsequent financial years.	

Note :

- Debit balance in CENVAT Credit Receivable (Capital Goods) A/c and CENVAT Credit Deferred (Capital Goods) A/c i.e. balance Credit Available for use in subsequent periods, will be shown on the Assets Side of the Balance Sheet under the head "Loans and Advances".
- Journal Entries for Sale, payment of balance Excise Duty are as in Point 2 above.

5. **CENVAT Credit where Capital Goods are acquired on Lease / Hire Purchase:**

   (a) **Accounting in Lessor's Books:** Lessor should account for the price of asset acquired from the Supplier, **net of excise duty only.** When the financing arrangement also covers ED portion, ED recoverable from the lessee should be debited to a separate a/c (and not included in Minimum Lease Payments) and recovered from the lessee. When the financing arrangement does not cover ED portion, the lessee would pay the ED directly to the Supplier and hence need not be recorded in the books of the Lessor.

   (b) **Accounting in Lessee's Books:** CENVAT Credit Receivable on Capital Goods acquired on lease should be treated in the same manner as in the case of outright purchase of asset.

6. **Review of balances in CENVAT Receivable Accounts:**

(a) **Write-off:** Balances in CENVAT Credit Receivable Accounts (Inputs and Capital Goods), should be reviewed at the end of every year. If it is found that the balances of the CENVAT are not likely to be used in the normal course of business, then, notwithstanding the right to carry forward such amounts under Excise Rules, the **non-usable excess credit** should be adjusted in the accounts, as under -

CENVAT Credit relating to	Treatment
(i) Inputs	• Debit the specific Raw Material or Purchase A/c, so as to increase the cost of consumption, & valuation of closing stocks. • Apportion the excess credit pro-rata to all purchases/components, if the specific Raw Material cannot be identified.
(ii) Capital Goods/FA purchased	• Debit the cost of Specific Fixed Asset. • Charge depreciation on the revised unamortized depreciable amount, over the balance useful life, prospectively. • If the specific Fixed Asset no longer exists, write off the excess unutilisable credit to P&L Account.
(iii) Capital Goods on Lease / HP	Write off on pro-rata basis to P&L A/c, along with Lease Rentals.

(b) **Reconciliation:** A reconciliation statement between the CENVAT Credit Receivable (Dr.) as per financial accounts and the credit available as per Excise Registers, should be prepared.

(c) **Non compliance with conditions:** Where conditions for availing credit have not been complied with, or are not being capable of compliance, e.g. where inputs are destroyed or fixed assets cannot be used for manufacture of the final products, the appropriate adjustments should be made as per point (a) above.

7. Payment of Duty Demands by set-off i.e. Debit to CENVAT Credit Receivable Account:

Situation	Treatment	RM Valuation
(a) Duty relating to Finished Goods	Excise Duty A/c Dr. To CENVAT Credit Rec'ble	No change
(b) Disallowance of CENVAT Credit on purchases during the period	Purchases / Raw Material A/c Dr. To CENVAT Credit Rec'ble	RM Inputs Cost to be increased to include ED
(c) Disallowance of CENVAT Credit on purchases of previous periods	If such inputs are consumed during the year: Same entry in (a) above. If such inputs are still in stock at the end of year: Same entry in (b) above.	**Not Applicable** RM Inputs Cost to be increased to include ED

8. Inventory Valuation Principles: The principles of inventory valuation are summarized below-

Item valued	Inventory Valuation Principle
Inputs where CENVAT Cr. Availed	Purchase Price net of Input Duty. (See Note below)
Inputs if CENVAT Cr. Not Availed	Total Purchase Price, including Input Duty. *e.g. purchases without requisite documents for availing CENVAT Credit; -purchases from Small Scale Supplier's who are Exempted from duty; purchases from dealers who are not eligible to issue CENVAT Invoice as per Excise Rules etc.*
Final Products	Value of Inputs should be net of duty on inputs i.e. Purchase Pricfc, net of Input Duty. However, provision should be made/ added for Excise Duty Liability on Final Products.
Capital Goods	Purchase Price net of Input Duty.

Note: If any input is used in the production of more than one final product, some of which are excisable while others are not excisable or charged to Nil rate of duty, the valuation of RM input will be as under -

- If separate RM inventory records are not maintained: All RM Inventory should be valued net of input duty.
- If separate RM jfly/entorv records are maintained: RM Inventory used for production pf excisable final products should be valued net of input duty; RM Inventory used for production of non-excisable goods or Nil duty goods, should be valued at actual cost, inclusive of input duty.

Illustration 1: Inventory Valuation principles

A Factory started activities on 1st April. From the following data, obtain the Value of Closing Stock on 30th April.

- Raw Materials purchased during April = 80,000 kg at Rs.12 (out of which Excise Duty = Rs.2 per kg). Stock on hand as on 30th April = 5,000 kg.
- Production during April = 14,000 units (of which 10,000 unite were sold). In addition to the production, 1,000 units were lying as WIP on 30th April (100% complete as to Materials and 60% complete as to conversion).
- Wages and Production Overheads = Rs.30 per completed unit.
- Selling Price = Rs.110 per unit (of which Excise Duty is Rs.10 per unit)

Solution:

Particulars	Computation	Rs.
1. Raw Material Valuation (net of Input Excise Duty)	5,000kg x Rs. l0 per kg	50,000
2. WIP Valuation (net of RM input duty)	(Rs.50 + 60% of Rs.30) x 1,000 units	68,000
3. Finished Goods Valuation (including ED on SP)	(RM 50 + Lab & OH 30 + ED 10) = Rs.90 x (14,000 units - 10,000 units)	3,60,000
Total		**4,78,000**

Computation of Cost per unit of production:

- Raw Materials: (80,000 - 5,000) = 75,000 kg for 15,000 units total = 5 kg x Rs. 10 (net of ED) = Rs.50
- Wages and Production Overhead = Rs.30 per completed unit (given)

Illustration 2: CENVAT Credit Accounting

A Factory went into commercial production on 1st April, it uses two raw materials M and N, on which excise duty of Rs.30 per Kg and Rs.20 per Kg respectively is paid. On 31st March it had stock of 2,000 Kg of M and 1,500 Kg of N which it had purchased at an all inclusive price of Rs.150 per Kg for M and Rs.120 per Kg for N. The Suppliers of the materials are to receive payment on 15th May.

During the month of April, the Factory manufactured 4,000 units of the end product for which the consumption of Materials M and N were 6,000 Kg and 4,500 Kg respectively. The Excise Duty on the end product is Rs.60 per unit. 30,000 units of the end product were despatched, 800 units were kept in bonded warehouse and balance 200 units were kept in finished goods godown.

During the month the Factory purchased 5,000 Kg of M at Rs.145 per kg (inclusive of Excise Duty Rs.30 per Kg) on credit of 60 days and 5,000 Kg of N at Rs.110 per Kg (inclusive of Excise Duty Rs.20 per Kg) on credit of 45 days.

The cost of “converting” the raw materials into finished product amounts to Rs.150 per unit of end product of which Rs. 100 is “cash cost” paid immediately and Rs.50 represents non-cash charge for depreciation. There is no Work In Process.

Sales are made at Rs.750 per unit in respect of credit transactions and at Rs.700 per unit in respect of cash transactions. 20% of despatches were in respect of cash transactions while the balance 80% were in respect of credit transactions (1 month credit).

1. Calculate CENVAT Credit Available, CENVAT Credit Availed of and balance in CENVAT Credit as on 30th April.
2. Show the necessary ledger accounts in respect of CENVAT.
3. Value the inventory of - (a) Raw Material; (b) Finished Goods in Bonded Warehouse and (c) Finished Goods in Finished Goods Godown on “First In First Out” principle.
4. Show the Ledger Accounts of Customers, Suppliers and Bank, assuming that the necessary bank balance is available at the start of the month to meet “cash” expenses of that month.
5. Calculate the profit earned for the month.
6. Calculate the Working Capital as on 30th April. State the impact of ‘CENVAT’ on Working Capital Requirement of the Factory as on 30th April.

Solution:

1. CENVAT Credit Available, Availed of and Balance Credit at the end of April

Material	M			N			Total Amount Rs.
	Kgs.	ED Rate	Amount	Kgs.	ED Rate	Amount	
Opening Stock for April	2,000	30	60,000	1,500	20 20	30,000	90,000
Purchases during April	5,000	30	1,50,000	5,000		1,00,000	2,50,000
Total Credit Available			**2,10,000**			**1,30,000**	**3,40,000**
Less: CENVAT Credit availed on Production of 40,000 units at Rs.60 p.u **(See Note)**							2,40,000
Balance in CENVAT Credit at the end of April							**1,00,000**

Note:

- Guidance Note on Accounting Treatment for Excise Duty, requires that a provision for liability in respect of unpaid excise duty should be made in the accounts in respect of stocks lying in the factory or bonded warehouse since the liability for excise duty arises when the manufacture of the goods is completed.
- CENVAT Rules permit storage of goods in bonded warehouses, without payment of duty. In the absence of information, Excise Duty has been considered on 800 units also which were kept in bonded warehouse.

2. CENVAT related Ledger Accounts

Dr. **(a) CENVAT Credit Receivable Account** Cr.

Particulars	Rs.	Particulars	Rs.
Apr 1 To balance b/d M = 60,000	90,000	Apr 30 By Excise Duty A/c - Transfer	2,40,000
N = 30,000			
April To Suppliers A/c M = 1,50,000			
N= 1,00,000	2,50,000	Apr 30 By balance c/d (closing balance)	1,00,000
Total	**3,40,000**	**Total**	**3,40,000**

Dr. **(b) Purchases Account** Cr.

Particulars	Rs.	Particulars	Rs.
April To Suppliers A/c			
M = 5,000 kg x (145-30)	5,75,000		
N = 5,000 kg x (110-20)	4,50,000	Apr 30 By balance c/d (closing balance)	10,25,000
Total	**10,25,000**	**Total**	**10,25,000**

3. Valuation of Inventory

(a) Raw Material Valuation

Material	Opg Stock + Purchases - Consumption = Clg Stock	Rate per kg	Value of Stock
M	2,000 + 5,000 - 6,000 = 1,000 kgs	145-30 = Rs.115	Rs. 1,15,000
N	1,500 + 5,000 - 4,500 = 2,000 kgs	110-20 = Rs. 90	Rs. 1,80,000
	Total		**Rs. 2,95,000**

Note: Raw Materials should be valued at Cost, net of CENVAT Credit.

(b) Finished Goods Valuation (assuming FIFO based consumption of Raw Materials)

Particulars	Rs.
1. Computation of Cost of Production of 4,000 units	
(a) Raw Materials M: 6,000 kg at (145 - 30 = Rs.l 15 per kg)	6,90,000
(b) Raw Materials N: 4,500 kg at (110 - 20 = Rs. 90 per kg)	4,05,000
(c) Conversion Costs at Rs.l50 per unit for 4,000 units	6,00,000
Total Cost of Production (net of Excise Duty on RM)	16,95,000
2. Cost per unit of Finished Product (net of Excise Duty on RM)	Rs. 423.75
3. **Add:** Excise Duty Payable on Finished Product (ED payable on manufacture). Hence, provision is to be created for unpaid duty liability.	Rs. 60.00
4. Average Valuation Rate per unit for Final Product	Rs.483.75
5. Valuation of Finished Goods:	
(a) Bonded Warehouse Stock: 800 units x Rs.483.75	Rs. 3,87,000
(b) Finished Goods Godown Stock: 200 units x Rs.483.75	Rs. 96,750
6. Total Value of Finished Goods	Rs. 4,83,750

Note: Valuation of Finished Goods is based on FIFO principle. Hence, Closing Stock of Finished Goods would consist of goods produced by consuming materials out of current period purchase. Hence, entire raw materials consumption has been taken at current period net purchase price of Rs.l 15 and Rs.90 per kg respectively.

4. Customers, Suppliers and Bank Accounts

(a) Customers Account

Particulars	Rs.	Particulars	Rs.
April To Sales 3,000 x 80% x Rs.750	18,00,000	April 30 By balance c/d (closing balance)	**18,00,000**

(b) Suppliers Account

Particulars	Rs.	Particulars	Rs.
April 30 To balance c/d (closing bal)	**17,55,000**	April 1 By bal. b/d (opening balance)	
		M:2,000 kg x Rs. 150 = 3,00,000	
		N: 1,500 kg * Rs.120 = 1,80,000	4,80,000
		April By Purchases A/c (value net of ED)	10,25,000
		April By CENVAT Credit Receivable	
		M: 5,000 kg x Rs.30 = 1,50,000	
		N : 5,000 kg x Rs.20 = 1,00,000	2,50,000
Total	**17,55,000**	**Total**	**17,55,000**

(c) Bank Account

Particulars	Rs.	Particulars	Rs.
April 1 To balance b/d (See Note)	4,00,000	April By Expenses A/c (4,000 x Rs.l00)	4,00,000
April To Sales 3,000 x 20% x Rs.700	4,20,000	Apr 30 By balance c/d (closing balance)	4,20,000
Total	**8,20,000**	**Total**	**8,20,000**

Note: It is assumed that the Factory has adequate cash balance equivalent to meet cash expenses for the month.

5. (a) Profit and Loss Account for the month of April

Particulars	Rs.	Particulars	Rs.
To Opening Stock of Materials:		By Sales: Cash: 3,000 * 20% x 700	4,20,000
M(150-30) x 2,000 kgs	2,40,000	Credit: 3,000 x 80% x 750	18,00,000
N(120-20) x 1,500 kgs	1,50,000	By Closing Stocks:	
To Purchases (as per Purch A/c above)	10,25,000	- Material M (as per valuation above)	1,15,000
To Excise Duty (CENVAT availed)	2,40,000	- Material N (as per valuation above)	1,80,000
To Conversion Costs (4,000 x 150)	6,00,000	- Finished Goods (as per vain above)	4,83,750
To Gross Profit c/d	**7,43,750**		
Total	**29,98,750**	**Total**	**29,98,750**

Note: It is assumed that Sale Prices of Rs.700 and Rs.750 are inclusive of the Duty of Rs.60 per unit on FG.

5. (b) Reconciliation of Profits

Particulars		Rs.
Profits for Output Sold:	Cash Sales: 3,000 x 20% * (700 - 483.75)	1,29,750
	Credit Sales: 3,000 x 80% x (750-483.75)	6,39,000
Total Profit based on Quantity Sold		
Less: Excess Cost of Opening Stock of Materials not considered in FG Valuation:		7,68,750
M: 2,000 kgs x (Rs.120 - Rs.l 15) (all prices net of ED)		10,000
N: 1,500 kgs x (Rs. 100 - Rs. 90) (all prices net of ED)		15,000
Profit as per above P&L Account		**7,43,750**

6. Computation of Working Capital as on 30th April

Particulars				Rs.
A. Current Assets:	Raw Materials Stock	Material M	1,15,000	
		Material N	1,80,000	2,95,000
	Finished Goods Stock	Bonded Warehouse	3,87,000	
		Finished Goods Godown	96,750	4,83,750
	Debtors/Customers			18,00,000
	Bank Balance			4,20,000
	CENVAT Credit Receivable			1,00,000
	Total Current Assets			**30,98,750**
B. Current Liabilities: Suppliers/Sundry Creditors				17,55,000
C. Net Working Capital (A - B)				13,43,750

Impact of CENVAT on Working Capital Requirements:

- 3,000 units of Finished Goods have been despatched by way of sale without payment of a single rupee in cash. Cash outlay so saved at Rs.60 perunit is Rs.2,40,000. (i.e. to the extent of CENVAT Credit Availed).
- Creation of a Current Assess worth Rs. 1,00,000 in CENVAT Credit Receivable Account, reduces the pressure on Working Capital.

Illustration 3: CENVAT on Capital Goods

A Company purchased a plant for Rs.50 Lakhs during the financial year and installed it immediately. The price charged by the Vendor included Excise Duty (CENVAT Credit Available) of Rs.5 Lakhs. During this year, the Company also produced excisable goods on which Excise Duty chargeable is Rs.4.50 Lakhs. Show the Journal Entries describing CENVAT Credit treatment. At what amount should the Plant be capitalized?

Solution:

1. Journal Entries

S. No.	Transaction and Entry	Debit	Credit
1	Fixed Assets A/c Dr.	45,00,000	
	CENVAT Credit Rec'ble (Capital Goods) A/c Dr.	2,50,000	
	CENVAT Credit Deferred (Capital Goods) A/c Dr.	2,50,000	
	To Asset Vendor / Bank A/c		50,00,000
	(Being Plant purchased recorded, including immediate CENVAT Credit .mailable of 50%, balance 50% (assumed) credit available in subsequent year)		
2	Excise Duty A/c Dr.	2,50,000	
	To CENVAT Credit Recble (Capital Goods)		2,50,000
	(Being set off of CENVAT Credit during the year)		
3	Excise Duty A/c Dr.	2,00,000	
	To Bank		2,00,000
	(Being balance Excise Duty payable Rs.4,50,000 Rs.2,50,000 set-off, now settled)		
4	**Subsequent Financial Year**		
	CENVAT Credit Rec'ble (Capital Goods) A/c Dr.	2,50,000	
	To CENVAT Credit Deferred (Cap. Goods)		2,50,000
	(Being transfer of balance CENVAT Credit available on Capital Goods)		

2 Balance Sheet (abstract)

Liabilities	Rs.	Assets	Rs.
		Fixed Assets: Plant at Cost	45,00,000
		Less: Depreciation	??
		Current Assets, Loans and Advances:	
		CENVAT Credit Deferred (Cap. Goods)	2,50,000

6. State Level Value Added Tax (VAT)

1. **Salient Features of VAT:**

   (a) **VAT Credit:** A registered dealer (trader/manufacturer) is entitled to an input tax credit (called as VAT Credit), in respect of taxes paid on purchases made during the period, where the purchases arise in the course of his activities as a dealer.

(b) **Set Off Facility:** VAT Credit is jillowed for purchase of inputs/supplies meant for sale, or for utilization in the process of production for such sale, irrespective of when these are utilized/sold, and reduces the immediate tax liability of the dealer.

(c) **Purchase within State:** VAT Credit is available for all for purchase of inputs/supplies in a State, meant for sales within the State or sale in other States. Even for Stock Transfer/Consignment Sales of goods out of the State, input tax paid in excess of a certain percentage is eligible for VAT Credit. VAT Credit is not allowable for taxes paid on purchases from other States.

(d) **Refund of Excess VAT Credit:** Where VAT Credit exceeds the tax payable on sales in a month, the excess credit is carried over to the future month(s). Any excess unadjusted VAT Credit at the end of the specified period, is eligible for refund.

(e) **VAT Goods, Exempt and Zero Rate Goods:** VAT legislation of each State will specify the goods which are covered under VAT, and the relevant VAT rates. In case of "exempt" goods, the dealer is not eligible to claim VAT Credit for tax paid on the purchase of inputs. However, in case of "Zero Rate" Goods, the dealer is eligible to claim VAT Credit for tax paid on the purchase of inputs. Also, Goods not covered by VAT are taxed under the Sales Tax Act or other Act.

(f) **Export Sales:** Export Sales are "Zero Rate" Sales under VAT. Hence, VAT need not be charged and paid on Sales made. However, the Exporter is entitled to VAT Credit in respect of tax paid within a State on the purchase of inputs. This VAT Credit is not restricted only to those goods which are meant or used in the manufacture of exports. If in any tax period, the VAT Credit exceeds the output tax, and the dealer has declared international exports in the same tax period, he can claim refund of excess VAT credit. The units located in SEZ/EOU's are either exempted from payment of input tax, or eligible for refund of input tax paid, within a specified period.

(g) **Deferral Scheme:** In some State VAT laws, industrial units may be granted deferral facility for payment of tax, net of VAT Credit, i.e. output tax is collected from customers at the time of making sale; but the payment (after setting off VAT Credit on inputs) is deferred to a future point of time.

(h) **Capital Goods – 36 months spread over:** VAT Credit is also available on capital goods (except a few items included in the negative list of respective State laws). This may be adjusted over a maximum of 36 equal monthly instalments. However, some States may reduce the number of instalments or may grant full credit in the month of purchase of Capital Goods.

(i) **Small Dealers – Composition Scheme:** Small dealers with annual gross turnover not exceeding specified limits, who are otherwise liable to pay VAT, however, have the option to pay tax under the Composition Scheme. Such dealers may pay tax at a prescribed small percentage of the Gross Turnover, and are not entitled to any VAT Credit.

(j) **Works Contracts:** Dealers executing Works Contracts may have the following options - (a) pay tax on the value of goods at the time of incorporation of goods in the works executed, at the rates applicable to those goods; or (b) pay tax under composition scheme, at a prescribed rate on the total consideration received. In the second case, such dealers may not be entitled to any VAT Credit or may be eligible for partial VAT Credit.

2. **VAT Credit in case of Inputs/Supplies:** The Accounting treatment illustrated herebelow is required only where VAT Credit is available. Hence, it is not required in the situations given below —

   (a) Dealers not registered under VAT;

   (b) Dealers having turnover below the specified limits and opting for Composition Scheme;

   (c) Dealers engaged in Works Contracts and opting for tax by way of composition; and

   (d) Purchase of goods from Unregistered Dealers (not eligible for VAT Credit).

Suggested Accounting Treatment

S.No.	Transaction and Entry	Debit	Credit
1	Purchase of Inputs (with VAT thereon) Purchases A/c (different category items) Dr. VAT Credit Receivable (Inputs) A/c Dr. To Suppliers / Sundry Creditors / Bank A/c	Purc Price net of VAT VAT Paid on Purchases	Purc Price incl. VAT
2	Sale of goods Bank/Sundry Debtors A/c Dr. To Sales A/c (different category items) To VAT Payable A/c	Price incl. VAT on Sales	Price excl. VAT VAT Colin on Sales
3	Set-off of VAT Credit VAT Payable A/c Dr. To VAT Credit Receivable (Inputs) A/c	VAT Credit available or VAT payable, whichever is less	
4	**Payment of balance VAT (if credit recble is less)** VAT Payable A/c Dr. To Bank	To be passed at the time of payment To the extent of VAT actually paid in cash, i.e. when Credit Rec'ble < VAT Payable on Sales	

Note:

- **Disclosure in Balance Sheet:**
  - (i) Debit balance in VAT Credit Receivable (Inputs), if any, will be shown on the Assets Side of the Balance Sheet under the head **"Loans and Advances".**
  - (ii) Alternatively, credit balance in VAT Payable A/c, if any, will be shown under **"Current Liabilities".** Where the dealer enjoys deferral benefits of VAT Payable, the credit balance will be shown as **Long Term Liability.**
- **Common Inputs:**
  - (i) Where common inputs axe used for making taxable sales as well as exempt sales, the dealer should, on the date of purchase, estimate the inputs expected to be used for making the taxable sales and for making exempt sales,
  - (ii) VAT Credit should be recognized only in respect of inputs which are expected to be used in making taxable sales. No VAT Credit should be recognized on inputs which are expected to be used in making exempt sales,
  - (iii) Where the actual use is different from the estimated use, an adjustment entry should be passed.
- **Stock Transfer/Consignment Sale:** In case of Stock Transfer/Consignment Sale of goods outside the State where VAT Credit is available only to an extent of input tax paid, the dealer should estimate the expected Stock Transfers/Consignment Sales and account for accordingly.

3. VAT Credit in case of eligible Capital Goods:

S.No.	Transaction and Entry	Debit	Credit
1	**Purchase of Capital Goods (with VAT thereon)** Fixed Assets A/c Dr. VAT Credit Deferred (Capital Goods) A/c Dr. To Asset Vendor / Bank A/c	Purchase Price net of VAT VAT paid on Purchases	Purchase Price incl. VAT
2	**Transfer of VAT Credit Rec'ble during the year** VAT Credit Recble (Capital Goods) A/cDr. To VAT Credit Deferred (Capital Goods)	Credit available during the year as per the relevant State VAT Law	

Note:

- Debit balance in VAT Credit Receivable (Capital Goods) A/c (after utilization for set-off for payment during the period) and Debit balance in VAT Credit Deferred (Capital Goods) A/c i.e. balance Credit Available for use in subsequent periods, will be shown on the Assets Side of the Balance Sheet under the head **"Loans and Advances".**
- Depreciation on Machinery will be charged on the Purchase Price net of VAT.

4. Adjustment (i.e. Debit) to VAT Credit Receivable A/c -

Situation	Treatment	Other Points
(a) Set-off of VAT Payable on Sales	VAT Payable A/c Dr. To VAT Credit Rec'ble	No change in Input Stock Valuation.
(b) Disallowance of VAT Credit on purchases during the period	Purchases / Raw Material A/c Dr. To VAT Credit Rec'ble	RM Inputs Cost to be increased to include VAT
(c) Disallowance of VAT Credit on purchases of previous periods	<u>If such inputs are used/sold during the year;</u> (prior period item) Profit and Loss A/c Dr. To VAT Credit Rec'ble <u>If such inputs are still in stock at the end of year:</u> Same entry in (b) above.	RM Inputs Cost to be increased in include VAT
(d) Disallowance of VAT Credit on Capital Goods (See Note below)	<u>If asset is still in use:</u> Relevant Asset A/c Dr. To VAT Credit Rec'ble <u>If asset no longer exists:</u> Profit and Loss A/c Dr. To VAT Credit Rec'ble	Deprn to be charged on revised amt, incl. VAT Appropriate disclosure to be made in a/cs.

Note: In situation (d) above, where the VAT Credit disallowed on Capital Goods is VAT Credit Deferred (Capital Goods) Account and has not be transferred to VAT the former account shall be credited while passing the Journal Entries.

5. **Inventory Valuation Principles:** The principles of inventory valuation are summarized below -

Item Valued	Inventory Valuation Principle
Inputs where VAT Credit Availed	Purchase Price net of Input VAT.
Inputs if VAT Credit Not Availed	Total Purchase Price, including Input VAT. *e.g. purchases without requisite documents for availing VAT credit, purchases from small dealers who are exempted from VAT; purchases from unregistered dealers who are not eligible to issue VAT Invoice etc.*
Final Products	Value of Inputs should be net of VAT on inputs i.e. Purchase Price, net of Input VAT.
Capital Goods, Components etc.	Purchase Price net of Input Duty

6. **Income Accounting:** Sales should be reported net of VAT. Hence, VAT Collection and VAT Payment should **not** be treated as Income and Expense respectively. VAT charged and collected by a dealer on Sales made by him should be credited separately to "VAT Payable Account". When a dealer has not charged VAT separately, but has made a composite charge, he should segregate the portion of Sale Price and VAT Collection at periodic intervals and credit the VAT Collection to "VAT Payable Account".

7. **VAT Refund Accounting:** Input tax which cannot be adjusted against VAT payable over the specified period of time and input tax paid on purchases made for exports, are eligible for refund. Refund of such VAT is recorded by the following entry –

Bank A/c	Dr.	Refund Amount received
To VAT Credit Receivable (Inputs/Capital Goods) A/c		

8. **VAT Credit on Inputs lying in Stock at the beginning of the Scheme:** VAT Credit is also available on tax-paid goods lying in stock at the inception of the VAT Scheme, if required documents are available with the dealer. The suggested accounting treatment is -

Transaction and Entry	Debit	Credit
VAT Credit available on Opening Stock		
VAT Credit Receivable (Inputs) A/c Dr.	If Credit is available immediately	
VAT Credit Deferred (Opening Stock) A/c Dr.	If Credit is available in future	
To VAT Credit Available on Opening Stock		Credit Available

Note:

- A Transfer Entry will be made from VAT Credit Deferred (Opening Stock) A/c to VAT Credit Receivable (Inputs) A/c, as and when VAT Credit on Opening Stock becomes available.
- VAT Credit Available on Opening Stock A/c (Credit Balance) will be shown as a deduction from "Opening Stock" in the Profit and Loss Account.

Illustration 1: VAT Accounting – Inputs / Supplies – Basics

The details of purchases made by a Registered Dealer during March are –

Particulars	Total Purchase Value	Input Tax Paid	Net Balance Amount
4% VAT Goods	Rs.20,80,000	Rs. 80,000	Rs.20,00,000
12.5% VAT Goods	Rs. 18,00,000	Rs.2,00,000	Rs. 16,00,000
VAT Exempt Goods	Rs. 4,00,000	–	Rs. 4,00,000
Total	**Rs.42,80,000**	**Rs.2,80,000**	**Rs.40,00,000**

The above input tax paid is fully eligible for VAT Credit. The details of Sales during this month are -

Particulars	Total Sale Value	Output Tax Collected	Net Sales Consideration
4% VAT Goods	Rs.22,88,000	Rs. 88,000	Rs.22,00,000
12.5% VAT Goods	Rs.20,25,000	Rs.2,25,000	Rs. 18,00,000
VAT Exempt Goods	Rs. 5,00,000		Rs. 5,00,000
Total	**Rs.48,13,000**	**Rs.3,13,000**	**Rs.45,00,000**

Suggest the accounting treatment for the above.

Solution:

S.No.	Particulars	Debit	Credit
1	4% VAT Goods Purchase A/c Dr. 12.5% VAT Goods Purchase A/c Dr. VAT Exempt Goods Purchase A/c Dr. VAT Credit Receivable (Inputs) A/c Dr. To Bank/Suppliers/Sundry Creditors (Being purchases of various goods and input tax thereon paid)	20,00,000 16,00,000 4,00,000 2,80,000	42,80,000
2	Bank/Customers/Sundry Debtors A/c Dr. To 4% VAT Goods Sales A/c To 12.5% VAT Goods Sales A/c To VAT Exempt Sales A/c To VAT Payable A/c (Being sale of various goods and VAT collection thereon)	48,13,000	22,00,000 18,00,000 5,00,000 3,13,000
3	VAT Payable A/c Dr. To VAT Credit Receivable (Inputs) A/c (Being set-off of VAT Credit against liability for VAT payment)	2,80,000	2,80,000
	• At the end of this month, the balance in VAT Payable A/c Rs. 33,000 will be displayed in the B/Sheet under the head **"Current Liabilities".** • The dealer may include the following disclosures in the Notes: (a) Cost of Inventories is net of VAT Credit; (b) Sales are exclusive of VAT.		
4	**For payment of VAT in the subsequent month** VAT Payable A/c Dr. To Bank A/c (Being liability for VAT of previous month, now settled)	33,000	33,000

Illustration 2: VAT Accounting – Capital Goods – Basics

On 1st June, a Registered Dealer purchased a Machinery for Rs.93,60,000 which includes State VAT of Rs.3,60,000. As per the State VAT Laws, the input VAT on Capital Goods is adjustable in 36 equal monthly instalments beginning from 1st July of the year. During the financial year, the dealer has set-off a sum of Rs.25,000 from the VAT Credit Receivable on Capital Goods, against VAT payable on the sales made by him. The dealer charges 10% p.a. depreciation on Machinery. Suggest the accounting treatment for the above.

Solution:

S.No.	Particulars		Debit	Credit
1	Machinery A/c	Dr.	90,00,000	
	VAT Credit Deferred (Capital Goods) A/c	Dr.	3,60,000	
	To Bank/Asset Vendor			93,60,000
	(Being machinery purchased and input tax thereon paid)			
2	VAT Credit Receivable (Capital Goods) A/c	Dr.	90,000	
	To VAT Credit Defeired (Capital Goods) A/c			90,000
	(Being VAT Credit availaole on Capital Goods for the current period i.e. 1st July to 31st March = Rs.3,60,000 x 9/36 = Rs.90,000)			
3	VAT Payable A/c	Dr.	25,000	
	To VAT Credit Receivable (Capital Goods) A/c			25,000
	(Being set-off of VAT Credit against liability for VAT payment)			
4	Depreciation A/c	Dr.	7,50,000	
	To Machinery A/c			7,50,000
	(Being Depreciation on Machinery = Rs.90,00,000 x 10% x 10/12)			

Balance Sheet as on 31st March end of financial year) (abstract)

Liabilities	Rs.	Assets		Rs.
		Fixed Assets: Machinery	90,00,000	
		Less: Depreciation	7,50,000	82,50,000
		Current Assets, Loans and Advances		
		VAT Credit Deferred (Capital Goods)		2,70,000
		VAT Credit Receivable (Capital Goods)		65,000

5.11 Guidance Notes on Derivatives

ACCOUNTING FOR EQUITY INDEX AND EQUITY STOCK OPTIONS

1. Financial Instrument

1. **Meaning:** Financial Instrument is a contract giving rise to a Financial Asset to an enterprise and Financial Liability to another. They include -
   (a) Primary Instruments i.e. Equity Shares, Preference Shares; Debentures etc. and
   (b) Derivative Instruments Options, Futures, Forwards, Swaps etc. However Commodity Derivatives are not Financial Instrument.
2. **Financial Asset:** It includes (a) Cash; (b) Contractual Right to receive cash or other financial asset from another enterprise; (c) Contractual Right to exchange financial instruments with another enterprise which is potentially favourable; and (d) Equity Instruments of another enterprise.
3. **Financial Liability:** It is a contractual obligation to - (a) deliver cash or other financial asset to another enterprise, or (b) to exchange a financial instrument with another enterprise that is potentially unfavourable.

2. Interest Rate Swap.

1. **Nature:** Interest Rate Swap is a financial contract between two parties to exchange a set of payments to minimize the interest cost to either of them.
2. **Exchange of Payment Obligation:** It involves exchange of one interest rate payment with other interest rate payment where the principal (an agreed amount called notional principal) is denominated in the same currency and is of the same value for an agreed period of time.
3. **Interest on Obligations:** One of the payment obligations exchanged will be entail a Floating Rate of Interest and the other will entail a Fixed Rate of Interest Payment.
4. **Swap Bank:** The parties to the Contract upon entering into the Contract, transact the payment obligations through the Swap Bank an intermediary to effect the Interest Rate Swap.

3. Currency Options relating to Foreign Exchange.

1. **Meaning:** Currency options give the client the right, but not the obligation, (a) to buy – in case of a put option; (b) sell - in case of a call option, a specific amount of currency at a specific price on a specific date.
2. **Risk Hedging Tool:** They act as a useful tool to hedge foreign exchange risk arising out of the Firm's operations. They help remove the downside risk without limiting the upride potential.

4. Derivatives: Meaning of Characteristics.

1. **Meaning:**
   (a) Derivative is a product whose value is derived from the value of one or more basic variables called bases i.e. value of an underlying asset.
   (b) Derivative is a forward, future, option or any other hybrid contract of pre-determined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real or financial asset or to an index of securities.

2. **Bases/Underlying Asset:** The underlying asset can be Securities, Commodities, Bullion, Currency, Live-stock (Index) or anything else.
3. **SCRA Definition:** As per Securities Contracts (Regulation) Act, derivative includes -
   (a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; or
   (b) a contract which derives its value from the prices, or index of prices, of underlying securities.
4. **Features:**
   (a) It has one or more underlying asset and one or more notional amounts or payments provisions or both. These terms determine the amount of settlement(s) and in some cases, whether or not settlement is required.
   (b) It requires no initial net investment or an initial net investment that is smaller than what is required for similar responses to change in market factors.
   (c) Its terms require or permit net settlement; it can be readily settled net by means outside the contract or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

5. Futures Contract.

1. Futures Contract means a legally binding agreement to buy or sell the underlying security on a future date.
2. Futures Contracts are the organized/standardized contracts in terms of quantity, quality (in case of commodities), delivery time and place for settlement on any date in future.
3. The contract expires on a pre-specified date which is called the expiry date of the contract. On expiry, futures can be settled by delivery of the underlying asset or cash. Cash settlement enables the settlement of obligations arising out of the future/option contract in cash.

6. (i) 'Option' and 'Option Premium'? (ii) "Buyer or Holder" "Seller or Writer" of an Option? (iii) How Option Contract operates.

1. **Meaning:** Option is a type of derivative instrument whereby a person gets the right to buy or sell at an agreed amount an underlying asset on or before the specified future date.
2. **Buyer/Holder:** The person who gets such right is called 'Buyer' or 'Holder'.
3. **Seller/Writer:** The person against whom the buyer/holder can exercise his right is called 'Seller' or 'Writer'.
4. **Obligation to Buy/Sell:**
   (a) The Buyer/Holder of the Option **has the right but not the obligation to buy or sell.**
   (b) The seller/writer of an option **has no right** but **has an obligation** to sell/buy the underlying asset as and when the buyer/holder exercises his right.
5. **Option Premium:** Option Premium is the price paid by the buyer/holder to the seller writer of an option for acquiring the right of option.
6. **Tenor of Options Contract:** Every option contract is for a specific period of time. On the expiry of the specified period, the contract also expires. The period of time is specified in the contract itself.
7. **Strike Price/Exercise Price:** The price at which the buyer/holder has the right to buy or sell and the seller/writer has an obligation to sell or buy is known as the Strike/Exercise price.
8. **Minimum/Maximum Gain or Loss:** The extent of loss/gain to parties to the Contract is as under –

Party	Buyer	Seller
Loss	Amount of loss is restricted to the premium paid to the Seller of the Option.	Unlimited Loss
Gain	Unlimited Gain	Maximum Gain is limited to the option premium charged by him from the buyer.

9. **Assets traded under Options Contract:** There can be options on commodities, currencies, securities, stock index, individual stock, **etc.**
10. **Futures vs. Options:** In a Futures Contract, both the parties are under obligation to complete the contract on the expiry date. Under Options Contract, the Buyer/Holder has a right, but no obligation to exercise the option, whereas the Seller/Writer has an obligation but no right to complete the contract.

7. Classification of an Options Contract.

Classification of Options Contract

- **Based on time of exercising right**
  - **American Style** Buyer / Holder can exercise his right **at any time before the contract** expires or on expiry date
  - **European Style** Buyer / Holder can exercise his right **only on the expiry date.**
- **Based on the nature of right**
  - **Call Option** Buyer / Holder gets the right to **purchase** the underlying asset.
  - **Put Option** Buyer / Holder gets the right to **sell** the underlying asset.

8. Rights and obligations of the parties involved in an Options Contract.

Option Type	Buyer / Holder	Seller / Writer
Call	• He has a right but not an obligation to buy the underlying asset. • Person buying a call option is considered to have made a 'long call'	• Obligation but no right to sell the underlying asset. • Person selling a call option is considered to have made a 'short call'.
Put	• Right but not an obligation to sell the underlying asset. • Person buying a put option is considered to have made a 'long put'.	• Obligation but no right to buy the underlying asset. • Person selling a put option is considered to have made a 'short put'.

9. Difference between Equity Index Options and Equity Stock Options.

Particulars	Equity Index Options	Equity Stock Options
Meaning	Derivative instruments whereby a person gets the right to buy/sell an agreed amount of equity index on the specified future date.	Derivative instruments whereby a person gets the right to buy/sell an agreed amount of equity stock on or before the specified future date.
Underlying Asset	Equity Index itself.	Equity Shares of a Company.
Time of Settlement	European Style, i.e., Buyer/Holder can exercise his option **only on the day on which the option expires.**	American Style, i.e., the Buyer/Holder can exercise his option at any time before the expiry date or on the date of expiry itself.
Mode of Settlement	Since delivery cannot be made, the difference between the strike/exercise price and the value of the index on the maturity date, is paid or received in cash.	Settlement either through delivery of shares or by payment of the difference between strike/exercise price and the value of the share in cash

10. The concept of 'at the money', 'in the money' and 'out of the money'.

Concept	Call Option	Put Option
At the Money	CMV = Exercise Price of the Option.	CMV = Exercise Price of the Option.
In the Money	CMV > Exercise Price of the Option.	CMV < Exercise Price of the Option.
Out of Money	CMV < Exercise Price of the Option.	CMV > Exercise Price of the Option.

CMV = Current Market Value

11. Key terms in connection with Options Contracts.

Term	Definition
Clearing Corpn. / House	Clearing Corporation/ House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/ Segment.
Clearing Member	Member of the Clearing Corporation and includes all categories of Clearing Members as may be admitted as such by Clearing Corporation to the Derivatives Segment.
Client	Person, on whose instructions and, on whose account, the Trading Member enters into any contract for the purchase/sale of any contract or does any act in relation thereto.
Contract Month	Month in which the Expiry Date falls.
Derivatives Exchange	Exchange approved by SEBI as a Derivative Exchange.
Derivatives Segment	Segment of an existing Exchange approved by SEBI as Derivatives Segment.
Derivatives	Derivatives includes – (a) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security; (b) a contract which derives its value from the prices, or index of prices, of underlying securities.
Exercise Date	Exercise Date is the date on which the buying/selling right in the option is actually exercised by the buyer/holder.
Exercise of an option	Exercise of an option means **enforcing the right** by the buyer/holder under the options contract of buying or selling the underlying asset at the Strike Price.
Expiry Date	Expiry Date is the **last date** on or up to which the option can be exercised.
Final Settlement Price	Final Settlement Price is the closing price of the Equity Index/Stock Option Contract on the last trading day of the contract or such other price as may be specified by the Clearing Corporation/House, from time to time.
Open Options	Total number of Equity Stock/Index Options which have not yet been offset and closed by an Opposite Equity Stock/Index Options nor fulfilled either by delivery of cash or by actual delivery of equity stock.
Trading Member	Member of the Derivatives Exchange/Segment and registered with SEBI.

12. Membership categories in the derivatives market.

The various types of membership in the derivatives market are as follows -

1. **Trading Member (TM) –** Member of the Derivatives Exchange and can trade on his own behalf and on behalf of his clients.
2. **Clearing Member (CM) –** Members permitted to settle their own trades as well as the trades of the other non-clearing members known as Trading Members who have agreed to settle the trades through them.
3. **Self-clearing Member (SCM) –** Clearing Members who can clear and settle their own trades only.

13. Trading mechanism in Equity Index Options and Equity Stock Options.

1. **Trading:** In India, trading in Options is done in a separate segment of existing Stock Exchanges known as 'Derivatives Segment'. A Client can trade in Options only through a Trading Member of the Exchange. A Clearing Member can also act as Trading Member.
2. **Guarantee:** The Clearing Corporation/House of the Exchange may act as legal counter-party to all deals or may provide an unconditional guarantee for all the deals in Options on the Exchange. So, both the parties

(buyer & seller) in an Options Contract would be assured that the obligations of the other party would be met, either by the other party or by the Clearing House by virtue of its guarantee.

3. **Time Period:** Each Exchange introducing trading in Options specifies the period for which such a contract can be entered into. **Example:** "Near Three Months" Contract means that, in January, one would be able to enter into contracts for January, February and March.

4. **Expiry Day:** The contracts will expire on a specified date of every month and the new contracts will be introduced on the next trading day. Example: In National Stock Exchange, the last Thursday of the Contract Month is the expiry date for contract.

5. **Multiplier:** Each exchange permitting trading in Equity Index Options and Equity Stock Options would provide the contract specifications. Such specifications would include size of a market lot for each individual stock.

14. Margin Requirements in respect of Option Contracts.

1. **Margins:** To minimise the risk of failure of parties to a contract in fulfilling their respective obligations under the contract, the Clearing Corporation prescribes margin requirements, including initial margin on Open Interests, and collects them from its Clearing/Trading Members. Clearing/Trading Members would collect margins from their respective clients.

2. **Mode of Payment:** Margins can be paid in any of the following forms - (a) Cash; (b) Provided by way of a Bank Guarantee; (c) Deposit Receipts; (d) Securities; or (e) such other prescribed mode.

3. **Members' Obligation:** The margins paid would be subject to such terms and conditions as the Clearing Corporation may specify from time to time. There is a continuing obligation on the members to maintain margins at the levels during the contract period. The levels are specified by the Clearing Corporation from time to time.

4. **Time of Payment:** Margins are required to be paid at the inception of the option contract (initial margin) as well as on daily basis (daily margin).

5. **Liability to Pay:** It is the Option Seller/Writer who is required to meet the margin requirements as he carries the obligation to perform the contract. The Option Buyer/Holder is not required to meet any margin requirements of the Clearing Corporation, as he possesses a right but no obligation to exercise call or put.

6. **Release of Margin:** If any margin charged by the Clearing Corporation is released, the Clearing Member will credit the account of the respective client.

15. Standard Portfolio Analysis of Risk (SPAN): How to compute-Margin Requirements?

1. **Software:** Standard Portfolio Analysis of Risk (SPAN) is a software used to calculate the margin requirements.

2. **Process:** SPAN calculates risk arrays for all products specified and gives the output in the form of a risk parameters file.

3. **Distribution:** The risk parameters file from SPAN is distributed to all the participants of Derivatives Segment.

4. **Calculation of Margin Requirement** Members, firms, customers, etc., use the data from SPAN risk file, together with their position data, to calculate SPAN margin requirements on their respective positions.

5. **Risk Scenarios:** SPAN calculates margin by determining the worst possible loss using 16 risk scenarios.

16. Premium.

1. **Meaning:** Option Premium is the price paid by the buyer / holder to the seller writer of an option for acquiring the right of option.

2. **Separate Bank Account:** When a person buys or sells options, the premium amount will be debited or credited to the separate bank account of the Clearing Member with the Clearing Corporation.
3. **Day of Credit/Debit:** The day on which the premium is normally debited or credited varies from Stock Exchange to Stock Exchange. Example: At the BSE and the NSE, this premium is normally debited or credited on the next trading day (T + 1 Basis).

17. "Squaring off of the position"?

1. **Meaning:** "Squaring Off of the position" refers to the process of entering a reverse contract, after entering into an option contract, in the same series with the same strike price
2. **Gain / Loss:** The gain or loss of the client will be the difference between the Option Premium Received and Paid after reducing / adding the brokerage charged by the Clearing Member.
3. **Objective:** It is a tool to mitigate the loss to the difference in the premium amounts by squaring off the position before the Expiry Date.
4. **Example:** A buyer/holder having bought S&P CNX NIFTY **call option** of January 2005 series with strike price of Rs. 1,120 can square off his position by **selling/writing** S&P CNX NIFTY call option of January 2005 series with Rs.1,120 as strike price.

18. How the option will be exercised on expiry of Call option/ Put Option?

1. **Call Option:** On the expiry of a call option, if the market price of the underlying asset is lower than the strike price, the call would expire unexercised.
2. **Put Option:** If on the expiry of a put option, the market price of the underlying asset is higher than the strike price, the put option would expire unexercised.
3. **Notice:** When an option Buyer/Holder decides to exercise his option, he gives the exercise notice through the Trading Network during the time specified by the Clearing Corporation.
4. **Assigning Notice:** The Clearing Corporation assigns the exercise notice to the option Seller/Writer through the trading member.
5. **Deemed to be Exercised:** Generally, options which are favourable to the Buyer/Holder on Expiry Date are deemed to be exercised and no special notice is required to be sent by the Buyer/Holder.
6. **Letting go a favourable option:** The Buyer/Holder can let a favourable option expire unexercised upon intimation to the Stock Exchange.

19. The Accounting treatment for payment of margin on Equity Index/Stock Options.

1. **Accounting Entry:** The following Journal Entry should be passed in the books of the Seller/Writer:

	Transaction	Accounting Entry
(a)	**Payment** of Margin	Equity Index Option/Stock Option Margin A/c Dr. To Bank Account
(b)	**Receipt** of Margin	Bank Account Dr. To Equity Index Option/Stock Option Margin A/c
(c)	**Lumpsum Deposit** of Margin Money (instead of paying/receiving on a daily basis)	Deposit for Margin A/c Dr. To Bank Account

	Transaction	Accounting Entry
(d)	**Payment** of Margin **adjusted** against Deposit	Equity Index Option/Stock Option Margin A/c Dr. To Deposit for Margin A/c
(e)	**Receipt** of Margin **adjusted** against Deposit	Deposit for Margin A/c Dr. To Equity Index Option/Stock Option Margin A/c

2. Disclosure in the Balance Sheet:

(a) **Equity Index/Stock Option Margin Account:** In the Balance Sheet, the balance in Equity Index/Stock Option Margin Account should be shown separately under "Current Assets".

(b) **Deposit for Margin Account:** At the year-end, any balance in the "Deposit for Margin Account" should be shown as a deposit under the head "Current Assets".

20. Entries for payment/receipt of Equity Index or Equity Stock Option Premium.

1. **Liability to Pay Premium:** The Buyer/Holder of the option is required to pay the premium.

2. **Accounting Treatment:** The accounting treatment in the books of the Buyer and Seller are as under –

Party	Buyer / Holder	Seller / Writer
Journal Entry for Premium	Equity Index/Stock Option Premium A/c Dr. To Bank	Bank Account Dr. To Equity Index/Stock Option Premium
Provision for Loss at year-end	**Amount of Provision =** Premium Paid Less Premium prevailing on the B/S date.	**Amount of Provision =** Premium prevailing on B/S date **Less** Premium received.
Journal Entry for Provision	Profit and Loss A/c Dr. To Provn for Loss on EIO/ESO	Profit and Loss A/c Dr. To Provn for Loss on EIO/ESO
Disclosure of unexpired options (Open Contracts)	**Assets Side: Current Assets:** Balance in "EIO/ESO Premium A/c" **Less:** Provn for Loss on EIO/ESO	**Liabilities Side: Current Liabilities** Balance in "EIO/ESO Premium A/c" **Plus:** Provision for Loss on EIO/ESO

3. **Multiple Options:** In case of multiple options, entries recommended above at the inception of the contract may be made in one "Equity Index/Stock Options Premium Account" in respect of options of all scrips. The amount of provision required in respect of each scrip or index should be aggregated and a composite "Provision for Loss on Equity Index/Stock Options Account" should be created by debiting the P&L A/c.

4. **Adjustment of Opening Balance:** Opening balances, if any, in the "Provision for Loss on Equity Index/Stock Options Account" should be adjusted against the current year provision.

21. Arunavo furnishes the following information about all options at the Balance Sheet Date. Determine the amount of provision to be made in his books of account.

Securities	L	K	J
Details of Options Bought			
Premium Paid	**20,000**	**10,000**	**10,000**
Premium prevailing on Balance Sheet date	**30,000**	**5,000**	**8,000**
Details of Options Sold:			
Premium Received	**10,000**	**30,000**	**10,000**
Premium prevailing on Balance Sheet date	**25,000**	**20,000**	**15,000**

Solution:

Determination of Provision Required in the Books of Ajay (Rs.)

Particulars	L	K	J
For Options Bought:	20,000	10,000	10,000
Premium Paid on all Open Options Bought	(30,000)	(5,000)	(8,000)
Less: Total premium prevailing on Balance Sheet Date			
Total (A)	**(10,000)**	**5,000**	**2,000**
For Options Sold:	25,000	20,000	15,000
Total premium prevailing on the Balance Sheet Date	10,000	30,000	10,000
Less: Total premium received on all Open Options sold			
Total (B)	**15,000**	**(10,000)**	**5,000**
Provision required = A + B	**5,000**	**NIL (Note)**	**7,000**
Aggregate Provision to be made (Rs.5,000 + Rs.7,000)		**12,000**	

Note:

1. **Multiple Option:** At the year-end, a **Stockwise provision** should be made **considering all open options** of any strike price and any expiry date under that stock/index taken together.
2. **Stock Q:** The aggregate amount for Stock Q constitutes an unrealized gain and therefore no provision should be made under consideration of prudence.

22. Accounting entries to be passed when the Multiple Open Options are settled.

Party	Buyer / Holder	Seller / Writer
Effect of Settlement	Buyer exercises his option only if it is favourable. Hence, the settlement results only in **profit.** Consequently, the difference amount is **received** by the Buyer.	Buyer exercises his option only if it is favourable to him. Hence, the settlement results only in a loss to the Seller. So, the difference amount is paid by the Seller.
Recognition of Premium	Profit and Loss A/c Dr. To Equity Index/Stock Option Premium A/c	Equity Index/Stock Option Premium A/c Dr. To Profit and Loss A/c
Settlement of Difference	Bank A/c Dr. To Gain on EIO/ESO A/c	Loss on EIO/ESO A/c Dr. To Bank

Party	Buyer / Holder	Seller / Writer
Margin released by Clg Corpn	*Buyer would not have paid any margin to Clearing Corporation. Hence no entry.*	Bank A/c Dr. To EIO/ESO Margin A/c

Note:

- **Squaring off of Transactions:** For calculating Profit or Loss in case of outstanding multiple options of the same scrip/index with the same **Strike Price** and the **same Expiry Date**, Weighted Average Method should be followed on squaring off of transactions.
- **Exercise of Options before Expiry Date:** For determining the Profit or Loss in case of outstanding multiple Equity Stock Options of the same **scrip, strike price** and **expiry date,** Weighted Average Method should be followed, if such options are exercised before the expiry date.

23. In respect of Equity Stock Options, what is the accounting treatment for options which are settled by actual delivery?

If the option is exercised, shares will be **transferred in consideration for cash at the strike price.** Theaccounting treatment in this case will be as under –

Party	Buyer / Holder	Seller / Writer
Call Option	Equity Shares of... Ltd A/c Dr. To Bank A/c (Being **receipt** of Equity Shares and **payment** of amounts due to Seller)	Bank A/c Dr. To Equity Shares of Ltd A/c (Being **delivery** of Equity Shares and receipt of amount due from the Buyer)
Put Option	Bank A/c Dr. To Equity Shares of Ltd A/c (Being **delivery** of Equity Shares and **receipt** of amount due from the Seller)	Equity Shares of... Ltd A/c Dr. To Bank A/c (Being **receipt** of Equity Shares and **payment** of amounts due to Buyer)

Note: Apart from the above, entries for transfer of balance in Option Premium Account to the Profit and Loss Account, Receipt of Margin etc. should also be passed.

24. Disclosure requirements applicable to Equity Index and Equity Stock Options.

1. **Accounting Policies and Method:**
   (a) Accounting Policies and the methods adopted for Equity Index Options and Equity Stock Options.
   (b) Criteria for recognition and the basis of measurement applied for Equity Index Options and Equity Stock Options.
2. **Margin Money Paid by Bank Guarantee/Lodging of Securities:** The following should be disclosed in respect all outstanding contracts at the year end:
   (a) Amount of Bank Guarantee.
   (b) Book Value and Market Value of Securities Lodged.
3. **Details of Outstanding Option Contracts:**
   (a) Name of the Equity Option Index
   (b) Total Premium carried forward as at the year end after adjustment of Provision for Losses.

Illustration 1: Settlement of Call Option.

Mr. Investor buys a stock option of Z Ltd. in July 2008 with a Strike Price on 30th July, 2008 Rs.250 to be expired on 30th August, 2008. The premium is Rs.20 per unit and the market lot is 100. The margin to be paid is Rs.120 per unit. Show the accounting treatment in the books of Buyer when:

(a) the option is settled by delivery of the asset, and

(b) the option is settled in cash and the Index price is Rs.260 per unit.

Solution:

Journal Entries in the Books of Investor/Buyer

1. When the option is settled by delivery of the asset

S. No.	Particulars	Debit Rs.	Credit Rs.
1 30.7.08	Equity Stock Option Premium (Z Ltd.) A/c Dr. To Bank Account (Being Premium Paid on Stock Option of Z Ltd. purchased at Rs.20 per unit for 100 units constituting one lot)	2,000	 2,000
2 30.8.08	Equity Shares of Z Ltd. A/c Dr. To Bank A/c (Being Call Option exercised and the shares acquired)	25,000	 25,000
3 30.8.08	Profit & Loss A/c Dr. To Equity Stock Option Premium (Being Premium on option written off on exercise of option)	2,000	 2,000

Note: No entries have passed in respect of Margin Payments. This is because, the buyer of the option contract is not required to pay any margins.

2. When the option is settled in cash and the Index Price is Rs. 260 per unit

S.No.	Particulars	Debit Rs.	Credit Rs.
1 30.7.08	Equity Stock Option Premium (Z Ltd.) A/c Dr. To Bank Account (Being Premium Paid on Stock Option of Z Ltd. purchased at Rs.20 per unit for 100 units constituting one lot)	2,000	 2,000
2 30.8.08	Bank A/c Dr. To Profit & Loss A/c (Being the profit on exercise of option received. Profit = Market Lot of 100 x (Index Price of Rs.260 Less Strike Price of Rs.250)	1,000	 1,000
3 30.8.08	Profit & Loss A/c Dr. To Equity Stock Option Premium (Being Premium on option written off on exercise of option)	2,000	 2,000

Illustration 2: Open Contracts - Disclosure in Balance Sheet

Devdas buys the following Equity Index Option and the seller/writer of this Option is Nitin.

Date of Purchase	28.03.2009
Type of Options	S&P CNX NIFTY - Call
Expiry date	31.05.2009
Premium per unit (Rs.)	15
Contract Multiplier (No. of units)	2,000
Margin per unit (Rs.)	150
Strike price (Rs.)	880

Margin calculated by SPAN is as follows:

On 29.03.2009 is Rs.3,50,000; On 30.03.2009 is Rs.2,50,000; On 31.03.2009 is Rs.2,70,000;

On 31.3.2009, the prevailing Premium Rate for the above option is Rs.12.50 Per Unit.

Give the accounting treatment in the books of both the parties. Also, show the B/Sheet (as at 31.3.2009) extract containing the appropriate disclosure of balance in Margin A/c.

Solution:

1. Books of Devdas (Buyer / Holder)

(a) Journal Entries

S.No.	Particulars	Debit Rs.	Credit Rs.
1 28.3.09	Equity Stock Option Premium A/c Dr. To Bank Account (Being Premium Paid on Stock Option purchased at Rs.15 per unit for 2,000 units constituting one lot)	30,000	 30,000
2 31.3.09	Profit and Loss A/c Dr. To Provision for Loss on Equity Stock Option A/c [Being amount provided for loss on Equity Stock Option A/c to the extent of Rs.2.50 per unit (Premium Paid Rs.15.00 Less Premium Prevailing Rs. 12.50) for 2,000 Units]	5,000	 5,000

Note: No entries have passed in respect of Margin Payments. This is because the buyer of the option contract is not required to pay any margins.

(b) Extract of Balance Sheet of Puru as at 31st March, 2009

Liabilities	Rs.	Assets	Rs.	Rs.
		Current Assets, Loans and Advances		
		(A) Current Assets		
		Equity Index Option Premium	30,000	
		Less: Provision for Loss	(5,000)	25,000

2. Books of Nitin (Seller / Writer)

(a) Journal Entries

S.No.	Particulars	Debit Rs.	Credit Rs.
1 28.3.09	Bank A/c Dr. To Equity Stock Option Premium A/c (Being premium received on Stock Option sold at Rs.15 per unit for 2,000 units constituting one lot)	30,000	30,000
2 28.3.09	Equity Index Option Margin A/c Dr. To Bank A/c (Being Initial margin paid on option contract at Rs.150 per unit for 2,000 units)	3,00,000	3,00,000
3 29.3.09	Equity Index Option Margin A/c Dr. To Bank A/c (Being further margin collected by the Stock Exchange as per SPAN i.e. Rs.3,50,000 - Rs.3,00,000)	50,000	50,000
4 30.3.09	Bank A/c Dr. To Equity Index Option Margin A/c (Being refund of extra margin received from the Stock Exchange as per SPAN i.e. Rs.2,50,000 - Rs.3,50,000)	1,00,000	1,00,000
5 31.3.09	Equity Index Option Margin A/c Dr. To Bank A/c (Being further margin collected by the Stock Exchange as per SPAN i.e. Rs.2,70,000 - Rs.2,50,000)	20,000	20,000

(b) Extract of Balance Sheet of Krish as at 31st March, 2009

Liabilities	Rs.	Assets	Rs.
Current Liabilities and Provisions: Equity Stock Option Premium A/c	30,000	**Current Assets, Loans and Advances** (A) Current Assets Equity Index Option Margin	2,70,000

Illustration 3: Options Trading

On the basis of the following information related to trading in Options, you are required to pass relevant Journal Entries (at the time of inception and at the time of final settlement) in the books of Aman (Buyer) and Suman (Seller). Assume that the price on expiry is Rs.950/- and both Aman and Suman follow the calendar year as an accounting year.

Date of Purchase	Option Type	Expiry Date	Premium per unit	Contract Lot	Multiplier
29.03.2008	Equity Index, Call	31.05.2008	Rs.10	2000 units	Rs.850 p.u

Solution:

1. In the books of Aman (Buyer)

S. No.	Particulars	Debit Rs.	Credit Rs.
29.03.08	Equity Index Option Premium A/c Dr.	20,000	
	To Bank A/c		20,000
	(Being premium paid on Equity Stock Options)		
31.05.08	Profit and Loss A/c Dr.	20,000	
	To Equity Index Stock Option A/c		20,000
	(Being premium on option written off on expiry)		
31.05.08	Bank A/c Dr.	2,00,000	
	To Profit and Loss A/c		2,00,000
	(Being profit on exercise of option received = 2,000 units * (Rs.950 - Rs.850)) (Exercise Price - Spot Price)		

2. In the books of Suman (Seller)

S. No.	Particulars	Debit Rs.	Credit Rs.
29.03.08	Bank A/c Dr.	20,000	
	To Equity Index Option Premium A/c		20,000
	(Being premium on Option collected)		
31.05.08	Profit and Loss A/c Dr.	2,00,000	
	To Bank A/c		2,00,000
	(Being loss on Option paid)		
31.05.08	Equity Index Option Premium A/c Dr.	20,000	
	To Profit and Loss A/c		20,000
	(Being premium on option recognized as income)		

2. Accounting for Equity Index Futures

1. Equity Index Futures (EIF).

1. **Derivatives** are a kind of financial instruments whose values change in response to the change in specified variable e.g. interest rates, security prices, commodity prices, index of prices or rates, or similar variables.

2. Equity Index Futures are a type of financial instruments/**derivatives**, which are bought or sold with specific motives like speculation, hedging and arbitrage.

3. EIF Contract represents a Futures Contract, where the underlying asset is **an Equity Index Future**, e.g. S&P CNX NIFTY Index, BSE 30 SENSEX etc.

4. Trading in the index reflects the views of the parties to the contract about the movement in the index. For example, if two persons enter into an EIF contract of one month's maturity at a price of Rs. 1,000 per unit, it means that the Buyer expects that the price of equity index at the time of maturity of the contract would be higher than Rs. 1,000 while the Seller expects it to be less than Rs. 1,000.

2. Forward Contract and Futures Contract.

Point	Forward Contract	Futures Contract
Meaning	Agreement between two parties to buy or sell an asset at a certain time in future for an agreed price (called Delivery Price).	Agreement between two parties to buy or sell an underlying asset (generally Equity Index) at a certain time in future for an agreed price.
Trading Place	There is no specific place for trading. It can be traded like any other commodity.	Normally traded on an Exchange.
Settlement	At maturity, the contract is settled by delivery of the asset by the seller to the buyer in return for payment of the Delivery Price.	EIF contract is settled by payment of difference between the price per unit as agreed in the contract and the value of the index on the maturity date. There is **no "delivery"** as such.
Exchange Regulations	Stock Exchange may not prescribe detailed regulations/features for Forward Contracts.	Stock Exchange may prescribe certain standardized features for a Futures Contract, including guarantee mechanism in order to minimize the risk of default by parties.

3. Key terms used in relation to EIF Contracts.

Term	Definition
Clearing Corporation/House	Clearing Corporation/House approved by SEBI for clearing and settlement of trades on the Derivatives Exchange/Segment.
Clearing Member	Member of the Clearing Corporation and includes all categories of Clearing Members as may be admitted as such by the Clearing Corporation to the Derivatives Segment.
Client	Person, on whose instructions and, on whose account, the Trading Member enters into any contract for the purchase or sale of any contract or does any act in relation thereto.
Contract Month	Month in which the Exchange/Clearing Corporation Rules require a contract to be **finally settled.**
Daily Settlement Price	Closing Price of the EIF Contract **for the day** or such other price as may be decided by the Clearing House from time to time.
Derivative Exchange/ Segment	Exchange/Segment approved by SEBI as a Derivative Exchange / Segment.
Final Settlement Price	**Closing Price** of the EIF Contract **on the last trading day** of the contract or such other price as may be specified by the Clearing Corporation, from time to time.
Long Position (in a EIF Contract)	**Outstanding Purchase Obligations** in respect of the EIF contract at any point of time.
Open Interest	It refers to the total number of EIF Contracts that have - 1. Not yet been offset and closed by an opposite EIF Contract; or 2. Not yet been fulfilled by delivery of cash.
Settlement Date	Date on which the **outstanding obligations** in an EIF contract are **required to be settled** as provided in the byelaws of the Derivatives Exchange / Segment.
Short Position (in a EIF Contract)	**Outstanding Sale Obligations** in respect of an EIF Contract at any point of time.
Trading Member	Member of the Derivatives Exchange/Segment and registered with SEBI.

4. Trading Mechanism in Equity Index Futures.

1. **Trading:** In India, trading in EIF is done in a separate segment of existing Stock Exchanges known as 'Derivatives Segment'. A Client can trade in EIF only through a Trading Member of the Exchange. A Clearing Member can also act as Trading Member.
2. **Guarantee:** The Clearing Corporation/House of the Exchange may act as legal counter-party to all deals or may provide an unconditional guarantee for all the deals in EIF on the Exchange. So, both the parties (buyer & seller) in an EIF contract would be assured that the obligations of the other party would be met, either by the other party or by the Clearing House by virtue of its guarantee.
3. **Time Period:** Each Exchange introducing EIF trading specifies the period for which such a contract can be entered into. Example: "Near Three Months" Contract means that, in January, one would be able to enter into contracts for January, February and March.
4. **Expiry Day:** The contracts will expire on a specified date of every month and the new contracts will be introduced on the next trading day. **Example:** In National Stock Exchange, the last Thursday of the Contract Month is the expiry date for contract.
5. **Multiplier:** Each Exchange permitting EIF trading would provide the contract specifications, e.g. National Stock Exchange permits a contract multiplier of 200 for the S&P CNX NIFTY Futures Contracts.

5. Margin Requirements in Equity Index Futures.

1. **Margins:** To minimise the risk of failure of parties to a contract in fulfilling their respective obligations under the contract, the Clearing Corporation prescribes margin requirements, including initial margin on Open Interests, and collects them from its Clearing/Trading Members. Clearing/Trading Members would collect margins from their respective clients.

2. **Mode of Payment:** Margins can be paid in any of the following forms - (a) Cash; (b) Provided by way of a Bank Guarantee; (c) Deposit Receipts; (d) Securities; or (e) such other prescribed mode.

3. **Members' Obligation:** The margins paid would be subject to such terms and conditions as the Clearing Corporation may specify from time to time. There is a continuing obligation on the members to maintain margins at the levels during the contract period. The levels are specified by the Clearing Corporation from time to time.

6. Daily Settlement Price and Daily Settlement Mechanism.

1. **Meaning:** Daily Settlement Price is the **Closing Price** of the EIF Contract **for the day** or such other price as may be decided by the Clearing House from time to time.

2. **Settlement Price:** All outstanding contracts (both Long and Short) of a Clearing Member in an EIF Contract would be deemed to have been settled at the Daily Settlement Price.

3. **Settlement of Dues:**

(a) **Amount of Settlement:** The Trading Member would be liable to pay to/entitled to collect from, the Clearing House the difference between the -

- Purchase/Sale Price of the contract and the Daily Settlement Price of that day; or
- Previous Day's Settlement price and Trading Day's Settlement Price.

(b) **Payment Mode:** The daily settlement obligation would be paid only in Cash.

(c) **Long or Short:** After settlement with the Clearing House, the Member would be deemed to be long or short, as the case may be, in contracts at the Daily Settlement Price.

Example: A Member buys one unit of an Equity Index Future of April Series (one-month) on 29th March for Rs. 1,420. The daily differences will be settled between the Member and the Clearing House as under-

Closing Price of Date	Assumed Price of EIF	Effect (called as Mark-to-Market Margin)
29th March	Rs. 1,400	Dealer should pay Rs.20 to the Clearing House.
30th March	Rs. 1,435	Dealer should receive Rs.35 from the Clearing House.
31th March	Rs. 1,430	Dealer should pay Rs.5 to the Clearing House.

The differences would be debited/credited to the separate Bank Account maintained by the Clearing Member with the Clearing Corporation. The Clearing Member would in turn, debit/credit the Bank Account of the Trading Member, who in turn would debit/credit the Bank Account of the Client.

Clearing Corporation ⟶ Clearing Member ⟶ Trading Member ⟶ Client

4. **Reverse Contracts:** At any time during the currency of the contract, either party to an EIF can square up its future obligations under the contract, by entering into a reverse contract, e.g. a buyer of 300 units of EIF under (say) August series can enter into a contract for sale of 300 units of EIF of the same series. On entering into reverse contracts, the loss/gain of purchase and sales contracts, offset each other automatically.

5. **Non-Payment of Dues by Clients:** In case of non-payment of daily settlement dues by clients, before the next trading day, the Clearing Member would be at liberty to close out the transactions by selling or buying the index futures contracts, as the case may be. Loss incurred in this regard would be borne by Client and met out of the margin moneys given by the Client, while gains if any, would accrue to the Client.

7. Accounting treatment at the inception of EIF Contract in the books of the Client.

1. **Accounting Entries:** No entry is made for recording the contract of Purchase/Sale of EIF, at its inception, except for payment of Margin Moneys. The following entry should be passed for payment of - (a) Initial Margin determined by the Clearing Corporation/House for entering into EIF Contracts; and (b) Additional Margins paid, if any.

Initial Margin - Equity Index Futures A/c	Dr	XXX	
To Bank Account			XXX

Note: No entry is passed when the amount due under the margin is furnished in the form of a Bank Guarantee or when it is furnished by lodging Securities.

2. **Disclosure Requirements:**

   (a) **Initial Margin/Additional Margin:** The balance in the "Initial Margin - EIF A/c" should be shown separately under **"Current Assets"** in the Balance Sheet.

   (b) **Amount paid in excess of Initial/Additional Margin:** Where any amount has been paid in excess of the initial/additional margin, the excess should be disclosed separately as a **"Deposit"** under the head **"Current Assets".**

   (c) **Bank Guarantee/Lodging of Securities:** Where the Client provides bank guarantees or lodges securities with the member, a disclosure should be made in the "Notes" to the Financial Statements of the Client.

8. Accounting treatment in case of payment/receipt of Mark-to-Market Margin at the time of daily settlement.

1. **Objective:** Mark-to-Market Margin is collected to cover the notional loss, which a member or his client would incur if the net cumulative outstanding transactions in all securities are closed out at the Closing Price of the relevant trading date, which is different from the Transaction Price.

2. **Computation of Margin Amount:**

   (a) For Buy Position: (Actual Trade Price Less Closing Price) x Cumulative Buy Position.

   (b) For Sell Position: (Closing Price Less Actual Trade Price) x Cumulative Sell Position.

3. **Accounting Entries:**

	Transaction	Accounting Entry
(a)	**Payments made** on account of Daily Settlement by the Client	Mark-to-Market Margin - EIF A/c Dr. To Bank Account
(b)	**Payments received** on account of Daily Settlement by the Client	Bank Account Dr. To Mark-to-Market Margin - EIF
(c)	**Depositing a lumpsum amount** with the Broker/Trading Member for Mark-to-Market Margin Money	Deposit for Mark-to-Market Margin - EIF A/c Dr. To Bank Account
(d)	**Transfer** from Deposit A/c to Margin A/c for **payment of Margins**	Mark-to-Market Margin - EIF A/c Dr. To Deposit for Mark-to-Market Margin - EIF A/c
(e)	**Transfer** from Deposit A/c to Margin A/c **for receipt of Margins**	Deposit for Mark-to-Market Margin - EIF A/c Dr. To Mark-to-Market Margin - EIF A/c

4. **Disclosure:** At the year-end, balance in the "Deposit for Mark-to-Market Margin Account" should be shown as a "Deposit" under "Current Assets" in the Balance Sheet.

9. Open Interests accounted for as on the Balance Sheet date

Accounting treatment for balances in "Mark-to-Market - EIF A/c".

Mark-to-Market Margin - EIF A/c	Debit balance	Credit balance
1. Meaning of Dr. / Cr. Balance	**Net Amount paid** on the basis of movement in the prices of index futures till the B/Sheet date.	**Net Amount received** on the basis of movement in prices of index futures till the B/Sheet date.
2. Accounting Treatment	**Provision** should be created by debiting the P&L A/c, for anticipated loss equivalent to the net payment made to the Broker.	Net amount received being anticipated profit should be **ignored.**
3. Disclosure in Balance Sheet	Disclosed as **"Current Assets,** Loans and Advances'' **Less** Provision thereon.	Disclosed as Current Liability under **"Current Liabilities and Provisions''.**

10. Accounting treatment at the time of final settlement or at the time of squaring-up of the contract.

1. **Profit or Loss:** Profit/Loss on Final Settlement is determined at the expiry of a series of EIF Contracts as -**Profit/(Loss)** = Final Settlement Price **Less** Contract Prices of all the contracts in the series.

2. **Weighted Average:** If more than one contract in respect of the relevant series of EIF Contract is outstanding at the time of the squaring up of the contract, the contract price of the contract so squared-up, should be determined using Weighted Average Method for calculating Profit / Loss on squaring-up.

3. **Accounting Entries:**

	Transaction	Accounting Entry
(a)	**Recognizing Profit** on Final Settlement in the P&L Account	Mark-to-Market Margin - EIF A/c Dr. To P&L A/c (Profit on Final Settlement A/c)
(b)	**Recognizing Loss** on final settlement in the Profit and Loss Account **(provision for loss not created)**	P & L A/c (Loss on Final Settlement A/c) Dr. To Mark-to-Market Margin - EIF A/c
(c)	**Recognizing Loss** on final settlement in the Profit and Loss Account **(provision for loss created)**	Provision for Loss on Final Settlement (upto avlble amt) Dr. P & L A/c (Loss on Final Settlement A/c) (bal. figure) Dr. To Mark-to—Market Margin - EIF A/c
(d)	**Release of Initial Margin** paid on Equity Index Futures Account on Final Settlement, **if received**	Bank A/c Dr. To Initial Margin - Equity Index Futures A/c
(e)	**Release of Initial Margin** paid on EIF Account on Final Settlement, **if adjusted through Deposit Account**	Deposit for Mark-to-Market Margin - EIF A/c Dr. To Initial Margin - Equity Index Futures A/c

11. Accounting Treatment in case Client defaults in making payment in respect of Daily Settlement?

When a Client defaults in making payment in respect of a Daily Settlement, the contract is closed out. The accounting entries are given below –

	Transaction	Accounting Entry
(a)	Adjustment of amount not paid, against the initial margin	Mark-to-Market Margin - Equity Index Futures A/c Dr. To Initial Margin - Equity Index Futures A/c
(b)	**Release of initial margin** in excess of amount adjusted against Mark-to-Market Margin not paid, if received	Bank Account Dr. To Initial Margin - Equity Index Futures A/c
(c)	**Release of initial margin** in excess of amount adjusted against Mark-to-Market Margin not paid, **if adjusted through Deposit Account**	Deposit for Mark-to-Market Margin - EIF A/c Dr. To Initial Margin - Equity Index Futures A/c

Note:

- **Excess Liability:** Where the amount to be paid on daily settlement exceeds the initial margin, the excess is a liability and is shown under "Current Liabilities and Provisions", if it continues to exist on the B/Sheet date.
- **Profit/Loss on Contract:** The Profit/Loss on the contract so closed out should be calculated and recognised in the Profit and Loss Account in the same manner as in the case of squaring up of a contract.

12. Disclosure requirements for Equity Index Future Contracts.

1. **Margin Money Paid by Bank Guarantee/Lodging of Securities:** The following should be disclosed in respect all outstanding contracts at the year end –

   (a) Amount of Bank Guarantee.
   (b) Book Value and Market Value of Securities Lodged.

2. **Details of Contracts:**
   (a) Total number of contracts entered during the year.
   (b) Gross number of units of Equity Index Futures bought in respect of each series.
   (c) Gross number of units of Equity Index Futures Sold in respect of each series.

3. **Details of Outstanding Contracts:**
   (a) Number of Equity Index Futures contracts not settled (Open Interests).
   (b) Number of units of Equity Index Futures pertaining to outstanding contracts.
   (c) Daily Settlement Price as at the Balance Sheet date separately for Long and Short Positions, in respect of each series of Equity Index Futures.

Illustration 1: Arpita furnishes the following details about purchase of Equity Index Futures (EIF)

Date of Purchase	Name of Future	Expiry Date/ Series	Contract Price per unit (Rs.)	Contract Multiplier (No. of Units)
28.3.2009	ABC	May 2009	1,420	200
29.3.2009	CKD	June 2009	4,280	50
29.3.2009	ABC	May 2009	1,416	200

Daily Settlement Prices of the above units of Equity Index Futures were as follows:

Date	ABC May Series	CKD May Series
28.3.2009	1410	-
29.3.2009	1428	4300
30.3.2009	1435	4270
31.3.2009	1407	4290
01.4.2009	1415	4250
02.4.2009	1430	-
03.4.2009	1442	-

The contracts were settled as under:

(a) CKD June Series were settled on 1.4.2009.

(b) A contract of 200 units of ABC May Series were settled on 2.4.2009.

(c) The other contract of ABC May Series was settled on 3.4.2009.

Arpita had to pay a Initial Margin of Rs.5,000 by Cash on the inception of contract for ABC May 2009 Series Equity Index Futures.

Required:

1. Journal Entries in the books of Arpita.

2. Mark-to-Margin Account.
3. Balance Sheet extract showing treatment of Mark-to-Margin Account.

Solution:

1. Computation of Mark-to-Market Margin Money Receivable/Payable on Daily Settlement

Date	ABC May Series (Rs.)		CKD June Series (Rs.)		Net Amount (Rs.)	
	Receive	Pay	Receive	Pay	Receive	Pay
28.03.2009	-	2,000	—	—	—	2,000
29.03.2009	6,000	—	1,000	—	7,000	—
30.03.2009	2,800	—	—	1,500	1,300	—
31.03.2009	—	11,200	1,000	—	—	10,200
01.04.2009	3,200	—	—	2,000	1,200	—
02.04.2009	6,000	—	—	—	6,000	—
03.04.2009	2,400	—	—	—	2,400	—

Date	Units	DSP	Contract Price/ Previous DSP	Receive/(Pay)	Units	DSP	Contract Price/ Previous DSP	Receive/(Pay)
1	2	3	4	5 = (3 - 4) x 2	6	7	8	9 = (7 - 8) x 6
28.03.2009	200	1,410	1,420	(2,000)	—	—	—	—
29.03.2009	200 200	1,428 1,428	1,410 1,416	-3,600- 2,400 = **6,000**	50	4,300	4,280	**1,000**
30.03.2009	400	1,435	1,428	**2,800**	50	4,270	4,300	**(1,500)**
31.03.2009	400	1.407	1,435	**(11,200)**	50	4,290	4,270	**1,000**
01.04.2009	400	1,415	1,407	**3,200**	50	4,250	4,290	**(2,000)**
02.04.2009	400	1,430	1,415	**6,000**	—	—	—	–
03.04.2009	200	1,442	1,430	**2,400**	—	—	—	—

2. Mark-to-Market Margin - EIF A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
28.3.2009	To Bank	2,000	29.3.2009	By Bank	7,000
31.3.2009	To Bank	10,200	30.3.2009	By Bank	1,300
			31.3.2009	By Balance c/d	3,900
	Total	**12,200**		**Total**	**12,200**
1.4.2009	To balance b/d	3,900	1.4.2009	By Bank A/c	1,200
2.4.2009	To Profit & Loss A/c	2,400	1.4.2009	By Provn. for Loss - EIF A/c	1,500
3.4.2009	To Profit & Loss A/c	4,800	2.4.2009	By Bank A/c	6,000
			3.4.2009	By Bank A/c	2,400
	Total	**11,100**		**Total**	**11,100**

3. Accounting Entries in the Books of Shiva: (financial year ending 31.3.2005)

Date	Particulars		Debit Rs.	Credit Rs.
28.3.2009	Initial Margin - Equity Index Futures A/c	Dr.	5,000	
	To Cash Account			5,000
	(Being initial margin money paid in cash)			
28.3.2009	Mark-to-Market Margin - EIF A/c	Dr.	2,000	
	To Bank A/c			2,000
	(Being Net Margin Money paid for the day)			
29.3.2009	Bank A/c	Dr.	7,000	
	To Market-to-Margin - EIF A/c			7,000
	(Being Net Margin Money received for the day)			
30.3.2009	Bank A/c	Dr.	1,300	
	To Market-to-Market Margin - EIF A/c			1,300
	(Being Net Margin Money received for the day)			
31.3.2009	Market-to-Market Margin - EIF A/c	Dr.	10,200	
	To Bank A/c			10,200
	(Being Net Margin Money paid for the day)			
31.3.2009	Profit & Loss A/c	Dr.	3,900	
	To Provision for Loss on EIF A/c			3,900
	(Being Provision created for amount equal to debit balance in Mark-to-Margin for anticipated loss)			

4. Balance Sheet of Mr. Shiva as at 31.3.2009 (Extract)

Liabilities	Rs.	Assets	Rs.	Rs.
		Current Assets, Loans and Advances		
		(A) Current Assets		
		(B) Loans and Advances		
		Initial Margin - EIF A/c		5,000
		Mark-to-Margin - EIF A/c	3,900	
		Less: Provision for Loss - EIF A/c	(3,900)	NIL

5. Notes to the Financial Statements as at 31.3.2009

(a) The following Equity Index Futures contracts have Open Interests as on the Balance Sheet date:

Name of Future	ABC	CKD
Series of Future	May 2009	June 2009
Nature of Position (Long/Short)	Long	Long
Number of Contracts	2	1
Number of Units involved	400	50
Daily Settlement Price as on Balance Sheet date (Rs.)	1407	4290

(b) Initial margin on Equity Index Futures Contracts has been paid in cash only.

(c) No Equity Index Futures Contract has been settled during the year.

6. Accounting Entries in the books of Arpita: (financial year ending 31.3.2010)

Date	Particulars	Debit Rs.	Credit Rs.
1.4.2009	Bank A/c Dr. To Mark-to Market Margin - EIF A/c (Being Net Margin Money received for the day)	1,200	 1,200
1.4.2009	Provision for Loss - EIF A/c To Market-to-Margin - EIF A/c (Being loss on settlement of PQR June 2009 Series)	1,500	 1,500
2.4.2009	Bank A/c Dr. To Market-to-Market Margin - EIF A/c (Being Net Margin Money received for the day)	6,000	 6,000
2.4.2009	Market-to-Market Margin - EIF A/c Dr. To Profit & Loss A/c (Being profit on settlement of ABC May 2009 Series - Lot 1)	2,400	 2,400
3.4.2009	Bank A/c Dr. To Market-to-Market Margin - EIF A/c (Being Net Margin Money received for the day)	2,400	 2,400
3.4.2009	Market-to-Market Margin - EIF A/c Dr. To Profit & Loss A/c (Being profit on settlement of ABC May 2009 Series - Lot 2)	4,800	 4,800
3.4.2009	Bank A/c Dr. To Initial Margin - EIF A/c (Being receipt of Initial Margin)	5,000	 5,000

7. Computation of Profit / Loss arising on settlement or squaring up of the contract

Name of the EFI	CKD	ABC (Lot 1)	ABC (Lot 2)
Series	June 2009	May 2009	May 2009
Date of Settlement	1.4.2009	2.4.2009	3.4.2009
Contract Price Per Unit	Rs.4,280	Rs.1,418 (See Note)	Rs.1,418 (See Note)
Settlement Price per unit (in Rs.)	Rs.4,250	Rs. 1,430	Rs. 1,442
Profit/(Loss) per unit	(Rs.30)	Rs.12	Rs.24
Number of units	50	200	200
Total Profit/(Loss)	(Rs. 1,500)	Rs.2,400	Rs.4,800

Note: For ABC EIF, weighted average price should be considered for Contract Price Per Unit. Weighted Average Price = [(Rs. 1,420 x 200 Units of Lot 1) + (Rs. 1,416 x 200 Units of Lot 2)] ÷ [Lot 1 200 + Lot 2 200] = Rs.1,418.

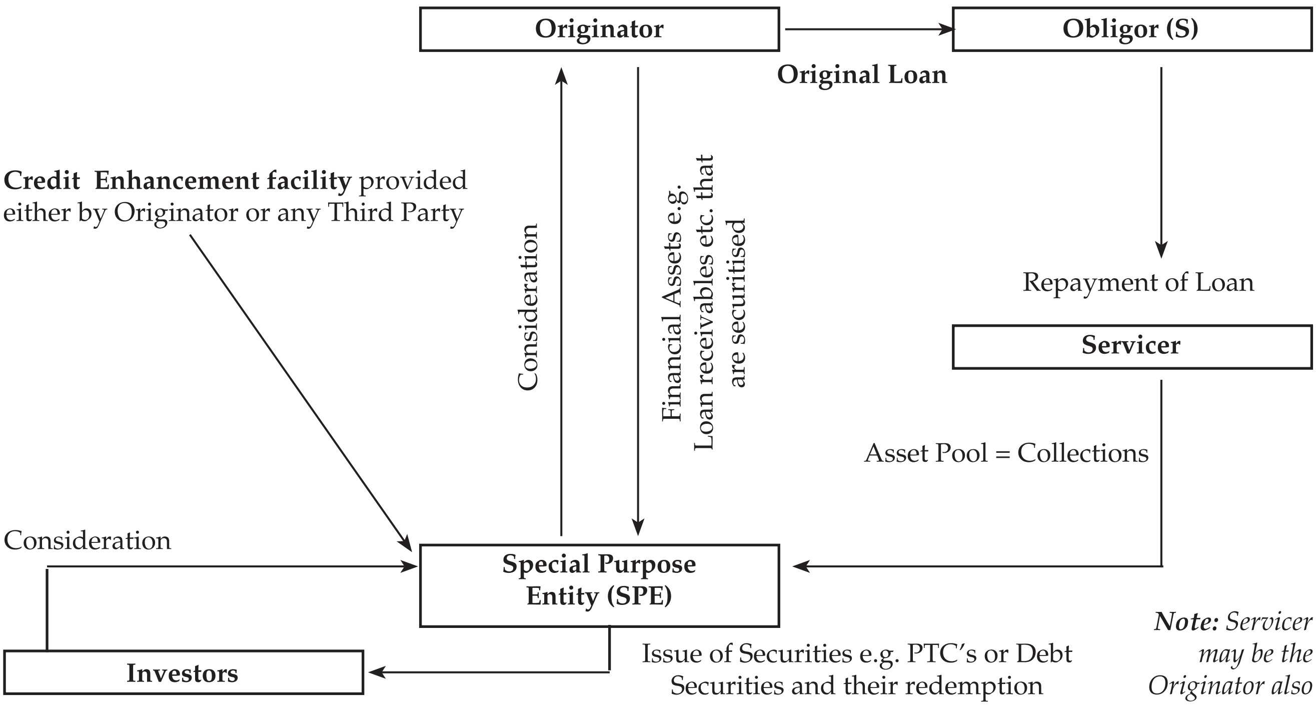
5.12 Guidance Notes for Special Businesses / Reports

1. ACCOUNTING FOR SECURITISATION

1. Securitisation Process:

1. **Securitisation:** Securitisation is the process by which financial assets (e.g. Loan Receivables, Mortgage backed receivables, Credit Card balances, Hire Purchase Debtors, Trade Debtors etc.) are transformed into securities. Securitisation is different from Factoring since the latter involves transfer of debts without transformation thereof into securities.

2. **Securitisation Flow:** The parties involved and the Securitisation Process is described as under -



Note: *Servicer may be the Originator also*

3. **Securitisation Process:**
   - **(a) Initial Lending Function:** Originator gives various Loans to different Borrowers (Obligors). Borrowers have to repay the loans in EMI's (Interest + Principal). These EMI's constitute financial assets/receivables for the Originator.
   - **(b) Securitisation Function:** Financial Assets/Receivables or defined rights therein, are transferred, fully or partly, by the Originator to a SPE. SPE pays the Originator immediately in cash or in any other consideration for taking over the financial assets. The assets transferred are termed **'Securitised Assets'** and the assets or rights retained by the Originator are called **'Retained Assets'**.
   - **(c) Financing Function:** SPE finances the assets transferred to it by issue of securities such as Pass Through Certificates (PTCs) and/or debt securities to Investors.

2. Features of Securitisation.

1. **Servicing:** The Originator may continue to service the securitised assets i.e. collect amounts due from borrowers, etc.), with or without servicing fee for the same. Sometimes, the Servicer may be an entity other than the Originator.

2. **Future Receivables:** The Originator may securitise or agree to securitise future receivables, i.e., receivables that are not existing at the time of agreement but which would be arising in future. In case of such, securitisation, the future receivables are estimated at the time of entering into the transaction and the purchase consideration for the same is received by the Originator in advance.

3. **Revolving Period Securitisation:** Future Receivables can be transferred as and when they arise, or at specified intervals, the transfers being on pre-arranged terms.

4. **Credit Enhancement:** It is an arrangement designed to protect the Investors (i.e. holders of the securities issued by an SPE) from losses and/or cash flow mismatches arising from shortfall or delays in collections from the securitised assets. The arrangement often involves one or more of the following –

   (a) **Cash Collateral:** Deposit of cash which can be used by the SPE, in specified circumstances, for discharging its financial obligation on its securities held by the investors.

   (b) **Over Collaterisation:** Assets in excess of the securitised assets are made available to the SPE, so that their realisation can be used to fund the shortfalls and/or mismatches in fulfilment of SPE's financial obligations.

   (c) **Recourse Obligation:** Obligation accepted by the Originator of the Securitisation Process.

   (d) **Third Party Guarantee:** Guarantee given by any Third Party, to meet any shortfall on the part of the SPE in meeting its financial obligations in respect of the securitisation transaction.

   (e) **Structuring of instruments:** Instruments issued by an SPE are structured into Senior Securities (issued to Investors) and Subordinate Securities (issued to Originators). Payments on subordinated securities are due only after the amounts due on the senior securities are discharged.

   Note: *Credit Enhancement facility can be provided either by the Originator himself or by any Third Party.*

3. Terms used in relation to Securitisation Process.

Call Option	An option that entitles the Originator to repurchase the Financial Assets transferred under a securitisation transaction from the SPE. The Option may be at a predetermined price or at a value to be determined, for example, fair value on the date of exercise of Call Option.
Clean-up Call Option	• An option which entitles the Servicer (who may be the Originator) to purchase the remaining transferred securitised assets or beneficial interests in the SPE. • The Servicer may use this option if the cost of servicing those assets or beneficial interests exceeds the benefits of servicing them.
Interest Strip	A contractual arrangement to **separate** the right to all or part of the **interest due** on a Debenture, Bond, Mortgage Loan or other interest bearing financial asset from the financial asset itself.
Investor	Persons who finance the acquisition of the securitised assets/beneficial interest therein by subscribing to PTCs/debt securities issued by an SPE.
Originator	Entity that owns the financial assets proposed to be securitized, and initiates the process of securitisation in respect of such assets.
Pass Through Certificates	Instruments acknowledging a beneficial interest in the securitised assets. Payment of interest on such instruments and the repayment of the principal are directly or indirectly linked to realisations from the underlying securitised assets. **(PTCs)**
Principal Strip	Right to the remainder of the financial asset, net of all rights that have been stripped therefrom by one or more contractual arrangements like the Interest Strip.

Recourse Obligation	It is an obligation of the Originator to - (a) Reimburse or compensate, fully or partly, the shortfall to the Investors; or (b) bear the risk of shortfalls, such as those arising from - • Failure of debtors to pay or to pay when due; • Pre-payments; or • Other defects in secuntised financial assets.
Servicing Asset	• A contract to service financial assets under which the estimated future revenues from servicing fees, late charges and other related revenues are expected to more than adequately compensate the Servicer (who may be the Originator) for performing the services. • A Servicing Contract can be either - (a) undertaken together with selling/securitising the financial assets being serviced; or (b) purchased or assumed separately.
Special Purpose Entity (SPE)	An independent entity, which acquires the financial asset under securitisation and holds them till maturity. SPE is generally constituted as a Trust. It may also be constituted in other forms like a Limited Company formed with a small capital, for the specific purpose of funding the transaction by issue of PTC's or Debt Securities.

4. Principles of derecognition of Securitised Asset in the books of Originator.

1. **Derecognition Criterion:** Securitised Assets should be **derecognized** in the Originator's Books, if and only if the Originator loses control of the contractual rights that comprise the securitised asset, either by a single transaction or by a series of transactions taken as a whole. The Originator loses such control if it surrenders the rights to benefits specified in the contract.

2. **Analysis of Conditions:** Whether or not the Originator has lost control over the securitised asset should be determined on the basis of the facts and circumstances of the case by considering all the evidence available. If the position of either the Originator or SPE indicates that the Originator has retained control, the Originator **should not remove** the securitised asset from its balance sheet.

3. **No Loss of Control:** The Originator will not be deemed to have lost control over the securitized asset, in each of the following cases – *(Hence, derecognition may not be permissible in the following cases)*

   (a) **Creditors' Rights:** Creditors of the Originator are entitled to attach or otherwise deal with the securitised assets;

   (b) **No Rights to SPE:** SPE does not have the right (to the extent it was available to the Originator) to pledge, sell, transfer or exchange for its own benefit the securitised asset;

   (c) **Resumption of Control:** Originator has the right to reassume control of the securitised asset except –

   - Where it is entitled to do so by a Call Option, where such Call Option can be justified on its own commercial terms as a separate transaction between the SPE and the Originator, e.g. Where the Call Option is exercisable at fair value of the asset on the date of exercise of the Option; or
   - Where it is entitled to do so by a Clean-up Call Option.

4. **Originator's Obligation of Repurchase:**

   (a) **Obligation Only:** Sometimes the securitised asset may be beyond the control of the Originator, but the Originator may be under an obligation (not an entitlement) to repurchase the Securitised Asset at a later date, at a specified price. Such obligation accepted by the Originator should be accounted for as per AS - 4 and a provision should be created for the contingent loss arising from the obligation.

   (b) **Obligation-cum-Entitlement:** Where the Originator is both entitled and obligated to repurchase the securitised asset at a pre-determined price, the Originator has not lost control over the securitised asset. So, it **should not be removed (i.e. should not be derecognized)** from the Originator's Balance Sheet.

5. Accounting treatment for Securitised Asset in the books of an Originator?

Particulars	Derecognition Criterion met	Derecognition Criterion not met
Treatment of Consideration	Difference between Book Value of Securitised Asset and consideration received should be disclosed separately as Gain/Loss arising arising on securitization, in the **P&L** Account.	Asset should continue to be recognised in the books of Originator. Consideration received for the transferred assets, should be accounted as a Borrowing secured against the Securitised Assets.
Expenses on Transactions e.g. Legal Fee	Should be **expensed** at the time of the transaction and should not be deferred.	Should be either amortised over the term of the Secured Borrowing or recognized immediately in the P & L Account.
Disclosure in P&L Account	• Gain (Cr.) [or] Loss (Dr.) on Securitisation; • Expenses on Transaction **(fully)** (Dr.)	Expenses on Transaction (Dr.) - • either **fully** w/off in year of transaction; • or amortization share for the year.
Disclosure in Balance Sheet	Securitised Assets will not be shown in the Originator's Balance Sheet.	• **Assets Side:** Securitised Assets. • **Liabilities Side:** Secured Loans from SPE (Secured against Securitised Assets)
Recourse Obligation	Contingent Loss arising therefrom should be recognized by creating a provision as per AS-4.	

6. Accounting for Future Receivables /Revolving Securitisation.

Particulars	Future Receivables	Revolving Securitisation
Consideration from SPE	Receivables that are not existing at the time of agreement but which would be arising in future are securitized. Consideration therefor is received by the Originator **in advance.**	Financial Assets are transferred as and when they come into existence or at specified intervals. Consideration is paid to the Originator **at the time of such transfer.**
Accounting Treatment	• Consideration received by Originator should be accounted for as an **Advance.** • Derecognition principles will be applicable as and when the relevant assets come into existence.	All accounting requirements applicable for regular Securitisation (like derecognition, expenses on transaction etc.) except those applicable to Future Receivables, apply to Revolving Securitisation also.

7. Measurement & Recording the consideration received by the Originator?

1. **Consideration:** Consideration given by SPE to the Originator may consist of- (a) Cash or (b) Non-Cash items (e.g. Securities issued by SPE).

2. **Measurement of Consideration:** While Cash Consideration is directly determinable, the Non-Cash component of the consideration should be measured at the lowest of–

   (a) Fair Value of the non-cash component;

   (b) Net Book Value of the securitised assets as reduced by the cash received; and

   (c) Net Realisable Value of the securitised assets as reduced by the cash received.

3. **Fair Value:** Fair Value is the price agreed upon between knowledgeable, willing parties in an Arm's Length Transaction. Fair Value is determined based on the following principles –

Situation	Fair Value =
Where Quoted Market Price in an active, liquid and freely accessible market is **available**	Quoted Market Price
Where Quoted Market Price is not available	• Value based on the market prices of assets similar to those received as consideration, if available, **[or]** • Value based on generally accepted valuation techniques e.g. Present Value of Estimated Future Cash Flows.

8. Partial Derecognition: The accounting requirements?

1. **Partial Securitisation:** The Originator may sometimes transfer only a part of the financial asset in a securitisation transaction instead of transferring the complete asset. This may be done either by - (a) Transfer of Proportionate Share in the asset; (b) Transfer of one or more benefit streams in the asset.
2. **Accounting Treatment:** The accounting treatment for part transfer is described as under –

Particulars	Transfer of Proportionate Share in the asset	**Transfer of one or more of benefit streams** (Interest Strip, Principal Strip, etc.) **in the asset:**
Explanation	Transfer of proportionate share of loan (including right to receive both interest and principal), in such a way that all future cash flows, profit/loss arising on loan will be **shared** by Originator and SPE in **fixed proportions.**	Originator may securitise the Principal Strip of the loan while retaining the Interest Strip and Servicing Asset.
Accounting	• Part of the original asset which meets the derecognition criteria set out above should be derecognized. • The remaining part (not transferred) should continue to be recognized in the books. • If any new interest has been created as a result of the securitization transaction (e.g. Call Option), such new interest should also be recognized as per accounting principles.	
Carrying Amount	Previous Carrying Amount of the asset is apportioned among the part transferred and the part retained in the **agreed ratio** e.g. 60% for Originator and 40% for SPE. 60% will be derecognized while 40% of the previous carrying amount will be retained in B/Sheet.	Carrying Amount of the financial asset should be apportioned between the part(s) transferred and the part(s) retained on the basis of their **relative fair values** as on the date of transfer.

Note: If Fair Value of the part of the asset that is retained cannot be measured reliably, that part should be valued at a nominal value of Re.l.

9. Priyanka Ltd. holds Rs.10,000 of loans yielding 18% interest p.a. for their estimated lives of 9 years The Fair Value of these loans, after considering the interest yield is estimated at Rs.11,000.

The Company securitises the principal component of the loan plus the right to receive interest at 14% to Gunjan Corporation, a Special Purpose Entity, for Rs.10,000/-.

Out of the balance interest of 4%, it is stipulated that half of such balance interest, namely 2%, will be due to Priyanka as fees for continuing to service the loans. The Fair Value of the servicing asset so created is estimated at Rs.350. The remaining half of the interest is due to Arul as an interest strip receivable, the Fair Value of which is estimated at Rs.650.

Give the accounting treatment for the above.

1. Fair Value of securitised component of Loan

Particulars		Rs.	Rs.
	Fair Value of Loan		11,000
Less:	Fair Value of Servicing Asset	350	
	Fair Value of Interest Strip	650	1,000
	Fair Value of securitised component of Loan		**10,000**

2. Apportionment of Carrying Amount based on Relative Fair Values

Particulars	Fair Values Rs.	% to Total Fair Value	Proportionate Carrying Amount Rs.
(1)	(2)	(3)	(4) = Rs. 10,000 x (3)
Fair Value of Securitised Component of the Loan	10,000	90.91%	9,091
Fair Value of Servicing Asset	350	3.18%	318
Fair Value of Interest Strip	650	5.91%	591
Total Fair Value	**11,000**	**100.00%**	**10,000**

3. **Profit on Securitisation** = Net Proceeds from Securitisation **Less** Apportioned Carrying Amount

= Rs. 10,000 Less Rs.9,091 = **Rs.909**

4. Journal Entries in the books of Originator

S.No.	Particulars	Debit Rs.	Credit Rs.
1	Bank A/c Dr.	10,000	
	To Loans (Cost of Securitised Component)		9,091
	To Profit on Securitisation		909
	(Being Securitisation of Principal and right to 14% interest)		
2	Servicing Asset A/c Dr.	318	
	Interest Strip A/c Dr.	591	
	To Loans		909
	(Being creation of Servicing Asset and Interest Strip Receivable)		

10. Accounting treatment of Securitisation Transactions in the books of SPE.

1. **Asset Recognition:** The SPE should recognise the asset received under a securitisation transaction, if the Originator loses control over the securitised asset, as per the conditions described earlier.

2. **Consideration:** The asset so received should be recognised at the **amount of consideration**, if paid in cash. In case of **non-cash consideration,** the asset should be recorded either at its intrinsic value or at the fair value of the consideration, whichever is more clearly evident. If both the values are equally evident the asset should be valued at the **lower** of the two values.

3. **No Control Rights to SPE:** The SPE **should not recognise** the asset received if– (a) beneficial ownership in the securitised asset has not been transferred to the SPE; or (b) the Originator has not lost control over the asset. In such case, the consideration paid to the Originator should be recorded as a lending secured against the financial asset received under securitisation transaction.

4. **Amounts received under PTC:** Amount received by the SPE (from Investors) on issue of PTCs or other Debt Securities should be shown on the **Liability Side** of the Balance Sheet, properly describing its stature.

11. Accounting treatment for Securitisation in the books of the investor.

1. **AS - 13:** The Investor should account for the PTCs and/or debt securities acquired by it as an investment as per AS - 13, 'Accounting for Investments'.
2. **Other Accounting Principles:** Where AS - 13 is not applicable because the Investor is specifically exempted from the application of AS - 13, the investments in PTCs and/or other securities should be valued and accounted for as per the relevant accounting principles applicable to the Investor.

12. Disclosure requirements in the Financial Statements of various parties.

Originator	Special Purpose Entity	Investor
• Nature and extent of securitisation transaction(s), including the financial assets that have been derecognised. • Nature and amounts of the new interests created, if any. • Basis of determination of fair values, wherever applicable.	• Nature of the securitisation transaction(s) including, in particular, a description of the rights of the SPE vis-a-vis the Originator whether arising from the securitisation transaction or a transaction associated therewith. • Basis of determination of fair values, wherever applicable.	• Disclosure of investments in PTCs and/or debt securities as per AS - 13. • Where Investor is specifically exempted from the application of AS - 13, the Investor should make suitable disclosures as per the relevant requirements.

Note: In the Financial Statements of the Originator, Contingent Loss arising from Recourse Obigation should be recognized by creating a provision therefor as per AS - 4.

2. ACCOUNTING FOR OIL & GAS PRODUCING ACTIVITIES

1. Introduction.

1. **Applicability:** This Guidance Note applies to costs incurred on acquisition of mineral interests in properties, exploration, development and production of oil and gas activities, i.e., upstream operations of E & P Industry. The Guidance Note deals with accounting aspects of such costs, but does not apply to –
   (a) Accounting and reporting issues relating to the transporting, refining and marketing of oil and gas;
   (b) Activities relating to the production of natural resources other than oil and gas; and
   (c) Production of geothermal steam or the extraction of hydrocarbons as a by-product of the production of geothermal steam or associated geothermal resources.

2. Terms and Definitions:

Term	Definition
Cost Centre	Unit identified to capture costs based on suitable criteria such as geographical or geological factors, e.g. a field or a country.
Field	Area consisting of a reservoirs) related to individual geological structural feature and/or stratigraphic condition.
Reservoir	Porous and permeable underground formation containing a natural accumulation of producible oil or gas that is confined by resistant rock or water barriers and is individual and separate from other reservoirs.
Unit of Production (UOP) method	Method where is calculated on the basis of the number of production or similar units expected to be obtained from the asset by the enterprise.
Abandon	To discontinue attempts to produce oil and gas from a mining lease area or a well and to plug the reservoir as per regulatory requirements and salvage all recoverable equipments.

Block	A defined area for purposes of licensing or leasing to an enterprise or enterprises for exploration, development and production rights.
Bottom-Hole Contributions	• Money or property paid to an operator for use in drilling a well on property in which the payer has no property interest. The payer may receive proprietary information on the well's potential productivity. • Such contributions are payable when the well reaches a pre-determined depth, regardless of whether the well is productive or non-productive.
Condensate	Low vapour pressure hydrocarbons obtained from Natural Gas through condensation or extraction and refer solely to those hydrocarbons that are liquid at normal surface temperature and pressure conditions.
Dry Hole Contribution	Contribution made by one enterprise to costs incurred by another enterprise that is drilling a nearby well to obtain information from the enterprise drilling the well. It is generally made when the well is complete and is found to be unsuccessful.
Geological and Geophysical Studies	Processes which seek surface or subterranean indications of earth structure or formation where experience has shown the possibility of existence of mineral deposits.
Geological Survey	Exploratory programme directed to examination of rock and sediments obtained by boring or drilling, or by inspection of surface outcroppings.
Geophysical Survey	Study of the configuration of the earth's crust in a given area, as determined by the use of seismic, gravity, magnetic and geo-chemical procedures.
Mining Lease	License issued for offshore and onshore properties for conducting development and production activity.
Natural Gas Liquids (NGL)	Hydrocarbons (primarily ethane, propane, butane and natural gasoline) which can be extracted from wet natural gas and become liquid under various combinations of increasing pressure and lower temperature.
Petroleum Exploration License (PEL)	License issued for offshore and onshore properties for conducting exploration activity; issued by Central Government for off-shore properties and respective State Government for on-shore properties.
Support Equipment and Facilities	Equipment and facilities of the nature of service units, camp facilities, godowns (for stores and spares), workshops (for equipment repairs), transport services (trucks and helicopters), catering facilities and drilling and seismic equipment.
Work-Over	Remedial work to the equipment within a well, the well pipework or relating to attempts to increase the rate of flow.

2. Oil and Gas Reserves: Classification.

1. **Meaning:** Oil and Gas Reserves are those quantities of mineral oil, natural oil and natural gas liquids, which are anticipated to be **commercially recoverable** from known accumulations from a given date onward. Estimation of all oil and gas reserve involves some degree of uncertainty, depending upon availability of reliable geological and engineering data at the time of the estimate and interpretation of data.

2. **Classification:** Based on relative degree of uncertainty, Oil and Gas Reserves can be classified as –

Oil and Gas Reserves

Proved Oil and Gas Reserves

Those which are **reasonably certain** to be commercially recoverable in future from known oil and gas reservoirs.

Unproved Oil and Gas Reserves

Those the recoverability of which has **not been proved with reasonable certainty.**

further classified into

Proved Developed Oil and Gas Reserves

Reserves that can be expected to be recovered through **existing wells** with **existing equipment** and operating methods.

Proved Undeveloped Oil and Gas Reserves

Reserves that are expected to be recovered from -

- **new wells on un-drilled acreage,** or
- existing well for which a relatively major expenditure is required for recompletion

Note:

- Additional Oil and Gas expected to be obtained should be included as "Proved Developed Reserves" only– (i) after testing by a pilot project; or (ii) after the operation of an installed programme has confirmed though production response that increased recovery will be achieved.
- Reserves on un-drilled acreage should be limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Other reserves can be claimed only if it can be demonstrated with certainty that there is continuity of production from existing productive formation.
- Estimates for Proved Undeveloped Reserves should not include any acreage for which an application of advanced recovery technique is contemplated unless such techniques have been proved effective by actual tests in the area and in the same reservoir.

3. Different types of "Wells" in the context of exploration activities.

Well Type	Description
Development Well	It is a well which is drilled, deepened, completed or recompleted within a **proved area** of an oil or gas reservoir, to the depth of a stratigraphic horizon known to be **productive.**
Service Well	It is a well drilled or completed for the purpose of **supporting production** in an existing field e.g. wells for purposes like gas injection (natural gas, propane, butane or flare gas), water injection, steam injection, air injection, polymer injection, salt-water disposal, water supply for injection, observation or injection for combustion.
Stratigraphic Test Well or Expendable Well	• It is a drilling effort, geologically directed, to obtain information pertaining to a specific geologic condition. • They are drilled **without the intention of being completed** for hydrocarbon production. They include wells identified as core tests and all types of expendable holes related to hydrocarbon exploration. • These Wells are classified as - (a) Development-Type Stratigraphic Test Well (**drilled** in a proved area) and (b) Exploratory-type Stratigraphic Test Well (**not drilled** in a proved area).

Exploratory Well	- It is drilled for the purpose of **searching** undiscovered oil and gas accumulations on any geological prospect. An exploratory well is a well that which is not a Development Well or Service Well or Stratigraphic Test Well.
Appraisal Well	It is a a well drilled as part of an **appraisal drilling programme** to determine the physical extent of oil and gas reserves and likely production rate of a field.
Dry Hole	A well which has proved to be non-productive.

4. Petroleum Industry (E&P Industry): Cost Classification.

The costs of E&P Industry are classified based on the nature of activities as under –

Activities	Brief description of Activity	Treatment
1. Acquisition Activities	Towards **acquisition right(s)** to explore, develop and produce oil and gas.	**Capitalised initially;** Depreciation (Depletion) charged to cost of oil and gas produced based on Units **of Production** Method.
2. Exploration Activities	Towards **prospecting activities** conducted in the search for oil and gas.	
3. Development Activities	**Development** activities for extraction of oil & gas.	
4. Production Activities	**Operation and Maintenance** an enterprise's wells and related equipment and facilities, including depreciation and operating costs.	Added to the cost of oil and gas produced, as on **Operating Revenue Cost.**

1. Acquisition Activities:

Description of Activity	Costs incurred
- Identification of areas of oil and gas finds. - Approaching the owner who owns the rights for the exploration, development and production of the under ground minerals in the respect of the property or area. - Obtaining a License (PEL) from State/Central Government for surveys and exploration. - Obtaining a Mining Lease (ML) for engaging, in development and production activities.	- All costs incurred to purchase, lease etc. to **acquire a property** or mineral right; - Costs incurred in **acquiring the right** to explore, drill and produce oil and gas; - Initial Costs (and **not** Annual License Fees) incurred for obtaining the PEL / LOA and ML. - Lease Bonus, Brokers' Fees, Legal Costs, Cost of temporary occupation of land, Crop Compensation paid to farmers etc.

2. Exploration Activities:

Description of Activity	Costs incurred
- Aerial, Geological, Geophysical, Geochemical, Palaeontological, Palynological, Topographical and Seismic surveys, analysis, studies and their interpretation; - Investigations relating to the subsurface geology including structural test drilling; - Exploratory type stratigraphic test drilling; - Drilling of exploration and appraisal wells and other activities such as surveying; - Drill site preparation and all work necessarily connected therewith for the purpose of oil and gas exploration.	All direct and allocated indirect expenditure of exploration activities including– - Costs of surveys and studies, rights of access to properties to conduct those studies and salaries and other expenses of geologists, geophysical crews and other personnel conducting those studies; (G & G Costs) - Costs of carrying and retaining undeveloped properties, such as delay rental, *ad valorem* taxes on properties, legal costs for title defence, maintenance of land and lease records and annual licence fees in respect of PEL; - Dry Hole and Bottom Hole Contributions; - Costs of drilling and equipping exploratory and appraisal wells; and - Costs of drilling exploratory-type stratigraphic test wells.

3. Development Activities:

Description of Activity	Costs incurred
• Purchase, shipment or storage of equipment and materials used in developing oil and gas accumulations; • Completion of successful exploration wells; • Drilling, completion, re-completion and testing of development wells; • Drilling, completion, and re-completion of service wells; • Caying of gathering lines; • Construction of offshore platforms and installations, installations of separators, tankages, pumps, artificial lift; • Other producing and injection facilities required to produce, process and transport oil or gas into main oil storage or gas processing facilities, either onshore or offshore; and • Laying of infield pipelines, the installation of the storage or gas processing facilities.	• Costs incurred to gain access to and prepare well locations for drilling; • Costs of surveying well locations for the purpose of determining specific development drilling sites, clearing ground, draining, road building and relocating public roads, gas lines and power lines necessary to develop proved oil and gas reserves; • Drill and equip development wells, development-type stratigraphic test wells and service wells, cost of platforms and of well equipment e.g. casing, tubing, pumping equipment and the wellhead assembly; • Costs incurred to acquire, construct and install production facilities like lease flow lines, separators, treaters, heaters, manifolds, measuring devices and production storage tanks, natural gas cycling and processing plants and utility and waste disposal systems; • Costs of providing advanced recovery system. • Depreciation Cost and Operating Cost of support equipment and facilities in connection with development activities, and annual license fees for Mining Lease.

4. Production Activities:

Description of Activity	Costs incurred
• **Pre-Wellhead Activity:** Lifting the oil and gas to the surface, operation and mainenance of wells, extraction rights, etc;	• **Pre-Wellhead costs:** Labour, R & M, materials, supplies, fuel and power, property taxes, insurance, severance taxes, royalty, etc., in respect of lifting the oil and gas to the surface, operation and maintenance including servicing and work-over of wells.
• **Post-Wellhead Activity:** Gathering, treating, field transportation, field processing, etc. upto the outlet valve on the lease or field production storage tank, etc.	• **Post-Wellhead costs:** Labour, R&M, materials, supplies, fuel and power, property taxes, insurance, etc., in respect of gathering, treating, field transportation, field processing, including cess upto the outlet valve on the lease or field production storage tank, etc.

5. Methods of capitalisation of Acquisition, Exploration and Development Costs?

Acquisition, Exploration & Development Costs can be capitalized using - (1) Successful Efforts Method **(SEM)** and (2) Full Cost Method **(FCM)**. The accounting treatment under these methods are compared below –

1. **Capital WIP:** The following costs should be treated as **"Capital WIP"** of a Cost Centre **when incurred -**

Successful Efforts Method (SEM)	Full Cost Method (FCM)
(a) **All** Acquisition Costs;	(a) **All** Acquisition Costs;
(b) Exploration Costs **for -** (i) drilling and equipping exploratory and appraisal wells; & (ii) drilling exploratory-type stratigraphic test wells;	(b) **All** Exploration Costs;
(c) **All** Development Costs.	(c) **All** Development Costs.

2. **Charging off as Expense:**

Successful Efforts Method (SEM)	Full Cost Method (FCM)
• **General:** Costs incurred for purposes other than acquisition, exploration & development should be charged as expense when incurred. • **No Proved Reserves:** If the cost of drilling exploratory well relates to a well that is **determined to have no proved reserves,** then such costs net of any salvage value should be transferred from Capital Work in Progress and charged as **expense.**	Costs incurred for purposes other than acquisition, exploration and development should be charged as expense when incurred.

3. **Capitalisation / Transfer:**

Successful Efforts Method (SEM)	Full Cost Method (FCM)
• **Acquisition Costs: Entire Cost** should be capitalised from Capital WIP to the "Gross Block of Assets". • **Exploration & Development Costs:** Costs relating to **"Proved Developed Oil and Gas Reserves"** should be capitalised as **'Completed Wells'** from Capital WIP, when a well is ready to commence commercial production or within 2 yrs from date of completion of drilling, whichever is earlier. **Note:** Costs can be carried over for more than 2 years only if - (a) presence of proved reserves can be **reasonably demonstrated;** and (b) development of the field in which the well is located has been **planned** with required capital investment.	• **Commercial Production:** When any well in a cost centre is ready to commence commercial production, the costs corresponding to all the proved oil and gas reserves in that cost centre should be capitalised from Capital WIP. • **Reserves proved subsequently:** If oil and gas reserves are proved subsequently, Capital WIP relating to such reserves should be capitalised at the time when the said reserves are proved. • **Unsuccessful Efforts:** Expenditure which does not result in discovery of proved oil and gas reserves should be transferred from Capital WIP to the "Gross Block of Assets" as and when **so determined.**

4. **Depreciation under Units of Production Method:** Under SEM, Depreciation is calculated separately for – (a) Acquisition Costs and (b) Other Costs. *See separate question below*

5. **Suggested Method:** The Guidance Note recommends the use of **SEM as the preferred method,** though the use of FCM is also permitted. Change from FCM to SEM can be made, and with **retrospective effect only**. The change will be treated as a change in accounting policy and AS - 5 and the resulting deficiency/surplus should be charged/credited to the P & L A/c in the year of such change.

6. Depreciation charged under SEM and FCM?

1. **Depreciation under SEM:** The Depreciation Charge within a cost Centre is determined as under–

Item	For Acquisition Costs	For Other Costs
Depreciation Rate (UOP Rate)	$\frac{\text{Acquisition Cost of the Cost Centre}}{\text{Proved Oil and Gas Reserves}}$	$\frac{\text{Depreciation Base of the Cost Centre}}{\text{Proved Developed Oil and Gas Reserve}}$
Depreciation (UOP) Charge for the period	UOP Rate x Production for the period	UOP Rate x Production for the period .

Notes:

(a) **Depreciation Base** for the Cost Centre is calculated as under

	Gross Block of the cost centre **(excluding Acquisition Costs)**	xxxx
Add:	Estimated Dismantlement and Abandonment costs (Net of estimated salvage values) pertaining to Proved Developed Oil and Gas Reserves	xxxx
Less:	Accumulated Depreciation	(xxxx)
Less:	Accumulated Impairment Charge ofthe Cost Centre	(xxxx)
	Depreciation Base for the Cost Centre	xxxx

(b) **Proved Oil and Gas Reserves =** Proved Oil and Gas Reserves estimated at the end of the period + Production during the period.

(c) **Proved Developed Oil and Gas Reserves is calculated as under-**

	Proved Developed Oil and Gas Reserves estimated at the end ofthe period	xxxx
Add:	Production during the period	xxxx
Add:	Additional reserves from advanced recovery techniques (only if the required investments have been capitalized)	xxxx
	Proved Developed Oil and Gas Reserves	xxxx

2. **Depreciation under FCM:** Depreciation Charge for all costs within a cost centre is determined as under –

Depreciation (UOP) Rate = Depreciation base ofthe Cost Centre # Proved Oil and Gas Reserves.

Depreciation (UOP) charge for the period = UOP Rate x Production for the Period.

Notes:

(a) **Depreciation Base** of the Cost Centre is calculated as under –

	Gross Block ofthe Cost Centre	xxxx
Add:	Estimated Dismantlement and Abandonment Costs (Net of estimated salvage values) for facilities set up for developing Proved Oil and Gas Reserves	xxxx
Add:	Estimated Future Expenditure (based on Current Costs) to be incurred in developing the Proved Oil and Gas Reserves	xxxx
Less:	Accumulated Depreciation	(xxxx)
Less:	Accumulated Impairment Charge ofthe Cost Centre.	(xxxx)
	Depreciation Base for the Cost Centre	**xxxx**

(b) **Proved Oil and Gas Reserves** is calculated as under–

	Developed and Undeveloped Oil and Gas Reserves estimated at the end of the period	xxxx
Add:	Production during the period	xxxx
	Proved Oil and Gas Reserves	**xxxx**

3. **Other Points relating to Depreciation:**

(a) If the Oil Reserves and Gas Reserves are contained, **a common unit of measure** is used to determine depreciation. Conversion Factor used is 1000 Cubic Meters of Gas = 1 Metric Tonne of Oil.

(b) Rates of depletion should be reviewed for revision once in every year. These revisions are accounted for **prospectively** as Changes in Accounting Estimates.

(c) **AS - 28** (Impairment of Assets) provisions should be applied at the end of every year. Each Cost Centre should be treated as a Cash Generating Unit.

7. Arguments for and against Successful Efforts Method (SEM).

Arguments in favour of SEM	Arguments against SEM
1. An asset is an economic resource expected to provide future benefits. SEM reflects this **normal concept of asset.** 2. Costs of unsuccessful efforts are charged to expense as they occur. This **prevents** the capitalisation of unsuccessful exploratory efforts & consequent **distortion of financial statements.** 3. SEM recognizes the **matching concept** thereby recognizing only those expenses in the P & L Statement that bear a direct association to the earning of specific items of income. 4. Income smoothing is greatly reduced. So, SEM realistically **reflects the management's successes or failures** in its efforts to find new oil and gas reserves.	1. Under SEM, the P&L Statement can give a **false impression of performance** in terms of success in finding new oil and gas reserves. 2. Charge-off of unsuccessful pre-production costs under SEM results in an understatement of assets and net income of a growing enterprise that has a successful and increasing exploration programme. 3. Success of projects usually cannot be measured till completion of exploration activities, taking many years. SEM leads to **pre-mature** assessment of success/failure. 4. All pre-production costs are incurred to find and develop whatever reserves result from pre-production activities, on an enterprise-wide basis SEM does not recognize this aspect and has a project-wise micro-view (than macro-view).

8. Arguments for and against Full Cost Method (FCM).

Arguments in favour of FCM	Arguments against FCM
1. All exploration projects will not result directly in addition of reserves. FCM **recognizes uncertainty** and reflects the way in which enterprises search for, acquire, and develop mineral resources. 2. Total Costs are depreciated on a pro-rata basis in relation to the total reserves in a large cost centre, rather than independently to reserves in many small cost centres. So, there is a **better matching** of income and expenses. 3. Costs of unsuccessful efforts are akin to normal recurring spoilage occurring in manufacturing operations and should be absorbed by good units manufactured. So, FCM operates like **absorption costing** for long-term inventories. 4. FCM **avoids annual 'distortions'** of income resulting from expensing the charges for unsuccessful pre-production activities are eliminated substantially, as compared to SEM.	1. Many Costs that fail to meet the general definition of 'asset' are **wrongly capitalized.** 2. Costs that do not result directly in future benefits should be immediately charged to revenue. FCM capitalizes these costs, thus deferring the effects of expenses. Thus, **recognition of loss is delayed.** 3. Costs of unsuccessful activities are treated in the same way as successful activities and are matched against future revenues from all of the enterprise's successful exploration and development activities. This **hampers the measurement** of the **efficiency and effectiveness** of the enterprise's exploration and development activities.

9. Accounting treatment of Abandonment Costs.

1. **Meaning:** Abandonment Costs are the costs incurred on discontinuation of all operations and surrendering the property back to the owner, e.g. plugging and abandoning of wells, dismantling of wellheads, production and transport facilities and to restoration of producing areas as per license/legal requirements.

2. **Accounting Treatment:**

   (a) The enterprise should capitalise the amount of provision required to be created for subsequent abandonment, at the beginning itself.

   (b) Provision for estimated abandonment costs should be made at current prices considering the environment and social obligations, terms of mining lease agreement, etc. Abandonment Costs should not be discounted to their present value.

3. **Recognition of Gain/Loss:**

   (a) Gain or Loss **should not be recognised** if only an individual well or individual item of equipment is abandoned as long as the remainder of the wells in the cost centre continue to produce oil or gas. Instead, the asset being abandoned be deemed to be fully depreciated.

   (b) Gain or loss **should be recognised** when the last well on the cost centre ceases to produce and the entire cost centre is abandoned.

10. Accounting treatment of – (1) Support Facility Costs and (2) Borrowing Costs.

Type of Cost	Accounting Treatment
Cost of acquiring or constructing support equipment and facilities used in E & P Activities	• Entire Cost should be capitalized as per AS - 10. • Depreciation/depletion should be calculated as per AS - 6 and accounted for as Exploration Cost, Development Cost or Production Cost, as appropriate.
Borrowing Costs	Should be **capitalized** as per AS - 16. For this purpose, all the costs that are classified under Capital WIP are considered as “Qualifying Asset”.

11. Disclosure requirements in the Financial Statements of E & P enterprise.

An E & P enterprise should disclose the following in its financial statements -

1. Method of accounting followed i.e. whether Full Cost Method of Successful Efforts Method.
2. Net Quantities of an enterprise’s interests in proved reserves and proved developed reserves of- (a) **Oil** (including condensate and natural gas liquids); and (b) **Gas.**

Note:

- Quantitative data should be given as at the beginning and additions, deductions, production and closing balance for the year, on Geographical Basis.
- Quantities should be stated in Metric Tonnes for Oil Reserves and Cubic Meters for Gas Reserves.

STUDY NOTE - 6

Government Accounting in India

This Study Note includes:

- General Principles of Government Accounting
- Comparison with Commercial Accounting
- Audit of Government Companies
- Public Accounts Committe

6.1 Government Accounting in India

The accounting of Government activities is specialised in nature. Government of India means the Central (union) government or state government or union territory government or all the three as the context may imply. The immediate objective of Government accounting is not to ascertain the gain or loss on the transactions of the Government as a whole in carrying out its activities. The activities of the Government are determined by the needs of the country. The main branches of its activities being known, it is a matter for decision what expenditure will be necessary during any year in carrying out these activities. After a decision has been reached on this point, it becomes necessary to determine how to raise sufficient money to meet that expenditure.

6.2 General Principles of Government Accounting

The general principles of Government Accounting are as follows:

1. The Government Expenditure are classified under Sectors, major heads, minor heads, sub-heads and detailed heads of account, the accounting is more elaborate that that followed in commercial accounts. The method of budgeting and accounting under the service heads is not designed to bring out the relation in which Government stands to its material assets in use, or its liabilities due to be discharged at more or less distant dates.
2. In its Budget for a year, Government is interested to forecast with the greatest possible accuracy what is expected to be received or paid during the year, and whether the former together with the balance of the past year is sufficient to cover the later. Similarly, in the compiled accounts for that year, it is concerned to see to what extent the forecast has been justified by the facts, and whether it has a surplus or deficit balance as a result of the year's transactions. On the basis of the budget and the accounts, Government determines (a) whether it will be justified in curtailing or expanding its activities (b) whether it can and should increase or decrease taxation accordingly.
3. In the field of Government accounting, the end products are the monthly accounts and the annual accounts. The monthly accounts serve the needs of the day-to-day administration, while the annual accounts present a fair and correct view of the financial stewardship of the Government during the year.

Basic Structure of the form of the accounts:

(1) Period of Accounts: The annual accounts of the central, state and union territory government shall record transactions, which take place during financial year running from 1st April to 31st March.

(2) Cash basis Accounts: With the exception of such book adjustments as may be authorized by these rules on the advice of the Comptroller and Auditor General of India (CAG). The transaction in government accounts shall represents the actual cash receipt and disbursement during a financial year.

Form of Accounts: There are mainly three parts i.e. consolidated fund, contingency fund and public account.

In consolidated fund there are two divisions i.e. revenue consisting of section for receipts heads and expenditure heads [Revenue Accounts] capital, public debts, loan consisting of section of receipts heads [capital accounts] where as contingency fund accounts shall be recorded to the transactions connected with the government set up under article 267 of the constitution and Public account transactions relating to the debt deposit, advances, remittances and suspense shall be recorded.

6.3 Methods of Government Accounting

The mass of the Government accounts being on cash basis is kept on Single Entry. There is, however, a portion of the accounts which is kept on the Double Entry System, the main purpose of which is to bring out by a more scientific method the balance of accounts in regard to which Government acts as banker or remitter, or borrower or lender. Such balances are, of course, worked out in the subsidiary accounts of single entry compilations as well but their accuracy can be guaranteed only by a periodical verification with the balance brought out in the double entry accounts.

Business and merchant accounting methods are different than government accounting system because government accounting system is ruling over the nation and keeps various departments i.e. production, service utility or entertainment industry etc. The operations of department of government some times include under talking of a commercial or quasi-commercial character and industrial factory or a store. It is still necessary that the financial results of the undertaking should be expressed in the normal commercial form so that the cost of the services or undertaking may be accurately known. In the government account there are few problems affected adversely. In the case of central and state government transaction communication procedure, bank accounts and uniformity are improper. In the paper it suggested Central and state government should adopt it fully computerized accounting system in routine procedure of all transactions and adopted accounting system should be familiar with global accounting standards. Improvement programs i.e. symposium, seminar is helpful for sustaining the accounting system. Graduate level accounting syllabus should be modified as per government accounting procedure and methods.

Business and merchant accounting methods are different than government accounting system because government accounting system is ruling over the nation and keeps various departments i.e. production, service utility or entertainment industry etc. government accounting system is wider than the any specific company accounts.

6.4 Comparison with commercial accounting

The principles of Commercial and Government Accounting differ in certain essential points. The difference is due to the fact that, while the main function of a commercial concern is to take part in the production, manufacture or inter-change of gods or commodities between different groups or individuals and thereby to make profit, Government is to govern a country and, in connection therewith, to administer the several departments of its activities in the best way possible.

Government Accounts are designed to enable Government to determine how little money it need take out of the pockets of the tax-payers in order to maintain its necessary activities at the proper standard of efficiency. Non-Government Commercial accounts, on the other hand, are meant to show how much money the concern can put into the pockets of the proprietors consistently with the maintenance of a profit-earning standard in the concern.

6.5 Comptroller and Auditor General of India

The organisations subject to the audit of the Comptroller and Auditor General of India are:

- All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.
- About 1200 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations.
- Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.

Over 4400 authorities and bodies substantially financed from Union or State revenues

6.6 Audit of Government Companies (Commercial Audit)

There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The primary auditors of these companies are Chartered Accountants, appointed by the Union Government on the advice of the Comptroller and Auditor General, who gives the auditors directions on the manner in which the audit should be conducted by them. He is also empowered to comment upon the audit reports of the primary auditors. In addition, he conducts a supplementary audit of such companies and reports the results of his audit to Parliament and State Legislatures.

6.7 Audit Board Setup in Commercial Audit

A unique feature of the audit conducted by the Indian Audit and Accounts Department is the constitution of Audit Boards for conducting comprehensive audit appraisals of the working of Public Sector Enterprises engaged in diverse sectors of the economy.

These Audit Boards associate with them experts in disciplines relevant to the appraisals. They discuss their findings and conclusions with the managements of the enterprises and their controlling ministries and departments of government to ascertain their view points before finalisation.

The results of such comprehensive appraisals are incorporated by the Comptroller and Auditor General in his reports

Nature of Audit

While fulfilling his Constitutional obligations, the Comptroller and Auditor General examines various aspects of Government expenditure. The audit done by CAG is broadly classified into Regularity Audit and Performance Audit.

Performance Audit

Performance audit to see that Government programmes have achieved the desired objectives at lowest cost and given the intended benefits.

Regularity Audit (Financial)

In regularity (financial) audit and in other types of audit when applicable, auditors should analyse the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial statements.

Action on Audit Reports

The scrutiny of the Annual Accounts and the Audit Reports thereon by the Parliament as a whole would be an arduous task, considering their diverse and specialised nature, besides imposing excessive demands on the limited time available to the Parliament for discussion of issues of national importance. Therefore the Parliament and the State Legislatures have, for this purpose, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU), to which these audit Reports and Annual Accounts automatically stand referred.

CAG's Role

Under section 10 of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 (56 of 1971), the Comptroller and Auditor General shall be responsible-

(a) for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such accounts; and

(b) for keeping such accounts in relation to any of the matters specified in clause (a) as may be necessary;

Provided that the President may, after consultation with the Comptroller and Auditor General, by order, relieve him from the responsibility for compiling-

(i) the said accounts of the Union (either at once or gradually by the issue of several orders); or

(ii) the accounts of any particular services or departments of the Union;

Provided further that the Governor of a State with the previous approval of the President and after consultation with Comptroller and Auditor General, by order, relieve him from the responsibility for compiling-

(i) the said accounts of the State (either at once or gradually by the issue of several orders); or

(ii) the accounts of any particular services or departments of the State;

Provided also that the President may, after consultation with the Comptroller and Auditor General, by order, relieve him from the responsibility for keeping the accounts of any particular class or character.

(2) Where, under any arrangement, a person other than the Comptroller and Auditor General has, before the commencement of this Act, been responsible-

(i) for compiling the accounts of any particular service or department of the Union or of a State, or

(ii) for keeping the accounts of any particular class or character, such arrangement shall, notwithstanding anything contained in subsection (1), continue to be in force unless, after consultation with the Comptroller and Auditor General, it is revoked in the case referred to in clause (i), by an order of the President or the Governor of the State, as the case may be, and in the case referred to in clause (ii) by an order of the President.

Section 11—Comptroller and Auditor General to prepare and submit accounts to the President, Governors of State and Administrators of Union Territories having Legislative Assemblies

The Comptroller and Auditor General shall, from the accounts compiled by him or by the Government or any other person responsible in that behalf prepare in each year accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrators of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates, as he may, with the concurrence of the Government concerned, determine:

Provided that the President may, after consultation with the Comptroller and Auditor General, by order, relieve him from the responsibility for the preparation and submission of the accounts relating to annual receipts and disbursements for the purpose of the Union or of a Union Territory having a Legislative Assembly:

Provided further that the Governor of a State may, with the previous approval of the President and after consultation with the Comptroller and Auditor General, by order relieve him from the responsibility for the preparation and submission of the accounts relating to annual receipts and disbursements for the purpose of the State.

The Comptroller and Auditor General of India play a key role in the functioning of the financial committees of Parliament and the State Legislatures. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness submit to the Committees and helps the Committees to check the correctness of facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations. The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature.

In respect of those cases in Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

6.8 Public Accounts Committee

Composition

The Committee on Public Accounts is constituted by Parliament each year for examination of accounts showing the appropriation of sums granted by Parliament for expenditure of Government of India, the annual Finance Accounts of Government of India, and such other Accounts laid before Parliament as the Committee may deem fit such as accounts of autonomous and semi-autonomous bodies (except those of Public Undertakings and Government Companies which come under the purview of the Committee on Public Undertakings).

The constitution and working of the Public Accounts Committee is governed by Rules 253 to 286 and 308 to 309 of the Rules of Procedure and Conduct of Business in Lok Sabha and Directions 48 to 73, 96A, 97, 97A, 99 and 100 of the Directions by the Speaker, Lok Sabha.

Constitution of the Committee

The Committee consists of not more than 22 members comprising 15 members elected by Lok Sabha every year from amongst its members according to the principle of proportional representation by means of single transferable vote and not more than 7 members of Rajya Sabha elected by that House in like manner are associated with the Committee. The Chairman is appointed by the Speaker from amongst its members of Lok Sabha. The Speaker, for the first time, appointed a member of the Opposition as the Chairman of the Committee for 1967-68. This practice has been continued since then. A Minister is not eligible to be elected as a member of the Committee. If a member after his election to the Committee is appointed a Minister, he ceases to be a member of the Committee from the date of such appointment. The Public Accounts Committee consists of fifteen Members elected by Lok Sabha every year from amongst its members according to the principle of proportional representation by means of single transferable vote. Seven members of Rajya Sabha elected by that House in like manner are associated with the Committee. This system of election ensures that each Party/Group is represented on the Committee in proportion to its respective strength in the two Houses.

Change in set-up

From its inception in the year 1921 till early 1950, the Finance-member was appointed as the Chairman of the Committee and its Secretarial functions were looked after by the Finance Department (later Ministry of Finance). With the coming into force of the Constitution of India on 26th January, 1950, the Committee became a Parliamentary

Committee under the control of Speaker. Its Secretarial functions were transferred to the Parliament Secretariat (now Lok Sabha Secretariat).

Functions of the Committee

The Examination of the Appropriation Accounts relating to the Railways, Defence Services, P&T Department and other Civil Ministries of the Government of India and Reports of the Comptroller and Auditor-General of India thereon as also the Reports of the Comptroller and Auditor-General on Revenue Receipts mainly form the basis of the deliberation of the Committee.

One of the duties of the Committee is to ascertain that money granted by Parliament has been spent by Government within the scope of the demand. It considers the justification for spending more or less than the amount originally sanctioned. If any money has been spent on a service in excess of the amount granted by the House for the purpose, the Committee examines with reference to the facts of each case, the circumstances leading to such an excess and makes such recommendations as it may deem fit.

The functions of the Committee extend however, "beyond, the formality of expenditure to its wisdom, faithfulness and economy". The Committee thus examines cases involving losses, nugatory expenditure and financial irregularities.

While scrutinising the Reports of the Comptroller and Auditor-General on Revenue Receipts, the Committee examines various aspects of Government's tax administration. The Committee, thus examines cases involving under-assessments, tax-evasion, non-levy of duties, misclassifications etc., identifies the loopholes in the taxation laws and procedures and makes recommendations in order to check leakage of revenue.

Working of the Committee

The representatives of the Ministries appear before the Committee when examining the Accounts and Audit Reports relating to their Ministries. The Committee proceeds by way of interrogation of witnesses. The Comptroller and Auditor General is the "friend, philosopher and guide" of the Committee. He attends the sittings of the Committee and assists it in its deliberations.

The Committee may appoint one or more Sub-Committees/ Sub Groups to examine any particular matter. At the beginning of its term, the Committee appoints a few Working Groups/Sub Committees to facilitate the examination of the various Accounts and Audit Reports and Sub-Committee to consider the action taken by the Government on the recommendations made by the Committee in its earlier Reports. If it appears to the Committee that it is necessary for the purpose of its examination that an on the- spot study should be made, the Committee may, either in its entirety or by dividing itself into Study Groups decide to undertake tours to make an on-the-spot study of any project or establishment. All discussions held during tour by the Committee/Study Groups, with the representatives of the establishment, Ministries/ Departments, non-official organisations, Labour Unions etc. are treated as confidential and no one having access to the discussion, directly or indirectly is to communicate to the Press or any unauthorized person, any information about matters taken up during the discussions.

Report and Minutes

The conclusions of the Committee on a subject are contained in its Report, which, after its adoption by the Committee, is presented by the Chairman to the Lok Sabha. Minutes of the sittings of the Committee form Part II of the Report. A copy of the Report is also laid on the Table of Rajya Sabha. Generally, the Reports of the Committee are adopted by consensus among members. Accordingly, there is no system of appending minute of dissent to the Report.

Action Taken on Reports

After presentation to the Lok Sabha, the Report is forwarded to the Ministry or Department concerned which is required to take action on the recommendations and conclusions contained in the Report and furnish action taken replies thereon within six months.

Action taken notes received from the Ministries/ Departments are examined by the Action Taken Sub-Committee and Action Taken Reports of the Committee are presented to the House. A copy of the Report is also laid on the Table of Rajya Sabha.

Statements of action taken on Action Taken Reports

Replies received from Government in respect of recommendations contained in the Action Taken Reports are also laid on the Table of Lok Sabha/Rajya Sabha in the form of Statements. Government take action on the recommendations of the Committee and submit action taken notes to the Committee.

The Committee then present an Action Taken Report after considering the views of the Government. The Government further submit an "Action Taken Statement" on the action taken by the Government on the "Action Taken Report" of the Committee. The Action Taken Statement is generally laid before the House without any further examination by the Committee. Normally, almost all the recommendations of the Committee are implemented by the Government.

Process of Election

In April each year a motion is moved in Lok Sabha by the Minister of Parliamentary Affairs or Chairman of the Committee, if in office, calling upon members of the House to elect from amongst themselves 15 members to the Public Accounts Committee. After the motion is adopted, a programme, fixing the dates for filing the nominations/withdrawal of candidatures and the election, if necessary, is notified in Lok Sabha Bulletin Part-II. On receipt of nominations, a list of persons who have filed nomination papers is put up on the Notice Boards. In case the number of members nominated is equal to the number of members to be elected, then, after expiry of time for withdrawal of candidatures, the members nominated are declared elected and the result published in Bulletin Part-II. If the number of members nominated after withdrawals is more than number of members to be elected, election is held on the stipulated date and result of election published in Bulletin Part-II.

Association of Members of Rajya Sabha

Another motion is moved in Lok Sabha recommending to Rajya Sabha to nominate seven members of that House for being associated with the Committee. After adoption, the motion is transmitted to Rajya Sabha through a Message. Rajya Sabha holds election of members to the Committee and the names of members elected are communicated to Lok Sabha.

Appointment of Chairman

The Chairman of the Committee is appointed by the Speaker from amongst the members of Lok Sabha elected to the Committee.

As a convention, starting from the Public Accounts Committee of 1967-68, a member of the Committee belonging to the main opposition party/group in the House is appointed as the Chairman of the Committee.

Minister not to be Member of Committee

A Minister is not eligible to be elected as a member of the Committee and if a member, after his election to the Committee, is appointed as a Minister, he ceases to be a member of the Committee from the date of such appointment.

Term of Office

The term of office of the members of the Committee is one year.

Association of Members with Government Committees

A member, on his election to the Committee, has to communicate to the office of the Committee, the particulars regarding the various Committees appointed by Government with which he is associated, for being placed before the Speaker. Where the Speaker considers it inappropriate that a member should continue to serve on the Government Committee, the member is required to resign membership of the Committee constituted by Government. Where the Speaker permits a member to continue to hold membership of Government Committee, he may require that the report of the Government Committee shall be placed before the Committee on Public Accounts for such comments as the latter Committee may deem fit to make, before it is presented to Government. Whenever the Chairman or any member of the Committee on Public Accounts is invited to accept membership of any Committee constituted by Government, the matter **is likewise** to be placed before the Speaker before the appointment is accepted.

Functions of the Committee

The Public Accounts Committee examines the accounts showing the appropriation of the sums granted by Parliament to meet the expenditure of the Government of India, the Annual Finance Accounts of the Government of India and such other accounts laid before the House as the Committee may think fit. Apart from the Reports of the Comptroller and Auditor General of India on Appropriation Accounts of the Union Government, the Committee also examines the various Audit Reports of the Comptroller and Auditor General on revenue receipts, expenditure by various Ministries/ Departments of Government and accounts of autonomous bodies. The Committee, however, does not examine the accounts relating to such public undertakings as are allotted to the Committee on Public Undertakings.

While scrutinising the Reports of Comptroller and Auditor General on Revenue Receipts, the Committee examines various aspects of Government's tax administration. The Committee, thus, examines cases involving under-assessments, tax-evasion, non-levy of duties, mis-classifications etc., identifies loopholes in the taxation laws and procedures and make recommendations in order to check leakage of revenue.

Regularisation of Excess Expenditure

If any money has been spent on a service in excess of the amount granted by the House for the purpose, the Committee examines the same with reference to the facts of each case, the circumstances leading to such an excess and make such recommendations as it may deem fit. Such excesses are thereafter required to be brought up before the House by Government for regularisation in the manner envisaged in article 115 of the Constitution. In order to facilitate speedy regularisation of such expenditure by Parliament, the Committee presents a consolidated report relating to all Ministries/Departments expeditiously in advance of other reports.

Selection of Subject for Examination

As the work of the Committee is normally confined to the various matters referred to in the Audit Reports, and Appropriation Accounts, its work normally starts after the Reports of the Comptroller and Auditor General on the accounts of the Government are laid on the Table of the House. As soon as the Committee for a year is constituted, it selects paragraphs from those reports of the Comptroller and Auditor General were presented by for examination during its term of office.

Assistance by Comptroller and Auditor General

The Committee is assisted by the Comptroller and Auditor General in the examination of Accounts and Audit Reports.

Constitution of Working Groups/Sub-Committees

A number of Working Groups/Sub-Committees are constituted by the Chairman from amongst the members of the Committee for detailed examination of the subjects selected by the Committee and for considering procedural matters. A Sub-Committee is also constituted for scrutiny of action taken by Government on the recommendations contained in the previous reports of the Committee.

Calling for Information from Government

The Committee calls for, in the first instance, advance information from the Ministries/Departments in regard to subjects selected by it for examination.

Study Tours

The Committee undertakes on the spot study tours/visits of various Departments/Establishments connected with the subjects taken up for examination.

For the purpose, members of the Committee are divided into study groups. Each study tour is undertaken with the specific approval of the Speaker.

Evidence of Officials

The Committee later takes oral evidence of the representatives of the Ministries/Departments concerned with the subjects under examination.

Ministers not called before Committee

A Minister is not called before the Committee either to give evidence or for consultation in connection with the examination of Accounts by the Committee. The Chairman of the Committee may, however, when considered necessary but after its deliberations are concluded, have an informal talk with the Minister concerned to apprise him of (a) any matters of policy laid down by the Ministry with which the Committee does not fully agree; and (b) any matters of secret and confidential nature which the Committee would not like to bring on record in its report.

6.9 Role of Public Accounts Committee

The role of the Public Accounts Committee is to assess the integrity, economy, efficiency and effectiveness of government financial management. It achieves this by:

- examining Government financial documents; and
- considering the reports of the Auditor - General.

A significant amount of the committee's work involves following up matters raised in the reports to Parliament by the Auditor - General. This ensures that public sector financial issues are scrutinised for the benefit of the Parliament and the public.

While scrutinising the Appropriation Accounts of the Government of India and the Reports of the Comptroller and Auditor General thereon, it is the duty of the Committee to satisfy itself—

- that the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged;
- that the expenditure conforms to the authority which governs it; and
- that every re-appropriation has been made in accordance with the provisions made in this behalf under rules framed by competent authority.

An important function of the Committee is to ascertain that money granted by Parliament has been spent by Government "within the scope of the demand". The functions of the Committee extend "beyond the formality of expenditure to its wisdom, faithfulness and economy". The Committee thus examines cases involving losses, nugatory expenditure and financial irregularities.

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament.

6.10 Committee on Public Undertakings

The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are:-

a. to examine the reports and accounts of public undertakings.

b. to examine the reports of the Comptroller & Auditor General on public undertakings.

c. to examine the efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination,including evaluation of the policies, programmes and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

Review of accounts

The accounts of Government Companies set up under the provisions of the Companies Act (including Government Insurance Companies and deemed Government Companies) are audited by the Comptroller and Auditor General of India (CAG) under the provisions of Section 619 of the Companies Act. Under these provisions, the CAG (i) shall appoint statutory auditor of a Government company, (ii) may conduct supplementary or test audit of accounts of a Government Company, and (iii) may comment upon the report of the statutory auditor. In addition he issues directions to the statutory auditors regarding the manner in which the accounts of a Government Company are to be audited.

The accounts certified by the Statutory Auditors (Chartered Accountants) appointed by the Central Government on the advice of the CAG under the Companies Act, 1956 are subjected to supplementary or test audit by officers of the CAG and CAG gives his comments or supplements the report of the Statutory Auditors. The Companies Act, 1956 empowers the CAG to issue directions to the Statutory Auditors on the manner in which the Company's accounts shall be audited.

Audit Reports

Reports in relation to the accounts of a Government Company or Corporation are submitted to the Government by the CAG under the provisions of Section 19-A of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 as amended in 1984. Every year, the CAG present Audit Reports to the Parliament containing his observations on the accounts and transactions of Government companies and corporations as detailed below:

Report No.1 (Commercial) - Review of Accounts and financial results gives an overall appreciation of the performance of the Companies and Corporations as revealed by their accounts and information obtained in audit. This report has been prepared without taking into account the comments under Section 619(4) of the Companies Act, 1956 and the qualifications contained in the Statutory Auditors' Report.

Report No. 2 (Commercial) - Comments on Accounts' gives a resume of the important comments of the CAG on the accounts of the Companies and Corporations and the reports submitted by the Statutory

Auditors (Chartered Accountants) on the audit of the Companies in pursuance of the directions issued by the CAG.

'Report No. 3 (Commercial) - Audit Observations' contains the results of supplementary audit and observations on individual topics of interest noticed in the course of audit of the Companies and Corporations and short reviews on aspects of their working.

The statutes governing some corporations and authorities require their accounts to be audited by the CAG and reports given by him. In respect of Airports Authority of India, National Highways Authority of India, Inland Waterways Authority of India and Damodar Valley Corporation, the CAG is the sole auditor under the relevant statutes. In respect of Central Warehousing Corporation and Food Corporation of India, the CAG has the right to conduct audit independently of the audit conducted by the Chartered Accountants appointed under the statutes governing the two Corporations.

Audit Boards are set up under the supervision and control of the CAG to undertake comprehensive appraisals of the performance of the Companies and Corporations subject to audit by CAG. Each Audit Board consists of the Chairman (Deputy Comptroller and Auditor General), two or three whole-time members of the rank of Principal Directors of Audit under CAG and two technical or other experts in the area of performance of the Company or Corporation, who are part-time members. The part-time members are appointed by the Government of India (in the respective Ministry or Department controlling the Company or Corporation) with the concurrence of the CAG. The reports of the CAG based on such performance appraisals by the Audit Board and other reviews are issued to the Government as separate reports in addition to the annual reports.

Provision exists in the Acts governing Reserve Bank of India, Export-Import Bank of India, Industrial Reconstruction Bank of India, National Bank for Agricultural and Rural Development and National Housing Bank for the Central Government to appoint CAG, at any time, to examine and report upon their accounts.

6.11 Specimen Report

REVIEW OF ACCOUNTS OF – FOR THE YEAR ENDED 31ST MARCH 2008 BY THE COMPTROLLER AND AUDITOR GENERAL OF INDIA

Note : This Review of Accounts has been prepared without taking into account the comments under Section 619 (4) of the Companies Act, 1956 and qualifications contained in the Statutory Auditors' Report.

1. FINANCIAL POSITION

The table below summarises the financial position of the Company under broad heading for the last three years

(Rs. in lakh)

	2005-06	2006-07	2007-08
Liabilities			
(a) Paid-up capital			
(i) Government			
(ii) Deposits awaiting allotment of shares			
(b) Reserves and surplus			
(i) Free reserves and surplus			
(ii) Share premium account			
(iii) Capital reserves			
(c) Borrowings			
(i) From Government of India			
(ii) From Financial institutions			
(iii) Foreign currency loans			
(iv) Cash credit			
(v) Others			
(vi) Interest accrued and due			
(d) (i) Current liabilities and provisions			
(ii) Provision for gratuity			
Total			
Assets			
(e) Gross block			
(f) Less : Depreciation			
(g) Net block			
(h) Capital work-in progress			
(i) Investments			
(j) Current assets, loans and advances			
(k) Miscellaneous expenditure not written off			
Total			
(m) Working capital (j-d(i)-c(vi))			
(n) Capital employed (g+m)			
(o) Net worth (a+b(i)+b(ii)-k)			
(p) Net worth per Rupee of Paid-up capital (in Rs.)			

2. SOURCES AND UTILISATION OF FUNDS

Funds amounting to Rs. – lakh from internal and external sources were realised and utilised during the year as follows :-

		(Rs. in lakh)
Sources of funds		
a)	Depreciation	
b)	Increase in borrowed funds	
c)	Decrease in working capital	
Utilisation of funds		
a)	Loss for the year	
b)	Increase in Fixed assets	
c)	Increase in Misc. Exp. not written of	
d)	Increase in capital work in progress	

3. WORKING RESULTS

The working results of the Company for the last three years ending 31st March 2008 are given below:

(Rs. in lakh)

Particulars	**2005-06**	**2006-07**	**2007-08**
i) Sales			
ii) Less : Excise duty			
iii) Net Sales			
iv) Other or Misc. Income			
v) Profit/Loss before tax and prior period adjustments			
vi) Prior period adjustments			
vii) Profit/Loss before tax			
viii) Tax Provisions			
ix) Profit after Tax			
x) Proposed Dividend			

4. RATIO ANALYSIS

Some important ratios on the financial health and working of the Company at the end of last three years ending 31st March 2008 are as follows.

	2005-06	**2006-07**	**2007-08**
A. Liquidity Ratio			
Current ratio			
Current assets, loans and advances to Current liabilities and provision and interest accrued and due)			
B. Debit-Equity Ratio			
Long term debt to Net worth C(i)+C(v)/O			
C. Profitability Ratios			
a) Profit before tax to	(In percentage)		
i) Capital employed			
ii) Net worth			
iii) Sales			
b) Profit after tax to Equity			
c) Earning per share (in Rs.)			

5. INVENTORY LEVELS

The inventory levels at the close of the last three years ending 31st March, 2008 are as under :

(Rs. in lakh)

Particulars		**2005-06**	**2006-07**	**2007-08**
(a)	Raw materials			
(b)	Stores and spares			
(c)	Finished goods			
(d)	Others			
	Total			

The stock of finished goods represented -- days' sales each in and and 2 days sales in

6. SUNDRY DEBTORS

The following table indicates the volume of Sundry Debtors and sales for the last three years :

(Rs. in lakh)

As on 31st March	**Sundry debtors**			**Sales (including Excise Duty) during the year**	**% age of Sundry Debtors to Sales**
	Considered good	**Considered doubtful**	**Total**		
2006					
2007					
2008					

The Sundry Debtors as on 31st March, 2008 were outstanding for the period indicated below :-

(Rs. in Lakh)

Debt Outstanding	**Govt. Department**	**Private Parties**	**Total**
i) Upto one year			
ii) More than one year but less than 2 year			
iii) 2 years or more but less then 3 years			
iv) 3 years or more			
Total			

Principal Director of Commercial Audit & Ex-officio Member, Audit Board